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TAX NEWS & TIPS

MID-YEAR 2005

You're Great!

I usually feel overworked during the tax season. This year I suddenly realized how much you helped. I owe you a great, big THANK YOU!

Thanks for having your records in order. Thanks for being patient. But especially – Thanks for the trust and confidence you placed in me. I'll keep working to earn this from you.

Tax Time is Over!

Your return's been filed. Refund's been spent. You can relax and forget about taxes for another year.

Not so fast! It takes IRS months to sort things out. As records from across America are sifted, some problems inevitably appear. By accident someone changed a digit of a Social Security Number – and now it matches yours. Or the interest reported by your bank doesn't jive with your tax return. Somewhere a few refund checks got lost. More than 130 million tax returns were sent to IRS. There are bound to be problems.

Refund Late? The official line at IRS says they can't check until 10 weeks after you filed, but often they are much faster. There's automated help at 1-800-829-4477. A Refund Hotline is at 1-800-829-1954. The IRS website (www.irs.gov) has a "Where's My Refund?" link.

Uh-Oh – an IRS Letter! If you get a letter from IRS call me. The letters can be confusing. Don't risk making an even bigger mess – I'll be glad to handle it.

Will You Be Audited? There's no sure way to know. Most audits are simple. IRS computers compare returns with W-2s and records from

banks and brokers. Most audits deal with this matching. A letter is sent to question the issue.

You probably picture an audit as a face-to-face meeting with an IRS employee who asks lots of questions. IRS calls any questioning of your return an "audit." Mark Everson, IRS Commissioner, says in 2004 "audits" of high-income taxpayers were up 40% over 2003. Sounds scary. There were 195,200 "audits" of folks with \$100,000 or more of income. But 94% of the "audits" were simply the letters I mentioned.

Another look at the figures: for every 12,900 returns with \$100,000 or more of income there were 190 "audits." However, 178 were letters. Only 12 of the 12,900 returns had a face-to-face meeting. Not bad odds!

Protect Your Records. For now, simply put your return, records, receipts, and cancelled checks in a safe place. You might need to dig them out, but the chance is slim.

Older Records. It's a good idea to keep tax returns indefinitely. Also, keep records of investments and properties you still own. Other records – cancelled checks, receipts, bank statements, etc. – keep five years' worth of these. Destroy or shred any older records.

Youngster Getting A Summer Job?

If your teenager will get that first summer job you probably have some questions. Will this change my own taxes? Will my child be taxed, too? What sort of withholding should be claimed? Here are some facts, plus a couple of suggestions.

If the child won't reach age 19 in 2005 you still have a dependent.

No matter how much is earned. Up to age 24 this is true as long as your child is going to school full-time.

Yes, the youngster is taxed, but the tax is likely to be zero. The first \$5,000 of "earned" income is tax-free. There's a training opportunity here. Even though there may not be a tax, tell the youngster to claim no withholding allowances. Some tax will be withheld. Help the youngster read the first pay stub, and prepare for the reality of taxes. Early next year the youngster will need to file a return. I can help. It is very likely there will be a refund.


Think about that refund. Why not try some financial training with your youngster! A refund is always appealing, but try suggesting the youngster open a Roth IRA. Not a large amount, say \$200 or so taken from the refund. You just might start a valuable savings habit! With a little luck the habit will stick. Several years from now the "thank you" will be special music indeed!


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Planning For 2005


It's never too early to think about your next tax return. Some advance planning might put extra dollars into your pocket. Here are some of the key changes in store for 2005.


 **Standard Deduction** goes up to \$5,000 for a single filer, \$10,000 for a couple, and \$7,300 for a head of household. The personal exemptions will be \$3,200. This means a single filer pays no tax until income reaches \$8,200. For a couple it's \$16,400. If you'll reach age 65 or older this year, single filers add \$1,250, joint filers add \$1,000 for each spouse who is 65 or older.

 **Mileage Deductions.** If you drive for your job, business, or rental property you may claim 40½¢ per mile. For most folks this is the simplest way to get your deduction. Beware – IRS likes to audit these claims. You are advised to keep records of activity and mileage.

