Client advisor

CURRENT INFORMATION, NEWS AND TRENDS

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Missing Information? It Could Cost You!

It's more than halfway through the tax year and a good time for some tax planning and preparation.

Did we file your 2004 tax returns without a hitch or did you receive some correspondence from the IRS? Since tax season is such a hectic time, there is plenty of opportunity for you to overlook possible deductions. We try to make everything on our end go smoothly; however, you share the responsibility of making sure that you do not overpay your taxes.

When it is time to prepare the return, taxpayers often overlook the following important items:

Change in Status – If you got married, divorced, set up separate living arrangements, or began caring for someone in your home, please let us know. Some tax implications and other issues come into play that can affect your filing status. For example, alimony that is paid is deductible, while the alimony that is received is taxable. There are specific rules about what qualifies as alimony for tax purposes, so we need to review each newly divorced or separated taxpayer's situation to determine if the payment is truly alimony.

Medical Expenses – Even though you might think that you didn't incur enough medical expenses to itemize them, let us know about any large medical expenditures.

New Dependents – If you gained or lost a dependent, you must let us know. Having a baby, adopting a child, sending a child off to college or taking care of an elderly relative can all affect your taxes.

Vehicle Registration – Provide the amount of fees that you paid annually for each vehicle that you own. Keep in mind that if your state, county or other locality charges a fee based on something else other than the value of your vehicle, that portion is not deductible. This information is usually detailed on the renewal notice you receive from the governmental agency issuing the registration.

Loan Refinancing – If you refinanced a loan for home improvements, remodeling or repairs, any points, interest or property tax adjustments may be deductible. Provide us with the settlement statement from the refinance transaction so we can advise you of any deductions that may apply to you.

Non-Cash Contributions – Try to document any non-cash donations such as clothing, furniture and appliances that you make to Goodwill, Salvation Army, and other nonprofit organizations. These donations could add up to a large deduction. However, if you don't hold on to your receipts and documentation, you may be limited in the amount you can deduct, if any. New rules apply for auto donations, so be sure to confer with us before you donate a vehicle to a charity.

Unemployment Income – You may have been out of work during the year, which slips your mind by the time tax season rolls around. It is important for you to share this with us during your appointment. The state will issue you (and the IRS) a Form 1099-G showing the total you received in unemployment compensation; bring this form to the interview.

Stock Sales – Don't forget about those stock sales that you made early in the year. You can easily overlook them when doing your returns. Although you might forget about

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Is “Bunching” Right for You?

Are you one of those taxpayers whose itemized deductions are always just a little less or a little more than the standard deduction? If you are, think about using a tax technique known as “bunching.”

“Bunching” is a technique where a taxpayer takes the standard deduction one year and then itemizes in another. This is accomplished by planning when to pay deductible expenses so as to maximize them in the year the deductions are itemized. Deductible expenses that are commonly “bunched” are medical expenses, taxes and charitable contributions.

To clearly illustrate how “bunching” works, here are a few situations where you generally have flexibility in making a deductible payment:

- You can pay your child’s orthodontist bill all at once or pay in installments.
- You can make your property tax payments in two or more installments, or you can pay the entire amount in advance.
- If you have state income tax and make estimated tax installment payments, the 4th quarter estimate can be paid in December or January.
- Charitable contributions are deductible in the year paid. Therefore, you can plan your house of worship or other contributions in order to maximize them in one year and minimize them in another.

To find out if you would benefit from using this technique, please call our office for an appointment.

Inheritances Can Be Tricky

If you have received an inheritance or anticipate receiving one in the future, this article may answer many of your questions. The process of claiming an inheritance can be quite complex, and it helps to understand the basics and be aware of potential tax liabilities.

An inheritance is generally received after all applicable taxes have been paid along with any outstanding liabilities the decedent may have had. Exactly how the estate is handled will depend upon whether the assets were owned individually or in a trust. Without going into the intricacies of estates, trusts and probate, the result for a beneficiary will generally be the same. Inherited items on which the decedent had already paid taxes and which the estate tax (if any) has been paid will pass to the beneficiary tax-free. On the other hand, items of income that had not previously been taxed to the beneficiary and any appreciation or depreciation of assets acquired from the decedent will have tax implications. Some possible scenarios are provided below:

Bank Account – Take for instance, an inherited bank account worth $25,000, where the funds are not immediately distributed to the heir. The $25,000 account earns $375 of interest income after the decedent’s date of death. Out of the $25,375 that is received, the $25,000 is tax-free but the $375 is taxable as interest income.

