Have a great idea for our next workshop? Let us know!

Upcoming Workshops

Alternative Investments:
Thursday, March 17th

Life Insurance:
Tuesday, April 26th

Tax Planning:
Tuesday, May 24th

Account View:
June: TBD

To request a formal invitation to one of the events above, please email Dana at dpecenka@iwmpartners.com or by calling us at (714) 962-8000

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Audit Red Flags

What raises eyebrows at the IRS?

Are you worried about being audited? The fear may be overblown as only 0.86% of taxpayers had their federal returns examined in 2014. In 2014, 7.5% of millionaires had their returns scrutinized. Much of this is down to low staffing at the IRS. In 2011, during more prosperous times for the agency, the IRS audited 1.11% of returns. Still, no one likes extra stress courtesy of the IRS. Let's look at some red flags that might get you extra IRS scrutiny.

A Schedule C that hints at some odd bookkeeping. Schedule Cs get a close look annually as the IRS seeks to remedy the tax gap (the difference between federal taxes owed and federal taxes paid). As Schedule Cs are often filled out by solopreneurs and small business owners themselves, the chances increase for claiming substantial

Putting Your Tax Return to Work

Should your refund be spent? In 2014, more than 109 million tax filers received federal tax refunds, with the average refund at $2,792. What happens to that money?
According to H&R Block's Tax Institute, little of it is saved or invested: last year, more people used their refunds to settle debts or pay for cars or vacations than anything else. As nearly 80% of Americans end up getting a refund from the IRS each year (including about a third of Americans with incomes above $200,000), it is worthwhile to consider other uses for the lump sum.

Where else could your refund be directed? Putting it into a savings or checking account is sensible enough – but with the pathetic interest rates most bank accounts earn today, you may be wondering about alternatives. Here are some other options.

You could effectively put your refund into your workplace retirement plan. Does your employer offer to match your retirement plan contributions? If so, you might want to think about contacting your plan administrator or human resources officer and increasing your elective salary deferrals into the plan this year by the same amount as the refund. If you deposit the actual refund dollars in a checking or savings account, you can offset the increase in the amount of salary you defer by distributing the refund dollars from the bank account to yourself. Hopefully, that checking or savings account generates at least some interest on those deposited funds as well.

You could fully fund your IRA(s) with it. If you have not made the maximum allowable IRA contribution for 2015 – $5,500 across all your Roth and traditional IRAs, $6,500 for those 50 or older – you could boost that contribution as an effect of your refund. Another option: use the refund you fully fund your IRA for 2016.

You could tell the IRS to put the money in bonds. In addition to a direct deposit or a check in the mail, the IRS gives taxpayers who receive refunds a third option: the money can be used to purchase U.S. Series I Savings Bonds. Up to $5,000 of refund dollars can be invested this way (in multiples of $50).

You could use those dollars for home improvement. Do you think you will live in your current home for years to come? If so, you could apply your refund to energy-saving home improvements (including HVAC, roof and windows upgrades) that could result in some nice long-term savings for you. If you make such improvements, you might even be eligible for a federal tax credit of up to $500. Congress retroactively preserved this credit for the 2014 tax year, and may act to preserve it again for 2015. Even if that credit sunsets, the Residential Energy Efficient Property Credit is in place through the end of 2016 – a tax credit for up to 30% of the cost of qualifying alternative energy improvements to a primary residence.

You could make an additional mortgage payment or pay property tax. Assuming your home isn't underwater, you may want to use the refund dollars to reduce mortgage principal. Also, mortgage companies often keep a few thousand bucks in escrow to pay various tax and insurance expenses linked to your home, and some will actually let a borrower's savings account stand in for their escrow account. If they permit, you could make such payments out of an account of your own while it earns a (tiny) bit of interest.

Lastly, think about avoiding a refund altogether. In figurative terms, your federal tax refund amounts to an interest-free loan to Uncle Sam. If you don't particularly want to make that "loan" again, see if your W-4 can be tweaked to decrease that possibility.