 **Retirement Savings** can be higher in 2005.

- 401(k), 403(b), and 457 plans – defer up to \$14,000 (\$18,000 if you will be 50 or older by end of year).
- IRA or Roth IRA – up to \$4,000 (\$4,500 for age 50 or older).
- Self-employed SEP or Keogh – you may contribute up to \$42,000 if income is high enough.
- SIMPLE plan – defer up to \$10,000 (\$12,000 for age 50 or older).

 **Child Tax Credit** stays at \$1,000. Any dependent child who is not age 17 by end of 2005 reduces your tax bill by \$1,000. The credit begins to phase out for couples if income reaches \$110,000 (for single filers it's \$75,000).

 **Sales Tax vs. Income Tax.** This was a surprise to all of us in 2004. If you live in a state with no sales tax, skip this. For the rest of you, 2005 is the last year for this choice. You have a choice – deduct the income tax you pay or your sales taxes you pay. For sales tax we use tables that give average sales data for each state. Simpler than keeping receipts.

How Much Did Your Home Cost?

Back in 1997 Congress said you may exclude the first \$250,000 of gain when you sell your home. On a joint return, a couple could exclude up to \$500,000 of gain. In 1997 such a gain seemed impossibly large. Today many homes can top these figures. If yours is one of them, I think it's time to remind you how to find the *real* cost of your home.

Complete Rule. To earn the exclusion, you must answer “yes” to these:

1. Have you owned the property for at least 2 years before the sale?
2. Has this been your main home for at least 2 years in the 5-year period just prior to the sale?
3. Has it been at least 2 years since you claimed an exclusion?

Real Cost of Your Home. We start with your purchase price plus some of the closing costs. Then we add the cost of all improvements you made to the property. Anyone can recognize the added bedroom or kitchen remodel. But I'm looking for many more things! Let's play a little game:

Home improvements game: Let's pretend you're selling your home today. Pretend you suddenly find:

A Batch of Photos from the day you bought the home. Perhaps 50 of them – shots of inside and outside, a couple of shots of every room. (I know you don't have the photos – we're *pretending* here!)

Take New Photos. Now pretend you grab a camera and make duplicate shots of each photo – same angle, same exposure.

Find a Small Child, place the old and new photos side-by-side, and ask the child to find the differences. The child will spot the curtain rods, ceiling fans, new mailbox, switch plates, different faucets, built-in shelves, and more. These may not seem like improvements, but are you going to *sell* them? If they were not part of the original purchase contract, you must have *paid* for them! Their *cost* is added to the cost of your home. Even the \$2.98 paper towel holder above the sink.

How Can I Possibly Keep Records? Easier than you'd think. Play the game this week, and list everything you see. For some you have the records. List your best memory of costs for the other items – this is better than no record at all. For the future here's an easy way to keep your records:

A Large Envelope for each year. The trick is this – you may not put anything *inside* the envelope until you write the details on the *outside*. Walk around the house looking for the things you missed. Once a year this is quick and easy. There's another benefit. If you live in a home long enough, you'll replace the carpets a second time. The first set no longer counts! You consumed the carpets and cannot sell them. If you simply threw everything into a file, you'll never find the earlier carpet job. With the envelopes, you simply look back a few years for the envelope with the carpets written on the outside. Cross off the carpets! Easy.

I think you have more improvement costs (less gain) than you suspected!

Saving receipts is not likely to give a higher figure. However, we can increase the table amount if you buy a motor vehicle, boat, or airplane. The only other added item is for sales tax on building materials if you build or improve your home. This does not include tax on appliances or furnishings for the home.

Other Changes are minor for most folks. Capital gain rates are the same. Qualified Dividends still get the favorable capital gains rate. Tax brackets are indexed for inflation.

Call Me For Help with new items – family changes, large change of income, a move, job change, or new investments.

I understand the tax laws. I'd like to help you cut your tax bill as much as possible. Next February may be too late!

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Hidden “Flat” Tax

Make the wealthy pay their fair share! Sounds good. Tax laws have a provision to prevent people with large incomes from using ingenious deductions to cut their tax bill. It’s a complex item called “Alternative Minimum Tax” (AMT for brevity). It’s becoming big news. Perhaps you’ve seen a newspaper article or two about it.

Basics of AMT. First devised in 1981, this tax has changed little since 1983. Picture two side-by-side tax returns. One return is the familiar Form 1040. The “alternative” return focuses on income and ignores many common deductions and credits. (If you’re wealthy, you should pay your fair share!) The AMT is essentially a “flat” tax. It has only two brackets of 26% and 28%. You are forced to file whichever of two returns shows the higher tax.

