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How to Reduce Your Taxes Next Year (Part 2)

Before continuing from where I left off, let me recap what I shared in my previous article. To reduce your tax liability next year, you should:

1. Pay no more than you should
2. Max out your 401s
3. Sell off loss making shares

Here are a few more things you can do:

4. Write off the biggest tax breaks

In most cases, you can choose between writing off your state income tax or sales tax by itemizing your deductions. Choose the deductions that would likely give you the biggest tax break (which in most cases would be your income tax). If you live in a state with no income tax, or if you bought a large asset like a car or a boat, then you should write off your sales tax. Unless Congress acts this year or next, the ability to write off sales taxes will be gone after 2011.

5. Make charitable donations

You can claim tax deductions by making charitable donations if you itemize them. If you make donations in kind, you need to value them first. The charity you donate your items to will list the value of your items in Form 1098-C which you have to attach to your tax return.

If you make cash donations, keep your check buds or credit card statements as proof. If you contribute \$250 or more, you'll also need an acknowledgment from the charity.

6. Make significant charitable donations

If you are in a position to donate large amounts to charity, consider donating your profitable stocks and mutual funds that you have owned for more than a year. The amount deductible from your taxes is the fair market value of your shares at the time of donation, not at the time of purchase. This means you do not have to pay taxes on the capital appreciation of the shares.

7. Make energy-efficient home improvements

You can claim deductions to your taxes if you make energy efficient improvements to your principal home. The amount you can claim is 10% of the cost of new windows, doors, skylights, insulation, and heating and air conditioning systems, up to a maximum \$500 credit. The amount claimable for new windows is limited to \$200.

If you install alternative energy equipment such as geothermal pumps, solar energy panels and wind turbines, you can claim even more. The amount claimable is 30% of costs including installation without limit. This tax credit is valid until 2016.

8. Avoid buying mutual funds before the ex-dividend date

Mutual funds declare dividends to their investors on a certain day known as the ex-dividend date. If you intend to buy into mutual funds before the ex-dividend date just to earn the dividends, bear in mind that such dividends are taxable income. Furthermore, the value of the shares in the fund falls by the exact amount of dividends declared, meaning the fund is refunding you part of the purchase price you paid.

But the IRS is not concerned with the value of the fund. The agency sees your dividend as taxable income regardless of whether the value of your shares in the fund falls or not. So it would be wiser to buy mutual funds after and not before the ex-dividend date. Check up the mutual fund's website to find out the ex-dividend date.

I'll be sharing more tips on how to reduce next year's taxes in part 3 of this article.