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- **The Challenges of Withholding—Why breaking even is so hard to do**
- **Kinder, Gentler IRS? Here's the scoop on upcoming IRS focus areas**
- **Expected *reductions* in income require tax planning**
- **Why paying tax now can be cheaper than paying later**

Wealth Creation Strategies

Tax Law Analysis for the Lay Person

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Electronic Filing

About a dozen years ago I wrote an article in which I explained the reasons why we would not cooperate with the Internal Revenue Service in their crusade to have returns electronically filed. They touted the error-free aspects to such filing, while I looked at the costs of complying. They promised quicker refunds, which I analyzed from an interest rate perspective. In order to have paid for the hassle and additional time involved with e-filing, we would have had to charge our clients an extra $25-35 per return, as other tax professionals were doing. That amounted to a 33-45% annual percentage rate in exchange for getting a $2,000 refund two weeks faster. A person having his tax return prepared anytime after February 15 could have already gotten a two-week jump on his refund if he had seen us on February 1, at no additional cost.

However, times have changed. We decided to see whether e-filing had gotten any easier in the 2001 filing season. We also realized that sooner or later, the state and/or federal governments might mandate e-filing for tax practitioners. Without charging any additional fee, we began e-filing some of our returns. We quickly found it wasn't easy. Some of the problems were a result of State and Federal rules, while others were because our tax software company hadn't perfected their end of the process. Because of these difficulties, less than 10% of our 2001 returns were e-filed.

Despite this, we decided to give it another go in 2002. Since we didn't know whether it was going to work, we opted not to inform our clients of the impending experiment. How-ever, our software provider promised easier processes and the IRS and State informed us more returns would be approved (they have gradually increased the numbers and kinds of forms allowed, to the point at which even most of the esoteric forms we file would pass). More importantly, anthrax concerns prompted the IRS to open their mail off-site. We figured there could be a greater likelihood of lost tax returns as well as delays in processing. We also realized that lower paper and postage costs could offset the price paid to our provider, making it possible to continue to offer this additional service free of charge. And, instead of sending large envelopes to government agencies, e-filing requires only one thin envelope to be returned to us with the signed e-file documents, saving clients postage.

We ended up e-filing about two-thirds of our returns in 2002. There are a few that are not worth the cost of e-filing, while others cannot yet be e-filed. The most surprising of these included returns having more than one employee business expense form per person, or greater than 50% federal withholding (one client had 60% of his pension withheld in order to decrease quarterly payments required, due to other income). Also among those that could not be e-filed were returns for deceased persons and for employees having multiple employers withholding more than $1,000 in excess SDI (state disability insurance).

Others were not e-filed because explanations for bizarre situations are not included in the electronic return. While there's a case to be made for insuring that no human actually sees a return on which there are unusual deductions, we believe that some IRS inquiries have been avoided because of such explanations. On the other hand, they are probably not read in every case prior to audit.

We found that our e-filing experiment worked, overall, quite well. For first-time e-filers, we extend our thanks to those who read our instructions and promptly returned the required documents. The biggest problem on our end was organizing the flow of paperwork, which resulted in delayed e-filing of several returns. We apologize for these guffaws and will

do our best to insure that all e-filed returns are, in the future, promptly processed. We expect to increase the percentage of returns e-filed to 90% next year. If yours wasn't e-filed in 2002, the odds are it will be in 2003. If for some reason you object, please inform us ahead of time.

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Withholding the Right Amount: More Challenging Than Ever

If you don't want a year-end surprise of a huge tax bill or a large refund that the government willingly holds interest-free, the right number of withholding allowances needs to be claimed on form W-4. Deter-mining the number of such allowances with the goal of breaking even has always been challenging. It has recently gotten far more difficult, with an increasing risk of under-withholding among married couples when both spouses work.

The basic concept is really quite simple. Each allowance is "worth" the personal exemption amount, which is now $2,950. One allowance can be claimed for every $2,950 that the actual deductions exceed the standard deduction. The calculation for a single person having $20,000 in itemized deductions with no income other than wages, then, is easy. Subtract the standard deduction for single persons, currently $4,700, from the $20,000 and divide the difference by $2,950. The result, approximately five, is the number of allowances that can be claimed with the expectation of breaking even. (For ease of understanding, we'll ignore the actual allowance for personal exemptions.)