— Shawn

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substantial deductions that may be hard to substantiate.[2]

Taxable income of $1 million or more. Millionaires work with accountants for a reason – generally speaking, returns prepared by tax professionals raise far fewer red flags than DIY ones. If you will make around $1 million this year, look back at the first paragraph of this article and consider whether or not it might be wise to defer some potentially taxable income into 2016.[2]

Bad math. The IRS does spot mediocre mathematics in returns. However, it also finds unreported and underreported taxable income through the same scrutiny. The IRS says taxpayers and preparers made 2.3 million math mistakes on their 2013 federal returns. Not only are these general errors, but also errors in the calculation of income, as well as missing information.[3]

Huge deductions. Is your money-losing small business venture truthfully just a hobby? Did you really donate $6,000 worth of office supplies to a charity, and do you have the receipts to back that up? The IRS routinely checks returns for deductions that seem outlandish.[2]

Living large. Does the IRS peruse social media? Yes it does, as we all do. The IRS has done good detective work for years; its investigators know to check out DMV and employment records to get a better picture of an errant taxpayer. Today, photos and posts on Facebook and Twitter can telegraph potentially valuable nuggets of information, particularly about young taxpayers who have come into wealth that their returns don't seem to show.

Keep it simple. File early and accurately. Keep your receipts and other pertinent papers on file. Spend a little time each month arranging your financial matters so that taxes can remain a relatively painless process.

— Mico

1 - time.com/3721148/irs-tax-returns-audits/ [2/24/15]
2 - kiplinger.com/slideshow/taxes/T056-S011-irs-audit-red-flags/index.html [3/15]
3 - bankrate.com/financing/taxes/irs-catches-millions-of-math-mistakes/ [3/31/15]

Tax Efficiency in Retirement

How much attention do you pay to this factor?

1 - ssa.gov/planners/taxes.htm [2/23/15]
2 - denverpost.com/business/ci_27383286/ira-vs-401-k-which-is-better [1/25/15]
3 - desmoinesregister.com/story/money/business/2014/11/01/jim-sandager-donate-shares-directly-charities/18304273/ [11/1/14]
4 - accountingweb.com/article/how-make-most-federal-annual-gift-tax-exclusion/224201 [12/18/14]

Will you pay higher taxes in retirement? Do you have a lot of money in a 401(k) or a traditional IRA? If so, you may receive significant retirement income. Those income distributions, however, will be taxed at the usual rate. If you have saved and invested well, you may end up retiring at your current marginal tax rate or even a higher one. The jump in income alone resulting from a Required Minimum Distribution could push you into a higher tax bracket. While retirees with lower incomes may rely on Social Security as their prime income source, they may pay comparatively less income tax than you will in retirement – because up to half of their Social Security benefits won't be counted as taxable income.1 Given these possibilities, affluent investors would do well to study the tax efficiency of their portfolios as some investments are not particularly tax-efficient. Both pre-tax and after-tax investments have potential advantages.

What's a pre-tax investment? Traditional IRAs and 401(k)s are classic examples of pre-tax investments. You can put off paying taxes on the contributions you make to these accounts and the earnings these accounts generate. When you take money out of these accounts come retirement, you will pay taxes on the withdrawal. Pre-tax investments are also called tax-deferred investments, as the invested assets can benefit from tax-deferred growth.

What's an after-tax investment? A Roth IRA is a classic example. When you put money into a Roth IRA during the accumulation phase, contributions aren't tax-accumulation phase, contributions aren't tax-deductible. As a trade-off, you don't pay taxes on the withdrawals from that Roth IRA (as long as the withdrawals are considered qualified). Thanks to these tax-free withdrawals, your total taxable retirement income is not as high as it would be otherwise.[2] As everyone would like to pay less income tax in retirement, the tax-free withdrawals from Roth IRAs are very appealing. Given the huge federal deficit, the pressure is on to raise tax rates in the coming years – and in that light, after-tax investments look even more attractive.

It is also possible to convert a traditional IRA to a Roth IRA, so many investors are considering paying taxes on a Roth conversion today in order to get tax-free growth tomorrow. Certain tax years can prove optimal for a Roth conversion. If a high-income taxpayer is laid off for most of a year, closes down a business or suffers net operating losses, sells rental property at a loss or claims major deductions and exemptions associated with charitable contributions, casualty losses or medical costs ... he or she might end up in the lowest bracket, or even with a negative taxable income. In circumstances like these, a Roth conversion may be a good idea. Should you have both a traditional IRA and a Roth IRA? It may seem redundant, but it could actually help you manage your marginal tax rate. It gives you an option to vary the amount and source of your IRA distributions in light of whether tax rates have increased or decreased.