Capital Asset –The basis for gain or loss from the sale of an inherited capital asset, such as stock, real estate, collectibles, etc., is generally based on the value of the asset at the time of the decedent’s death. That is one reason that qualified appraisals are so important.

To explain this further, let’s assume that a vacant parcel of land is inherited with a date of death appraisal that values it at $15,000. If that property is sold for a net price of $15,000, there is neither gain nor loss and the $15,000 is tax-free to the beneficiary. If, on the other hand, the net sales price is more or less than the $15,000, there would be a reportable capital gain or loss. For capital gains tax purposes, the holding period is important. Assets held over one year are generally taxed at substantially less than those held for a shorter period of time. However, for inherited property, the beneficiary receives long-term treatment immediately, whether or not the decedent or the beneficiary had held it over one year. If there are expenses associated with selling the asset, then those expenses are deductible in figuring the gain or loss.

IRA or other Qualified Plan – Suppose the decedent had a traditional IRA account and the distributions from that account were taxable to the decedent. If you inherit that account, the distributions will be taxable to you as the beneficiary. Why is that? Because the decedent had never paid taxes on the income that went to fund the traditional IRA and therefore you, the beneficiary, will be stuck with the tax liability. The good news is that there are options for taking the income over a number of years which can soften the tax blow.

Life Insurance Proceeds – Generally, the proceeds from a life insurance policy are tax-free to the heirs. However, if the policy is not paid immediately, as most are not, the insurance company will include interest. That interest is taxable to the heirs.

Annuities and Installment Sale Notes – If the decedent purchased an annuity or had an installment sale note from the property he previously sold, the decedent’s basis will be tax-free, but the heirs will be obligated to pay tax on any amount received in excess of the decedent’s basis. For an annuity, the decedent’s basis would be what he paid for it. For an installment note, payments include: **(1)** a return of a portion of the asset’s cost (basis) which is not taxable, **(2)** a portion from the prior sale of the asset which is taxable as a capital gain, and **(3)** taxable interest on the note.

A trust or estate is required to file an income tax return and to report income earned by the estate or trust after the decedent’s passing and before the assets are distributed to the heirs. Each heir will generally receive a form called Schedule K-1(1041). It will include that heir’s share of income and must be included on the heir’s individual tax return. Although infrequent because the taxes are generally higher, the trust or estate may pay the income tax on the income. The executor or trustee is responsible for making sure the required tax returns are filed and for sending K-1s to the heirs.

There may be taxable income to the heir even though the inheritance has not yet been received. In addition, there are other factors to consider that have not been discussed. Therefore, during your tax appointment, it is important to let us know if you are expecting an inheritance.

Missing Information? It Could Cost You!... cont'd

them, the IRS won't - the brokerage firms are required to report the transaction to them. To calculate your gain or loss on these sales, we will need to know the cost basis of the shares you sold. This may entail some research on your part, but without the cost information you would have to pay tax on the full sales price. Also be sure to let us know about any stock options you exercised during the year.

Pension or IRA Withdrawals – An amount taken out of these accounts that isn't rolled into another retirement plan is usually taxable and penalties could possibly be incurred. Don't forget that you made these withdrawals! Call them to our attention even if you rolled them over into another retirement account.

Address Change – If you moved during the year, provide your new address. Correspondence from the IRS may get lost, and if there are due dates and penalties involved, you could pay dearly.

The information you provide to us, or fail to give us, could greatly affect the accuracy and outcome of your return. Being as thorough as possible will help reduce or eliminate any potential IRS inquiries. Best of all, it may even lower your taxes. Review this list and gather the information for your 2005 tax appointment. The differences may be enough to significantly reduce your tax burden.

Will Higher Mortgage Rates Put You At Risk?

Over the past few years, a large percentage of homeowners have refinanced to take advantage of historically low interest rates. Mortgages are generally available in two basic types: fixed and variable. If your mortgage is fixed, then your house payment will remain the same until you pay off the mortgage or refinance the loan. Many of the variable loan types have a period of time – often one, three or five years – for which the payments also remain fixed, based on attractive advertised rates. However, they still are variable rate loans and you should carefully consider what happens when they adjust. Another unknown is where will interest rates go in the future. Will you be financially able to service a larger payment?

If interest rates do go up, will it cause the housing market sales to slump and will that slump translate into declining home values? If that is the case and you anticipated refinancing that short-term or variable loan, will a decline in value have an adverse effect on your ability to refinance? Generally, the more attractive lower interest rate loan packages will lend 80% of the appraised value of the home. Will a decline in home value reduce your equity to the point that you would no longer qualify for a reasonably priced loan? This can become a serious problem for some, while for others, it simply becomes a financial inconvenience.

