THE 10 BIGGEST MISTAKES
THAT ANYONE CAN MAKE

Mistake Number 1 - Not taking full advantage of all of the deductions that are available to you.

When I get a new client, one of the very first things I do is review their prior year's tax returns. It is amazing to me how many times that I find that this client is not taking all of the deductions allowed by the Internal Revenue Service.

For example, Individual Retirement Accounts. From a tax advisor's perspective, the basic idea is that every one who can possibility afford it, should be contributing to some form of IRA every year. The possibilities include:

1. A traditional IRA
2. A Roth IRA
3. Or in the worse case, a Non-deductible IRA

While it is to early in the speech to numb you all of the various limitations that apply to each type of IRA, I do want to highlight a couple of points:

1. The rules for couples have changed dramatically in the last two years. It used to be that if only one spouse was an active participant in a retirement plan, then a traditional IRA deduction for the other spouse was barred if their total income was over $50,000. Now that same number is $160,000.

2. Contributions to Roth IRAs can be made irregardless of pension plan participation as long as your income is below $150,000 for joint filers and $95,000 for single filers. Even though there is no current deduction for these contributions, why pass up an opportunity for tax-free income in the future?

The second area of missed deductions I would like to highlight is donated goods. I dare say, before I started handing out a record-keeping and valuation guide such as the one in your seat, less than 1% of my clients took full advantage of this legitimate deduction. But with this guide, and a reminder of how our dearly beloved President deducted $5 for each of his used boxer shorts, I am proud to say that this percentage is now well 75%.

Other missed deductions include:

1. **Mortgage loan points on a refinance.** While these must generally be deducted over the life of the loan, if you refinance for the second time, you get an immediate deduction for the remaining points for your first refinance.

2. **Home office.** Think of this deduction as a pendulum. Five years ago almost no one qualified for this deduction. Now the rules have been liberalized, you can deduct not only a portion of your homes insurance and utilities, general repairs and housekeeping services.

3. **Job Hunting expenses.**

4. **Business use of the Internet, home and cellular telephones.**

5. **Stop smoking programs**

6. **Turn that hobby into a business!** Whether you sell your goods at the Roseville Auction or ebay, all you have to do is show a profit motive and that you have conducted yourself as a business would. For example, write a simple business plan, advertise and keep a journal of your activities. These simple steps will defeat the "hobby loss" rules that you hear so much about and allow you to deduct such otherwise personal items as supplies, postage and mileage.

Mistake Number 2 - Not taking advantage of certain tax favored investments.

Two prime examples of such favored investments are real estate and the stock market. In real estate, the government still lets you deduct 100% of your mortgage interest and real estate taxes on your personal residence. In addition, as long as you have lived in your house for at least two of the last five years, gains on the sale of your house up to $250,000 (or $500,000 if you are married and filing a joint return) are totally tax-free. Gone are the requirements that you must reinvest the proceeds in a more expensive house or wait until you are 55 or older to sell out. In fact, you can now sell a house every two years and qualify for this exclusion. You can also qualify for a partial exclusion if you have to move before two years, as long as the move is caused by a job transfer or health reason.

As far as investing in the stock market goes, you only need to know two things to see the advantage. First, you are not taxed on the

stock's appreciation until you actually sell the stock. While this may sound basic to some of you, it is a question that I get all the time. Second, as long as you hold the stock for at least a year, any gain is taxed at only capital gain rates, which can be as low as 10% or no more than 20%. Compared to the income tax rates for all other types of income, effective use of the capital gains tax rates can result is savings of over $200 for each $1,000 in gain.

Another way for investors to save money occurs when an investor sells less than his or her entire holdings in a particular stock or mutual fund. In this case, it is usually best to sell the shares in which you have the highest basis, thereby reducing your gain or increasing your loss. If the shares with the highest basis are not the first ones you acquired, it is imperative that you indicate to your broker the specific shares to be sold by reference to their purchase date and cost. Once you have done this, you also need to obtain a confirmation from your broker that these are the shares they sold for you.

