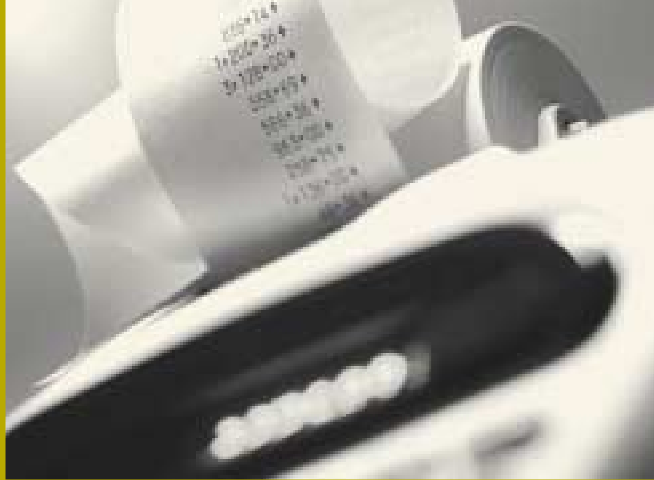
tax& financial UPDATE



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Investment Tax Blunders to Avoid

We realize that a mid-year review of your tax situation may not be at the top of your "to-do" list, but think of it this way: devoting a few minutes now could save you big bucks at tax time.

By following these tips, you can possibly reduce your taxes for the year and even increase the after-tax return on some of your investments:

- **Anticipate distributions from declining funds –** Since mutual funds are required to distribute capital gains to shareholders, you might receive a taxable distribution even though there was a decline in the share price of your fund this year. By preparing yourself and setting aside cash, you can avoid scrambling to pay taxes in April.

- **Purchase shares after the next scheduled distribution –** Don't buy a mutual fund shortly before a capital gains distribution since a portion of your investment will almost immediately be handed back to you. This will have you owing tax on the distribution with less money to reinvest.

- **Be prudent with "tax-exempt" investments –** Although the income from "tax-exempt" investments is generally nontaxable, funds will sometimes throw off capital gains distributions. This happens when the fund managers sell bonds, which can produce a taxable capital gain, and then buy other bonds. This can aggravate fund investors who don't expect to pay taxes on these types of investments.

  In addition, if you want the income to be tax-exempt for state income tax purposes, you need to make sure the fund is invested in your resident state muni-bonds since most states treat as taxable muni-bond interest derived from other states. Another common mistake is failing to change funds when you move from one state to another.

  If you are subject to the alternative minimum tax (AMT), be aware that interest from "private activity" muni-bonds is tax-exempt for regular tax purposes but not for AMT purposes.

- **Time your fund transfers wisely –** Frequently, people sell one bond fund to buy another as a way of rebalancing their portfolio. However, for tax purposes, that represents a sale of a security and the purchase of another. Thus, you will need to account for the gain or loss from the fund sold on your tax return. This is generally an unpleasant surprise to those unaware of this rule, especially if there is significant gain to report on the sale. If there is a loss, selling it during the current year will allow you to utilize the loss now. However, if there is a gain, consider waiting until just after the first of the year so that you can defer the gain.

- **Contribute the maximum –** If you maximize your retirement plan contributions, it will help maintain your current lifestyle years from now. In addition, it may also reduce this year's taxable income.

- **Sell a loser –** There probably isn't a stock market investor who isn't holding a stock that is worth less now than when it was bought. Selling a loser in a taxable account can save you money and free up cash for investments with more potential. This is because the IRS allows investors to offset realized gains with realized losses. In addition, $3,000 in additional losses can be used to reduce your taxable income. Don't sell for tax reasons alone, especially if you are confident that your dogs will turn into dream stocks. Just keep in mind that if a stock has dropped in price by 50%, it will need to gain 100% in order to break even.

- **Be aware of the limit on losses –** If you are thinking of cashing in all your dogs, consider that losses are limited

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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.

Investment Tax Blunders to Avoid (Cont'd)

to offsetting realized gains and up to $3,000 in ordinary income. Although losses higher than this amount can be carried over for use in the future, they would be of no benefit to you this year.

- **Stay away from wash sales –** If you would like to offset gains with losses, try and avoid "wash sales" since the IRS doesn't allow you to recognize the loss on such sales. A wash sale occurs when a security is sold at a loss and then repurchased within 30 days before or after the date it was sold.

  Don't fret. One way you can realize losses and keep your portfolio balanced is to sell and buy back a security 31 days after the sale. Individuals who cannot wait for that period of time should purchase a similar security (not identical) to the one that was sold.

- **Check your cost basis when you sell –** Although most people remember to include commissions on trades or mutual fund transaction fees when calculating cost basis, many fail to consider the dividend money that has automatically been reinvested, which results in taxpayers overpaying on taxes. Most commonly dividend reinvestment occurs with mutual funds but some companies also have dividend reinvestment plans for individual stockholders. Reinvested capital gains and dividends can add quite a bit to cost basis and make gains much smaller.

  Review all your purchases when it comes time to sell. You will have a smaller taxable gain and a much better idea of your actual return on a fund.