Let's complicate this just a bit. We'll assume our single person has a little side business netting $6,000 per year. One would think that he could offset this against the deductions and reduce the allowances claimed by two (in effect, we assume that the itemized deductions are $14,000 instead of $20,000). However, it's not that simple. If the wages are under the maximum level on which Social Security tax is assessed, an additional adjustment for self-employment tax must be made. If this is not done, he'll owe this additional tax (about 15% of $6,000, or $900). Similar adjustments need to be made for other income and allowable losses, as well as other kinds of taxes (such as the penalty for early withdrawal from a retirement account) and conversely, tax credits.

The math is similar for married people when only one spouse works. However, if both work, we need to take into account the fact that the withholding tables assume a standard deduction of $7,850 for each spouse. Worse still, the tables assume each can have large incomes taxed at low rates. Following the first $7,850 tax-free deduction, a $12,000 chunk of income is taxed at 10%. The next $34,700 is taxed at 15%, followed by a $66,150 stretch of income taxed at 27%. The withholding—and the correct tax (again ignoring personal exemptions)—for a married person having income of $54,550 and no deductions is $6,405 (zero on the first $7,850 + 10% of the next $12,000 + 15% of the last $34,700). This is simple and problem-free if there's only one working spouse and no other income or deductions. Just stick with the formula and give the number of exemptions.

Married Filing Joint

Amounts	Tax Rate
First $7,850	0%
Next $12,000	10%
Next $34,700	15%
Next $66,150	27%

However, there is a huge problem if the other spouse also earns $54,550. Each employer withholds what would seem to be the correct amount--$6,405 per spouse, for a total of $12,810. Yet we can see from the tax rates described above that the tax on the entire second income is 27%, or $14,728. The under-withholding is huge—the difference between the $14,728 actual tax on the second income and the $6,405 withheld on that income, or $8,323.

The Withholding

	Married, Zero Allowances	
His Wage	$54,550	
Her Wage		$54,550
Withholding	$6,405	$6,405

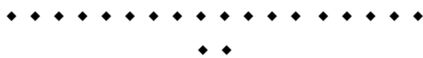
The Actual Tax

	Married Filing Joint	
Income	$54,550	$109,100
Tax	$6,405	$21,133

This is admittedly an extreme case. Most couples with this income have deductions in excess of the standard deduction, kids, child tax credits, etc. However, even with substantial deductions, many couples need to claim single filing status on their W-4s just to break even at year-end. But not even this

will completely solve the problem in 2002 with the new 10% tax bracket. Remember, the employer for each spouse assumes that $12,000 is taxed at this rate. Trouble is, there's only one such bracket—one $12,000 chunk taxed at 10%. Another way of looking at this is, take-home pay has just increased by $600 ($12,000 taxed at 10% instead of the old 15%; 5% of $12,000 is $600, which accounted for last year's special refund) for each spouse earning over $19,850 ($12,000 + $7,850) in 2002. Since there is only one $600 savings, many couples can expect to owe this much more or receive $600 less of a refund, not counting the effect of other changes.

If we complicate the married situation with some kids, child tax and dependent care credits, other business or rental income and losses, capital gains and losses, etc., you'll see that claiming the "right" number of exemptions with the goal of breaking even at year end is an art form. It is, nonetheless, one at which we enjoy taking our best shot. Therefore, we invite you to send to us your year-to-date pay stubs, along with expected changes in other income and deductions, so that we can see if you are on-track.



Caller ID and Call Blocking: Friends and Foes

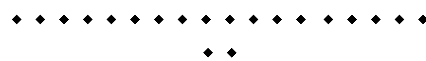
Many of you have Caller Identification as part of your phone service, especially cell phones. While a wonderful tool for discouraging unwanted calls and for seeing at a glance who is calling, it has its down side with us. To understand this, we need to describe our phone system.

Our main incoming line is 360-0985. If busy, calls get automatically routed to our secondary line, 360-0786. If we're unavailable, the call gets picked up only from line one on our answering machine. Since the odds of calling at the exact moment as someone else are small, we have opted not to further complicate our system. If the phone just rings, you need only call back in a couple of minutes to leave a message.

The problem arises from the fact that we make most of our calls first from line three, 363-7845, then from line two. If you call back using caller ID while we are in the office, you may get a busy signal. If we're not available, your call won't be answered.

Those of you with Caller ID may wish to take note of these numbers, so you will know it's us. You are best served if you return the call on our advertised phone line.