Smart moves can help you reduce your taxable income & taxable estate. An emphasis long-term capital gains may help, as they aren't taxed as severely as short-term capital gains (which are taxed at the same rate as ordinary income). Tax loss harvesting (selling the "losers" in your portfolio to offset the "winners") can bring immediate tax savings and possibly help to position you for better long-term after-tax returns. If you're making a charitable gift, giving appreciated securities you have held for at least a year may be better than giving cash. In addition to a potential tax deduction for the fair market value of the asset, the charity can sell the stock without triggering capital gains. If you're reluctant to donate shares of your portfolio's biggest winner, consider this: you could donate the shares, then buy more of that stock and get a step-up in cost basis as a consequence.[3]

The annual gift tax exclusion gives you a way to remove assets from your taxable estate. In 2016, you can gift up to $14,000 to as many individuals as you wish without paying federal gift tax. If you have 11 grandkids, you could give them $14,000 each – that's $154,000 out of your estate. The drawback is that you relinquish control over those dollars or assets.[4]

-- Barbie

Understanding the Gift

Most of us will never face taxes related to money or assets we give away.

1 - turbotax.intuit.com/tax-tools/tax-tips/Tax-Planning-and-Checklists/The-Gift-Tax-Made-Simple/INF12127.html [2/24/15]
2 - schwab.com/public/schwab/nn/articles/The-Estate-Tax-and-Lifetime-Gifting [1/28/15]

"How can I avoid the federal gift tax?" If this question is on your mind, you aren't alone. The good news is that few taxpayers or estates will ever have to pay it. Misconceptions surround this tax. The IRS sets both a yearly gift tax exclusion amount and a lifetime gift tax exemption amount, and this is where the confusion develops. Here's what you have to remember: practically speaking, *the federal gift tax is a tax on estates*. If it wasn't in place, the rich could simply give away the bulk of their money or property while living to spare their heirs from inheritance taxes. Now that you know the reason the federal government established the gift tax, you can see that the lifetime gift tax exclusion matters more than the annual one.

"What percentage of my gifts will be taxed this year?" Many people wrongly assume that if they give a gift exceeding the annual gift tax exclusion, their tax bill will go up next year as a result. Unless the gift is huge, that won't likely occur. The IRS has set the annual gift tax exclusion at $14,000 this year. What this means is that you can gift up to $14,000 *each* to as many individuals as you like in 2016 without having to pay any gift taxes. A married couple may gift up to $28,000 each to an unlimited number of individuals tax-free this year – this is known as a "split gift". Gifts may be made in cash, stock, collectibles, real estate – just about any form of property with value, as long as you cede ownership and control of it.[1] So how are amounts over the $14,000 annual exclusion handled? The excess amounts count against the $5.45 million lifetime gift tax exemption (which is periodically adjusted upward in response to inflation). While you have to file a gift tax return if you make a gift larger than $14,000 in 2016, you owe no gift tax until your total gifts exceed the lifetime exemption.[1]

"What happens if I go over the lifetime exemption?" If that occurs, then you will pay a 40% gift tax on gifts above the $5.45 million lifetime exemption amount. One exception, though: all gifts that you make to your spouse are tax-free provided he or she is a U.S. citizen. This is known as the marital deduction.[1,2]

"But aren't the gift tax and estate tax exemptions linked?" They are. The gift tax exemption and the estate tax exemption are sometimes called the *unified credit.* So if you have already made taxable lifetime gifts that have used up $4 million of the current $5.45 million unified credit, then only $1.45 million of your estate will be exempt from inheritance taxes if you die in 2016.[2] However, the $5.45 million unified credit extended to each of us is portable. That means that if you don't use all of it up during your lifetime, the unused portion of the credit can pass to your spouse at your death.[2]

-- Jim

Fun Fact

Maine has a special tax on blueberries, which are a valuable state resource. 99% of wildblue berries in the US are produced in Maine so it makes sense that the state wants to stay on the cutting edge of research and production. The tax is allotted for those purposes.