As an investor, you want what's best for your money. Be prepared and avoid the unnecessary headache at tax time. If you have specific concerns regarding your investments, please call our office so we can discuss them in detail.

Is Life Insurance a Sound Investment?

Most people don't look at life insurance from an investment perspective. However, it is becoming a popular option among corporations and trusts because it provides the best after-tax returns compared to other investment vehicles.

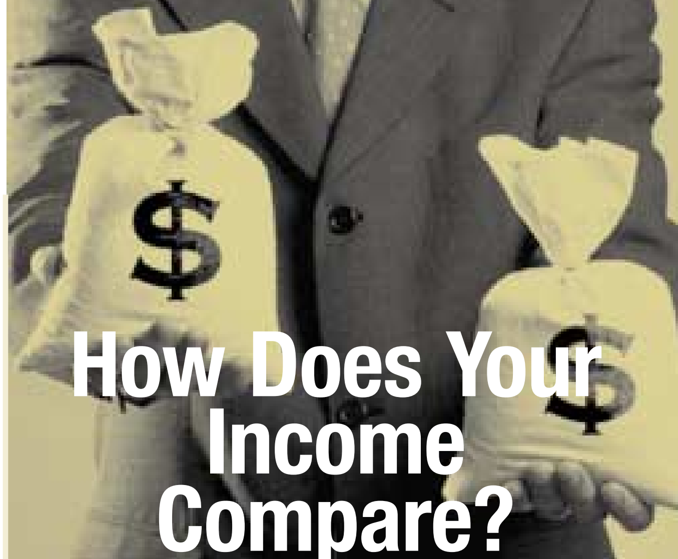
The easiest way to see what life insurance can and cannot do is to make a simple comparison with other investment options. Make sure that the comparison is fair and that all costs, including tax effects, are analyzed on a year-to-year basis for both the insurance and the alternative investment. Don't use investments that have completely different risk profiles; your comparison results will not be accurate.

If it is properly structured, life insurance can provide the following tax advantages:

- Your heirs will receive the death benefits tax-free.
- The cash values grow tax-deferred and any withdrawals are tax-free until the cumulative investment (in the contract) is recovered.
- A loan from the policy is not taxed as income.
- The death benefit will pay off any outstanding loan balances income tax-free at the time of death. The death proceeds can even be estate tax-free if the policy is owned by an Irrevocable Trust.

A life insurance program can be customized to meet your individual needs and objectives. If you are after the tax-advantaged cash value accumulation, you can minimize the life insurance benefit. In many cases though, the benefit is the most valuable feature since it immediately creates a capital sum at death that cannot be duplicated by any investment.

If you would like to discuss the tax benefits of a life insurance investment, please contact our office. Life insurance is a long-term proposition, but if you consider the returns on cash values available during life or the proceeds payable at death, how can you go wrong?



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

Keeping Your Finances Together

Has your financial situation gotten out of control? Many people cannot help spending more money than they make. In addition, some of us have our money allocated in the wrong type of investment vehicles.

This is where financial planning comes in. It's like having a road map that shows you how to get from Point A to Point B. A financial plan will help you put your specific life goals in perspective and show you how to achieve them.

Let's examine the most common financial mistakes that people make:

Lack of Planning – When vacation time rolls around, most people take the time to plan the trip out. They want to find the best deals at the right price. However, when it comes to their finances, very few invest the time needed to work on a plan.

Implementation – Some of us have made the effort to create a plan and stop there. Keep in mind that if you don't implement the plan, you won't get any closer to your goals.

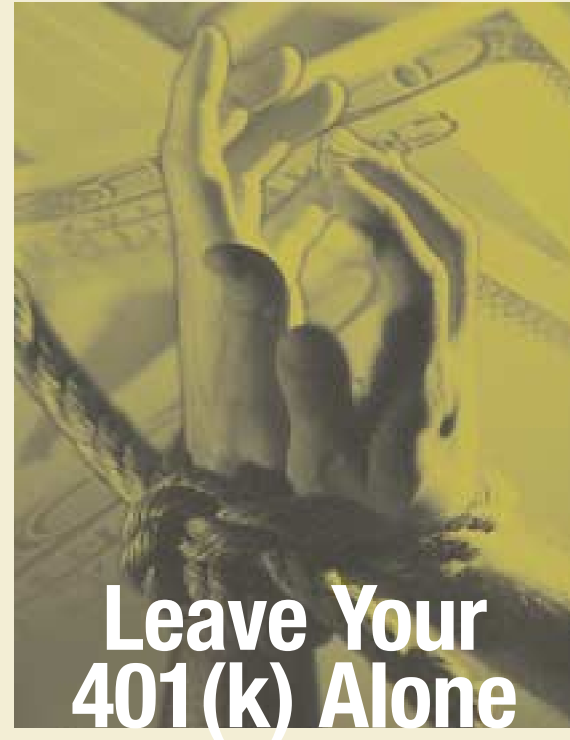
Planning Ahead – As with anything in life, the sooner you get started, the better. If you save and invest early, your investments will have more time to grow through the power of compounding.

Be Informed – In order to make wise choices, you need to know all your options. Ask plenty of questions – after all, you're investing your hard-earned money.