Call Blocking is also a wonderful tool, especially to avoid tele-marketing calls at dinnertime. How-ever, recall that we make our calls from two unadvertised phone numbers. You may wish to add these two outgoing numbers to your accepted list.



New TCMP-Like Audits

The IRS has not conducted a study to improve the selection of tax returns for audit (i.e., those that yield the greatest amount of additional tax) in 14 years (and arguably 20, since the 1988 version looked only at non-filers). There have been countless and massive tax law changes since. The criteria of so long ago can't be of much help in determining which returns to scrutinize.

While not as intrusive as the old Taxpayer Compliance Measurement Program, audits in which every single line of the tax returns of 80,000 hapless taxpayers were scrutinized, the new program, the National Research Program (NRP), will examine approximately 50,000 returns.

The interesting item reported so far about these upcoming inquiries is that the IRS will make maximum use of data they have already collected. In particular, through "extensive case-building," examiners will determine that some taxpayers are not worth contacting. In fact, about 9,000 will undergo this sort of audit.

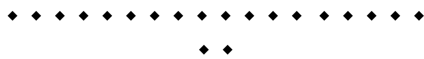
Another 9,000 will receive correspondence from NRP auditors requesting support for items. 30,000 others will be called in for a face-to-face inquiry. It is expected that these will be no more burdensome than ordinary audits because of the behind-the-scenes case-building. However, this will allow more time for questionable items.

2,000 unlucky taxpayers will be subjected to line-by-line examinations of their returns.

Auditors will query 9,000 taxpayers without their ever be-coming aware of the process, while investigating 41,000 others before the subjects even learn about it. If the audit surfaces, the auditor will already know quite a bit about the taxpayer's situation. This should be of some concern. The auditor will likely have already found evidence for any unreported income or other serious infractions in bank deposit records, which they have access to with a simple subpoena. However, I have not confirmed that they will use these powers. Perhaps, the "kinder, gentler IRS" will not do so. On the other hand, if the purpose

of this exercise is to find returns yielding the greatest additional tax, use of such power would do much to improve the results of their research.

While too late for past transgressions, I cannot strongly enough stress the need to report all income. If you suddenly realize that income was inadvertently omitted, it may not be too late to file an amended return. And it's never too late to improve record keeping. In particular, keep proof of any bank deposits that are not taxable, including gifts, loans, inheritances and simple transfers from account to account.



Tax Evasion With Offshore Bank Accounts

In an astonishing breach of privacy, the IRS reached an agreement with American Express, VISA and MasterCard to share information on persons using foreign bank accounts to pay bills, especially for large items such as cars and boats. The IRS won approval from a federal court in San Francisco to obtain such records by demonstrating that many card-holders were probably not complying with U.S. tax laws.

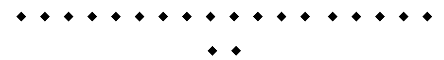
U.S. residents and citizens (residents and non-residents alike) are required to report all earnings, including income earned in foreign jurisdictions from work, investments and savings.

If the IRS finds expenses charged on credit cards issued by offshore banks, the odds are that an offshore account is being used to pay the credit card bills. The bank account likely earns interest income, subject to federal and state income tax. There's also a significant possibility that the money in the bank resulted from unreported foreign income, such as a business or rental income from properties owned overseas.

We are required to report the fact of foreign accounts totaling more than $10,000 on both the tax return and in a special report filed with the Treasury Department. I haven't filed one of these forms in 15 years. Since less than 120,000 individual tax-payers report such accounts on their returns and over 120 million returns are filed each year, the odds are slim that we would be filing such reports. However, I wonder if we're missing anyone. You are supposed to tell us about any and all income you earn. I'm sure that 95% of you do so. If you are among the small fraction who have inadvertently omitted some income, you may wish to come forward before the IRS forces your hand.

MasterCard has turned over records on some 230,000 accounts in Antigua, Barbados, the Bahamas and the Cayman Islands. The records include those of many "executives of publicly held companies, business owners, doctors, lawyers, investment professionals…and wealthy individuals." The IRS does not have the manpower to investigate every owner of these accounts, but I imagine they'll make their best effort. I would expect, too, that some high-profile individuals may become examples for the rest of us. One would hope that these include a few politicians.