Use the following table to determine the increase in payments when moving from one interest rate to another.

		New Interest Rate				
		4.0	5.0	6.0	7.0	8.0
Old Interest Rate	3.0	13.24	27.33	42.21	57.80	74.04
	4.0		12.44	25.58	39.36	53.69
	5.0			11.69	23.93	36.69
	6.0				10.97	22.39
	7.0					10.29

Example: Your current interest rate is 5%, but the variable mortgage or the refinanced mortgage will increase to 6%. Your current payment is $1,200 per month. First find the current interest rate (5%) in the left hand column and read across to the column labeled 6%. The result is 11.69, which is the percentage increase in payment between a 5% and a 6% interest rate increase. The current payment is $1,200, so the increase would be 11.69% of $1,200 or $140.28 per month.

For some individuals, a variable rate may be the only way to own a home. With the rising cost of home ownership, the options are limited for middle-to low-income earners. Before locking in at a lower interest rate, make sure you can meet your loan obligation just in case the rates start to climb.

How Does Your Income Compare?

Ever wonder how your income stands up against everyone else filing U.S. tax returns? The following table was derived from the IRS Statistics of Income based on taxpayers' reported adjusted gross income (AGI) for the year 2002 (the most recent statistical data available from the IRS).

AGI represents a taxpayer's total income after adjustments allowed for such items as moving deductions, foreign income exclusions, the self-employed medical insurance deduction, the educational interest deduction and certain other "above-the-line" deductions. You can find your AGI at the bottom of page 1 of your completed Form 1040 for each year. The table allows you to determine the percentage of taxpayers in your AGI bracket (Column A) and compare your standing in comparison to all other taxpayers (Column B).

For example, assume your AGI is $50,000. You would fall into a group comprised of 13.38% of all taxpayers. More importantly, your income is in a group representing the top 28.81%. To put it another way, you make as much or more than 71.19% (100% - 28.81%) of all the taxpayers filing tax returns.

2002 IRS Statistics of Income

Income (AGI)		(A) Percent	(B) Top percent
Amount	To under	in this group	of all taxpayers
Negative	5000	10.48	100.00
5,000	10,000	9.60	89.52
10,000	15,000	9.34	79.92
15,000	20,000	8.67	70.58
20,000	25,000	7.71	61.91
25,000	30,000	6.59	54.20
30,000	40,000	10.68	47.61
40,000	50,000	8.12	36.93
50,000	75,000	13.38	28.81
75,000	100,000	7.11	15.43
100,000	200,000	6.47	8.32
200,000	500,000	1.46	1.85
500,000	1,000,000	0.26	0.39
1,000,000	1,500,000	0.06	0.13
1,500,000	2,000,000	0.024	0.07
2,000,000	5,000,000	0.034	0.046
5,000,000	10,000,000	0.008	0.012
10,000,000	Plus	0.004	0.004

Tax calendar

Sep. - Dec.

September 15, 2005:

- Third installment of 2005 Individual Estimated Taxes due.

October 17, 2005:

- Last date to timely file your 2004 Individual Tax Return (Form 1040) if you are in the United States and filed an extension with Form 2688.

September – December 2005:

- Time for 2005 Year-End and 2006 Tax Planning. Contact this office to schedule a consultation appointment.
- Taxpayers who began their Minimum IRA Distributions before 2005 must withdraw their 2005 Distribution by December 31.

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Since You Asked...

Question: In the near future, I will be receiving disability income from an insurance policy at my place of employment. I have received conflicting answers about the taxability of that income. Can you clarify this for me?

Answer: It all depends on how the insurance premiums were paid. If your employer paid the premiums and those premiums were not included in your income, then the disability income is taxable to you. If you paid for the insurance directly or through your employer with post-tax dollars, then the disability payments will be tax-free to you. In other words, if the premium is paid with money that has already been taxed, then the income is tax-free. Otherwise, it is taxable.

Question: A few years ago, my brother got himself into financial difficulties and I loaned him $10,000. He has been unable to pay me back and I have decided to forgive the loan and write it off on my taxes. How do I report my loss on my tax return?

Answer: Non-business bad debts are reported on Schedule D as a short-term capital loss. The information required includes the name of the debtor. The reason for that is a debt that is written off by the lender constitutes income to the debtor.

Unfortunately in your case, you cannot write off the $10,000. To be deductible, a non-business bad debt must be enforceable debt and you, as the lender, must make reasonable efforts to collect on that debt. Such efforts to collect include legal action. If you decide to forgive your brother's debt, the loss is nondeductible.

The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.