Creeping Up On You. Until a few years ago only 1% or so of all returns contained an AMT. The Treasury expects about 4% of 2004 returns to show an AMT, and by 2008 the figure is expected to be 32%!

How can this be? The measure of “wealthy” was made in 1983 and has never been indexed for inflation. In time everyone will be “wealthy” if the law is left intact. The tax can begin to affect married couples at an income of \$90,000 or so, and less for single filers. While a couple earning \$90,000 is certainly not poor, the \$90,000 seemed a lot bigger in 1983! Worse, deductions for dependents, taxes paid, and job-related expenses are ignored completely.

Will it Change? The actual law is very complex. That’s exactly why Congress has dragged its feet about changing it. Rather than reform the AMT they enacted a couple of short-term fixes that are due to expire in 2006. Meanwhile, revenue from the AMT has become nearly 15% of all income tax, so an outright repeal is not likely.

Worse, it has become a political football. Nearly 68% of the affected taxpayers are from states that voted Democrat for president in the last election. Republicans seem content to watch the Democrats squirm.

It’s safe to say we will hear more about the AMT in the next couple of years.

Summer Day Care

When the youngsters are out of school it’s harder to find ways to keep them occupied while you’re at work. Day care centers often won’t accept school age children.

Fortunately there are several other choices in most communities. Even better, there may be tax credits to help cut the true costs.

Dependent Care Credits. The credits apply if you spend money for the care of a child under 13 years old. The purpose of the care must be to enable you to work (for couples both spouses must be working). In most cases the credit represents getting 20% of the cost refunded by the government.

Summer Opportunities. Check your local paper or phone book for YMCA, Scouts, local museums or art centers, churches, and youth groups. Many offer “day camp” experiences at affordable prices. The programs offer fun, supervision, and expose youngsters to new recreation and hobby experiences. They also help develop social skills.

Exceptions. Overnight camps do not qualify. Nor do programs which offer any education normally given in school – “computer camps” are an example. As long as it’s a “fun-and-games” sort of thing it qualifies.

Claiming The Credit. Be sure to keep receipts. Also, we must name the agency you paid, give its address and phone number, as well as its Tax ID Number.

Mandatory Withdrawals From Pensions

In two cases you are forced to make annual withdrawals of retirement money. This includes all pensions, IRAs (except the Roth IRA), and self-employed plans. You must take minimum annual amounts:

1. From your own accounts beginning the year you reach 70½.
2. From any inherited account beginning the year after the original account owner passes away.

Your Own Account – age 70½. The concept is easy to grasp. You earned this money years ago, but IRS agreed to tax it later. You are not allowed to continue the deferral beyond age 70½. The custodian of the account (your bank or broker) will tell you the minimum annual figure early each year. The calculation is easy. Simply divide your account balance at the *beginning* of the year by a factor from the table below. Use your age at the *end* of the year:

| Age | Divisor | 79 | 19.5 | 89 | 12.0 | 99 | 6.7 | 109 | 3.4 |
|-----|---------|----|------|----|------|-----|-----|------|-----|
| 70 | 27.4 | 80 | 18.7 | 90 | 11.4 | 100 | 6.3 | 110 | 3.1 |
| 71 | 26.5 | 81 | 17.9 | 91 | 10.8 | 101 | 5.9 | 111 | 2.9 |
| 72 | 25.6 | 82 | 17.1 | 92 | 10.2 | 102 | 5.5 | 112 | 2.6 |
| 73 | 24.7 | 83 | 16.3 | 93 | 9.6 | 103 | 5.2 | 113 | 2.4 |
| 74 | 23.8 | 84 | 15.5 | 94 | 9.1 | 104 | 4.9 | 114 | 2.1 |
| 75 | 22.9 | 85 | 14.8 | 95 | 8.6 | 105 | 4.5 | 115 | 1.9 |
| 76 | 22.0 | 86 | 14.1 | 96 | 8.1 | 106 | 4.2 | & up | |
| 77 | 21.2 | 87 | 13.4 | 97 | 7.6 | 107 | 3.9 | | |
| 78 | 20.3 | 88 | 12.7 | 98 | 7.1 | 108 | 3.7 | | |

You are free to take more. This is simply the smallest amount you may take. If you fall short IRS charges 50% of the shortfall as a penalty. And you still have to take the money out! If you have multiple accounts, you can combine the balances and take from whichever you choose. But be warned – the other custodian will send frightening warnings. After all, he does not want to be held responsible if you suffer the IRS penalty.