The surprising aspect to the IRS announcement was their estimate as to the number of Americans who they think engage in this form of tax evasion. I find it hard to believe it could be anywhere near the two million estimated. If true, this means that only a small fraction of holders of credit or debit cards linked to offshore accounts—perhaps 5%—have properly reported their savings held and interest earned outside the U.S. The implied rate of non-compliance with the tax laws in this particular area would then border on a staggering 95%. This is a rate of non-compliance similar to the estimate for reporting and paying taxes on household help. I have a feeling more of our clients may be evading taxes in this area than in that of offshore bank accounts. On the other hand, I've been surprised before.



The Importance of Informing Us about Substantial Changes in Income or Deductions

A few years ago, we had a client who was shocked when told that she owed an additional $40,000 in tax. The trouble was, we had no idea that the net income from her business had increased by $100,000 until March of the following year. If she had told us in, say, November or even December, she would have known about the additional burden in advance and planned accordingly. More important, we could have advised her of actions to take to mitigate the damage. When preparing the return, it's generally just too late.

This unfortunate incident led to a change in our "please note" sticker, which we include on the instruction letter sent with every return we prepare. We clarified that if there is *any* major change in expected income or deductions, we should be notified. We also changed

the color of this note to fuchsia, making it practically impossible to miss.

However, we still have our surprises. While frequently the changes about which we were not informed include substantial in-creases in income, a number of such changes involve major *reductions*. Few people realize that such situations often give rise to important planning considerations.

In the past year, a number of our clients had negative taxable income. This means they could have had additional income and paid zero tax. What a waste of perfectly good deductions!

In one such instance, a mature (over age 59 1/2) client had $20,000 negative taxable income. One strategy that he could have taken advantage of was to increase the withdrawals out of his IRA by $20,000 and pay zero tax. Had we known about the situation in advance we would have also suggested he consider withdrawing an additional $26,000 to take full advantage of his (single) 15% tax bracket. When a client has the opportunity to pay tax at 15% and, in the process, avoid future tax at 27%, we generally suggest taking advantage of this "tax arbitrage."

Another client, who also usually pays tax at a 27% (or higher) rate, experienced a huge loss in his business, resulting in $50,000 negative taxable income. He also had a stock portfolio on which there were (believe it or not) huge unsold gains. Ignoring for the moment a quirk in the law for 2001 only that completely mitigated the damage, if we had been informed about the loss in advance, he could have sold securities on which he held profits of al-most $100,000 at a total tax cost of only $3,000. He could have immediately re-purchased, thereby in-creasing his cost to reflect the cur-rent price. While you can't sell at a loss and re-purchase the same securities within 31 days, realizing a gain and buying back the next minute is allowed.

The quirk in the law mentioned turned this failure in planning into an enormous windfall. In fact, we were able to use this little gem (called the "deemed sale" provision) to several clients' advantage for 2001. However, this was a one-shot deal.

We've had a number of success stories over the years when our client informed us of expected low income before the year was out. In one such situation, we were able to convert $50,000 in a traditional IRA into a Roth IRA at no cost. How? The negative income was $50,000; we knew this in advance; and the law allows anyone to convert traditional IRAs into Roth IRAs if the adjusted gross income is under $100,000 (which, needless to say, it was). Our client also could have simply taken the $50,000 and paid federal and state early-withdrawal penalties of 12.5%, which would have been advisable if he had a need for the funds. However, he didn't need the money, so we were able to do something even better: we converted income that would eventually be taxed into a permanently non-taxable fund that will, if invested wisely, grow in value. The growth, too, will be withdrawn tax-free.

Another good excuse to contact us toward year-end is in cases where we set up large quarterly estimated tax payments. These are based on prior year income, or expected in-come when we prepare the return. A lot can change very suddenly, as we all found out on September 11. If the income takes a sudden turn south, we can at least stop or dramatically decrease the third and fourth quarterly estimates. Several clients unnecessarily made $10,000-$20,000 quarterly payments in September and January. There's no reason to overpay, only to see the government return your money interest-free the following April.

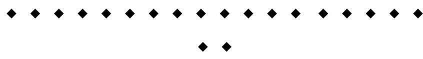
Yet another reason to call is to find if it's more beneficial to buy a home for all cash or obtain a mortgage (or, how much down payment to make). For example, one client paid cash for their home, only to borrow out of it in order to survive after a planned extended leave of absence from work. If they had instead financed the purchase and lived off savings, they would have avoided a number of tax and financial problems. These include non-deductible interest on any equity loan over $100,000, a higher interest rate on the equity loan than they would have paid on original financing, and possible Alternative Minimum Tax problems down the road.