Two more important points about stocks and mutual funds. If you participate in a "dividend reinvestment plan", don't forget to add the dividends you have received to the basis of your stock when you sell. And speaking of selling stock, if you own appreciated stock outside of your retirement account, and want to make a charitable contribution, think about giving the stock away rather than cash. If you do this, you can get usually get a deduction for the full fair market value of the stock without ever having to pay the capital gains tax.

No discussion of stock investments would be complete without mentioning the
<u>Third Biggest Tax Mistake</u> - failure to keep adequate records.

The cost of failing to keep records can be severe. For example, lets say you own 100 shares of AT & T that were acquired years and years ago when you were just a young wiper-snapper under an employee purchase plan of one of the then regional operating companies. Guess what. Unless you can find your records of these purchases, the Service's position is that your basis for figuring out your gain is zero. Therefore, instead of paying tax on just the appreciation on the stock, the Service will in effect make you pay a double tax on your original investment. On top of that, they can also hit you with an inadequate records notice, which will ensure that you will be paying the Service another visit real soon.

So how do you avoid such traps? One solution is to keep every scrape of paper your ever receive and buy stock in a storage facility company.

Probably a better alternative is to follow our record-keeping guide that I referred to earlier. Knowing which records to keep, and for how long, will both simplify your life and save you countless tax dollars in the future.

However, even your own records are sometimes not enough. For example, if you make a charitable contribution of $250 or more at any one time, believe it or not, your cancelled check is no longer sufficient support to justify your deduction. Yes, you heard correctly. Even if you have a cancelled check to your church, your college or even the American Red Cross, the IRS will deny the deduction, unless you also have a contemporaneous written receipt from the charity acknowledging the gift. This receipt must not only state what amount of money was received, but also include a statement valuing any goods or services that were received in exchange for the gift. Remember, I said "contemporaneous". You must have this acknowledgement before you file your tax return or risk losing your deduction.

One final word about records. According to many media reports, the 1998 IRS Restructuring and Reform Act supposedly shifted the burden of proof in audits away from the individual and to the IRS. Unfortunately, some reporters apparently failed to read the fine print. The burden only shifts once you get to Tax Court, and then only if you have cooperated with the Service at the audit and appeals levels, and of course kept adequate records. In other words, our dear friends in Congress have "reformed" the law, without really changing anything.

Mistake number 4 - Failing to take full advantage of employer provided benefits.

I get quite a few young couples that come to me after they have bought their first house, and want to know what else they should be doing for tax planning. The first question I ask is whether they are taking full advantage of their employer provided benefits. These often include:

1. 401 (k) plan or other retirement vehicle
2. Stock options or stock purchase plans
3. Flexible spending accounts
4. Group term insurance for both life and health and

5. Educational assistance

Of these plans, the most misunderstand and least utilized is the flexible spending account. This type of account allows you to put money aside on a before tax basis to pay for out of pocket medical and child care expenses.

There are two key issues here:

First, care must be taken not to set aside to much as these are "use or lose" type plans. In other words, if set aside $300 a month to pay for child care, and you wind up only paying $250 a month, you lose the $50 difference.

The second issue applies to couples who both spouses are eligible to participate in these types of plans. If one spouse earns more than $76,200, and the other does not, it is important for the lower earning spouse to be the one who sets aside their earnings thereby saving both income and social security taxes.

Mistake number 5 is improper use of retirement funds.

OK, this should be a no-brainer. **DO NOT**, I repeat, **DO NOT** ever take a premature distribution from your retirement account if you can in any way avoid it. Virtually everyone who does this thinks that because they have had the 10% federal penalty withheld from the distribution, they have paid their taxes. Unfortunately, nothing could be further from the truth. The distribution is subject to not only this 10% federal penalty but also to a 2-½% California penalty. In addition, it is also subject to both Federal and California income taxes. Worse yet, because these distributions are often sizable, they more often than not push the unsuspecting individual into a higher tax bracket. When added together, the effective tax rate on such premature distributions usually runs over 50%. As a final insult, often times the only source for repaying this unexpected liability requires yet another premature distribution. A much better alternative is try to obtain a loan from your employer's existing plan, apply for a hardship distribution or kidnap Patty Hearst and force her to rob a bank (sorry, I was just trying to see if anyone was still awake).