Inherited Account – Year Following Death. Suppose Aunt Mary passes away and you inherit her IRA. If she died in 2004, you will have mandatory withdrawals each year starting in 2005. Perhaps you moved the account to your own bank or broker, but this was not a “rollover.” It is still Aunt Mary’s account. Just read the statement – it might say “First National Bank, custodian of the IRA of Mary Smith (deceased), for the benefit of (your name).” Your minimum distribution uses a different life expectancy table than the one above, but the idea is very similar. So is the penalty. I can help you with the calculations.

We'll Print
Your Return Address
And
Postal Endorsement

Mailing Flap

You Add Postage
Or
We'll Print Your
Bulk Permit

You Add Your Client Address

Tips For You

Vehicle Donations – New Rules.

Donating a vehicle to charity is not the game it once was. For 2005, you might donate a vehicle, but the value of the deduction will be based on what the charity *receives* for the vehicle. Your estimate of value is no longer valid. Most charities do not even handle the vehicles. An agency collects them and “dumps” them on the wholesale auction market. In many cases they sell for a fraction of the “blue book” value. Unless your vehicle is actually *used* in doing the work of the charity there is no way to refute the value they name. They must send you your receipt within 30 days of the actual disposal of the vehicle.

The Wealthy Keep Paying. Late last year IRS released statistics on tax returns for 2002. The tax load on high-income folks crept up again. The top 5% of filers had 31% of all the income that was claimed, but they paid a whopping 54% of income tax collected. The 50% of filers with lowest incomes slid a little and paid only 3.5% of all taxes.

Protestor Pleads Insanity. Irwin Schiff may be the most famous tax protestor of all time. For years he sold books and gave lectures to show how the Tax Code is illegal. His materials continue to sell even though he has been jailed twice for failing to pay his own taxes.

The IRS put him on trial in Nevada seeking \$2.5 million in taxes and penalties. His lawyer claimed he suffers from “mental disease” and has a severe delusional disorder. A psychiatrist also told the Court he has been paranoid for years, as a result of heavy losses in a tax shelter.

Mutual Fund Investors need to keep careful records. Many people have turned to these funds in light of low interest rates paid on savings. If you invested in mutual funds please keep careful records. This is not a savings account. You bought stocks, and when you sell you must report your cost to measure your gain or loss. This is easy if you simply buy and hold. However, most investors “reinvest” the dividends. Each dividend payment represents another purchase! After a couple of years you may have 25 or more purchases. Their total is your real investment. Without the monthly records the calculation is impossible.

Withholding Tune-Up. I helped several of you calculate a different amount of withholding. Did you watch the next check to see if the right amount was withheld? You may have marked the form correctly, but someone had to enter the data to a computer. Mistakes happen. If you're not sure I can recheck the figures by seeing your pay stub. Call me if you're unsure. It's much simpler to check now than to face a big surprise when we prepare your next tax return.

Volunteer Expenses. If you help out at a church, school, or other tax-exempt agency your costs can be claimed as a charitable contribution to the agency. Watch for mailing costs, telephone expense, costs for supplies or copying. You may even deduct the cost of the refreshments you provide if you host a meeting for the group. You may also claim an allowance for your driving to events, meetings, activities, or rehearsals you help with. It's only 14¢ per mile, but you'd be surprised how quickly it can add up!

I'm proud to be paying United States taxes. The only thing is – I could be just as proud for half the money.

Arthur Godfrey

Your Tax Calendar

| | |
|----------|--|
| June 15 | 2 nd quarter estimated tax payments due. |
| Aug. 1 | 2 nd quarter payroll returns due (Aug. 10 if all deposits were paid). Forms 5500 due for pension or Keogh plans. |
| Aug. 15 | Extensions to file Form 1040 expire. |
| Sept. 15 | 3 rd quarter estimated tax payments due. |
| Today | Be sure to call if there are large changes in income! |