We don't write this to berate our clients, but rather to use the errors to help prevent future ones. We strongly encourage every one of you to inform us about major changes during the year. Doing so via fax or e-mail is most efficient. There's no excuse to be surprised at year-end, or worse, end up with wasted deductions that could have been offset with tax-free income. And if there is no potential income that can be created, for the ultimate in tax-favored mergers, you can run an ad under "personals" similar to this:

WANTED

One wealthy high-income woman with large capital gains to offset unaffordable Silicon Valley mortgage and enormous capital losses. Marriage

required by December 31. E-mail: FormerDotCommer@instantwealth.net.



The Ups and Downs of Tax Deferred Annuities

Tax Deferred Annuities can be a valuable tool for deferring income from one's peak producing years to retirement, when presumably in lower tax brackets. A lump sum investment is made, usually with an insurance company, which grows tax-free until withdrawal. Over time, substantial tax deferrals result on sums that range from $20,000 to $100,000 and more.

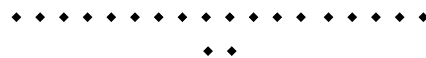
Aside from the fact that many of our retiree clients are *not* in lower tax brackets than when working, we have several concerns with these tax-deferred vehicles. One is that the up-front commissions and surrender fees imposed by the insurer can run to 5-10% of the investment, making it expensive to move the funds when a higher rate of return is found elsewhere. One retired annuity salesman is so upset over these fees that he's turned himself into a one-man crusade to get state insurance commissioners to stop the more egregious practices. These usually involve initial sales or transfers that are solely for the benefit of the salesman and not the client.

He is particularly troubled over the fact that retirees are often cajoled into buying annuities with scare tactics. While annuities are exempt from creditors, how much risk of being sued or bankruptcy does the typical retiree really have? Past the working and playing prime, the greatest peril by far is generally from automobile accidents. An umbrella liability policy covering up to two million dollars in damages for such incidents is inexpensive, and necessary if other non-exempt assets are to be protected.

We have a concern about such tax-favored investments that can add more to the overall cost than the commissions and fees. Deferring the tax is of no value in many cases and, in fact, it can make things far worse. We've seen a number of situations in which investors have been in the zero to 15% tax bracket during most of the deferral years. When they withdrew the funds all at once, they got pushed into 36% federal and state tax brackets (and higher as Social Security income became subject to tax as other income increased).

One such policy we recently ran across reported accumulated, but untaxed interest of $6,000 per year. If the interest had been included in income, the additional tax would have been only $940 annually, or $3,760 over a four-year period. However, our client suddenly withdrew the $24,000 accumulated earnings (plus enough of the principal to purchase a $30,000 car). The additional tax was $7,147. Therefore, the tax-cost of the annuity was almost $3,400 ($7,147 less the $3,760 tax if paid over four years).

This situation is not unique. It is generally an advantage to pay tax currently at low brackets than to pay later at higher ones. As described in the preceding article, fluctuating incomes can result in far greater overall tax costs than consistency. There may be an underlying message in regards to life, as well.



Russia Would Put Doug Out of Business

In an extraordinary twist of history, a former head of the KGB, President Vladimir Putin, has put the Russian government on a diet consisting of a 13% flat tax.*

Who would have thought that a prior head of the most oppressive agency in the most dictatorial state on the planet, the former Soviet Union, would create the most free-market oriented tax system extant?

The maximum advertised tax rate in the United States is 38.6%, in addition to state income taxes ranging up to 10% and self-employment tax of 15.3%. I haven't been able to uncover similar taxes in Russia.

Many economists and officials would have us believe that government revenues would plummet if we were to adopt such a system. Instead, tax revenues climbed 28% from year 2000—when Russia last had a 30% top rate—to 2001, when the new rate regime took effect. In addition, the Russian economy grew by 5%, while most of the West was mired in recession.

In addition (can you bear any more before we all emigrate to Russia?), there is no tax on sales of stocks, bonds and homes. Nor is there double-taxation of corporate income. Keep this in mind when you listen to tax-cut opponents such as Senators Barbara Boxer, Tom Daschle and Edward Kennedy. Remember this, too, if you want to help Doug and other Enrolled Agents find new lines of work.

*Rates do not include fees collected by the Russian Mafia for protection.