Mistake number 6 is failing to plan for your own death.

Funny, even though this is number six, I put off writing the explanation of this mistake until last. But the sad fact is even with all of the advances in medicine, all of us will eventually pass away. One

of the very few good things about this fact, is that with a little planning, we can ease the financial burden on our loved ones by taking a few simple steps. First, be aware that there are actually two different types of taxes you must plan for. The first is the regular income tax that we have been discussing all night. The second is the estate tax, which is a separate tax that is based primarily on the assets you have when you die.

To calculate this tax, all of the assets that you own, including your ½ share of all community property are added together. From this number we subtract your share of any liabilities such as mortgages and credit card debt. If the result exceeds $675,000, your estate is subject to the estate tax. As estate tax rates begin at 37%, this is a tax that cannot be ignored. The amount that is excluded from the tax (currently the $675,000 figure) is gradually scheduled to increase to $1,000,000 in 2006. However, with a very simple estate planning tool commonly referred to as a "living" or bypass trust", this exemption can be effectively doubled to $1,350,000. However, if you have not taken this simple precaution, do so tomorrow.

Even if you believe that the estate tax will never apply to you, you should also be wary of selling appreciated assets as you get older. Under current income tax law, the basis in assets that you own at the time of your death are "stepped-up" to the fair market value at the time of your death. For example, remember those AT & T shares that I referred to earlier that had a zero basis? Selling those before you die would have to be considered to be a huge mistake, as the income tax could be avoided by both you and your heirs, by simply holding onto the stock. If you really needed cash, a better alternative would have been to pledge the stock as collateral for a loan. Now I realize that the normal objective is to be debt free at retirement, but this could be one exception that makes sense.

Mistake number 7 is relying on your W-4 form to do your tax planning.

For those of you not familiar with this form, a W-4 is the form you give your employer annually that tells them how much to withhold from your paycheck or your retirement distribution. The problem here is two fold: first, all to often this is the only time you think of your current year's taxes until the following April 15th. Consequently, by then, most of your tax planning opportunities have gone by the wayside. Second, there are a number of assumptions built into the withholding tables that the W-4 instructions fail to highlight. For example, the Form assumes that you will have the same employer all

year long. However, if you change jobs, your new employer will give you the benefit of the 15% tax bracket on the first dollars you earn, even though your true tax rate on these dollars is actually 28% or higher. Another problem is for married couples who either itemize or have dependents. The spouse with the highest income should claim all of the withholding allowances. Otherwise, there will be under withholding, and quite probably an estimated tax penalty will be assessed.

<u>Mistake number 8</u> is picking a fight with the Internal Revenue Service.

Simple math: there are still over 100,000 of them and only one or two of you. While I will go into more detail later, always remember to be courteous to the person you are dealing with (and this implies even if they are a complete moron) and to escape with the shirt on your back should be considered a moral victory.

<u>Mistake number 9</u> is believing that the IRS is actually now a kindlier and gentler place.

At any given time, I represent well over 100 clients who have matters pending before the Service. Consequently, I am in almost daily contact with Service employees. The cold hard fact is that morale among IRS employees is at all time low. Basically, what you have is 100,000 trained attack dogs who are now being told that they cannot attack. Well, I don't care how much "sensitivity training" these agents are sent to, the fact of the matter is you simply can't teach an old dog new tricks.

<u>Mistake number 10</u> is don't under estimate the power of the State of California.

Because the State has been faster to embrace new technology than the Feds, it usually catches up to delinquent accounts and non-filers much faster than the IRS. Worse yet, the state has not developed uniform standards for payment agreements and offers in compromise, thereby making these much harder to obtain. Finally, the state has the power to assess a non-negotiable "demand penalty" which can literally cause someone who is otherwise owed a refund, to be assessed thousands of dollars in penalties.