Keep Organized Financial Records – Not only will maintaining good records help you determine where you stand financially, it is the best way to track your progress. Be sure to store your records in a place that is easily accessible. If you maintain part or all of them on a computer, it is essential to have a current back-up copy of the files; keeping an extra back-up copy in another location, such as a safe deposit box, is also a good idea.

The financial life of today's average family is much more complicated than it was a generation ago. People are faced with greater financial responsibilities like paying for a home, starting a business, funding college education and accumulating enough retirement income. Planning ahead has become a necessity if you want to realize all your lifetime goals.

Since some aspects of financial planning are quite complex, please call our office for assistance. We will discuss your specific needs and help you manage your financial resources wisely.



Leave Your 401(k) Alone

Are you in the process of changing careers or have you found a better job opportunity? When people leave a place of employment, they see it as the perfect time to cash in their 401(k). Doing so, however, could have serious financial repercussions.

When changing jobs, you have three options when it comes to your 401(k):

Keep the money where it is – Your employer is required by law to allow you to leave your funds in the company plan if your 401(k) funds total $5,000 or more. If you are pleased with the plan's overall performance, this may be the right option for you. However, this is not a good time to pull it out if you have lost money due to a bad market.

Roll it over to another account – If you choose this option, you will need to set up an IRA account at a financial institution of your choice or with a brokerage firm. Generally, this can be done online or through the mail. Make it clear to the 401(k) IRA plan administrator that the funds need to be directly sent to the new IRA plan administrator. Otherwise, you may incur taxes. Another rollover option is to make a direct transfer to another 401(k) or other qualified plan with your new employer. You may have to wait for eligibility at your new company to roll your funds into the new plan. In that case, leaving the funds in the existing 401(k) until the waiting period expires is the best option. Rolling over your 401(k) will provide you with significantly higher retirement funds, especially if you are many years away from retirement.

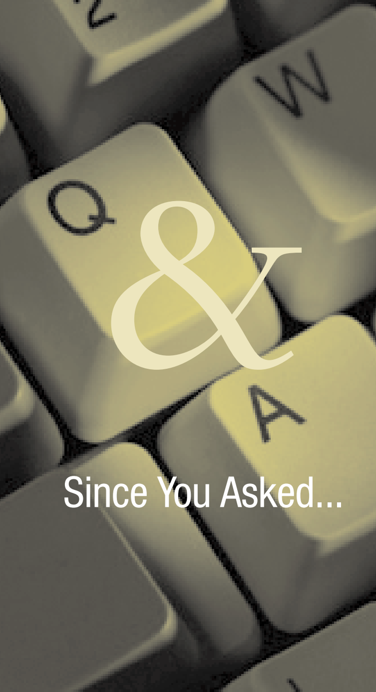
Take the money out – This option will cost you and should be avoided whenever possible. Your 401(k) provider will deduct 20% off the top and send it to the IRS. This amount will be applied to your income taxes when you file at the end of the year and may not be adequate to cover your tax liability. For example, you would owe an additional 8% of tax on the distribution amount if you are in the 28% tax bracket. And if you are under age 59-1/2, an additional 10% in early withdrawal penalties will apply.

Let's say you are under the age of 59-1/2 and in the 28% federal tax bracket with a $50,000 balance in your 401(k). Under this scenario, this is what would happen:

$ 50,000	*(401(k) Balance)*
– 10,000	*(20% Withholding)*
– 4,000	*(Additional taxes – 28% less 20% withheld)*
– 5,000	*(10% early withdrawal penalty)*
$ 31,000	*(Balance – but you are taxed on the full $50,000) Ouch!*

Of course, don't forget that the state will also take its share of the tax. Some states impose an early withdrawal penalty.

If you would like to discuss your options in detail, please call our office. There are significant tax consequences to consider, and we can help you keep your 401(k) growing.



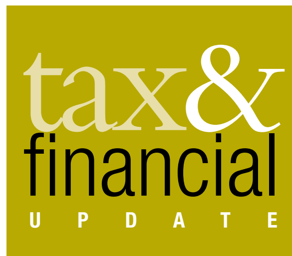
QUESTION: I am considering purchasing long-term care insurance. My insurance agent has indicated it will be tax-deductible and a portion of the premium will come back to me in the form of reduced income taxes. Can you provide some guidance?

ANSWER: Long-term care insurance premiums are an allowable medical deduction, but that does not guarantee that you will receive any tax savings because you paid the premiums. Unless you are self-employed, you must itemize your deductions in order to have a medical deduction. If you take the standard deduction, purchasing a long-term care policy will not provide any tax benefit. Secondly, even if you do itemize your deductions, medical expenses are only allowed as a deduction to the extent that they exceed 7.5% of your income (AGI). If you are taxed by the alternative minimum tax, that limitation increases to 10%. And finally, the amount that you (and your spouse if he or she also purchases coverage) can deduct for the insurance is limited to an amount based upon your age. The deductible premium amount is annually inflation adjusted, and for 2005 ranges from $270 for taxpayers age 40 or younger to $3,400 for those 71 or older.

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.



taxcalendar September - December 2005

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.