FINANCIAL SERVICES ADVISORY
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10 Reasons For The IRS To Flag Your Return

What sets off alarm bells at the IRS? Due to limited resources, the IRS only audits around 1% of all federal individual tax returns, while the other 99% skate through unexamined. Nevertheless, it pays to keep in mind these 10 "red flags" that could increase the chance you'll be tapped for an audit.

1. High income. The audit rate for 2011 tax returns, which was about 1.11% overall, jumped to 3.93% for taxpayers with income of $200,000 or more. That's almost one out of every 25 returns. The IRS tends to chase the "big money," and while that's no reason to earn less, you should realize that higher income exposes you to a greater audit risk.

2. Unreported income. The IRS computers match up the income listed on W-2 and 1099 forms with the income reported on individual returns. You're likely to draw IRS scrutiny if you don't report all of your taxable income or if you underreport the total, even if an omission is inadvertent. Check your tax forms to ensure the information is accurate.

3. Large charitable gifts. Besides providing personal satisfaction, deductions for charitable gifts can offset highly taxed income on your return. But the IRS may become suspicious if the amount you deduct is disproportionate to your income. In particular, make sure that deductions for gifts of property are legitimate and include an independent appraisal when required.

4. Home office deductions. If you qualify, you can write off your direct costs of using part of your home as an office, plus a percentage of everyday living expenses such as property taxes, mortgage interest, utilities, phone bills, insurance, etc. But the basic rule is that you must use the office "regularly and exclusively" as your principal place of business. Simply doing work at home when your main office is elsewhere won't cut it.

5. Rental real estate losses. Generally, "passive activity" rules prevent investors from deducting losses on rental real estate. But a special exception allows a loss deduction of up to $25,000 for "active participants," subject to a phase-out between $100,000 and $150,000 of adjusted gross income (AGI). Another exception applies to qualified real estate professionals. The IRS may zero in on taxpayers claiming losses under either exception.

6. Travel and entertainment expenses. This is often a prime audit target. IRS agents particularly look for self-employed individuals and other business owners who claim unusually large write-offs for travel and entertainment expenses and meals. Note that the tax law includes strict substantiation rules that must be followed in order to deduct any of these expenses.

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What Is Safe For You To Put Into A Safe Deposit Box?

Do you have a safe deposit box at your bank? That's a good idea if you need a secure place to store valuables and important papers. But be aware that a safe deposit box isn't the best place for everything.

What should you keep in the box? Unless you are an international spy needing multiple passports, currencies and firearms, mostly they are items you can't afford to lose or that would be extremely difficult to replace. This includes birth certificates, marriage certificates, a list of your insurance policies (usually, if you have the company name, insured and policy number, these can easily be replaced), trust and IRA documents, property deeds, rare coins, jewelry, stock or bond certificates, foreign currencies, treasured family photos, and other heirlooms. Don't worry about privacy because the bank can't snoop in its boxes. In fact, when you place items in the box, you can do so behind closed doors.

What should you keep out of the box? Basically everything else, including your will and related estate-planning documents. Depending on state law, a court order may be required to unseal the box if the owner dies. It's better to keep your will in a fire-proof safe accessible to other family members. You might also consider keeping a password protected electronic copy of any documents you hold in the box itself OUTSIDE of the box for ease in reference and access.

Also, don't use a safe deposit box to store documents such as a power of attorney that might be needed suddenly in case of an emergency.

Jim Joseph, CFP®
Vice President

"Ghost Story" Can Haunt Your IRA

The rules for contributing to an IRA are relatively simple. You put in the money for each tax year by the required deadline—the tax return due date for the year of the contribution—and tell the account custodian how you want the funds invested. In addition, you might roll over funds to an IRA from a 401(k) or another kind of "qualified plan" at work when you change jobs or retire. That way, your money can continue to grow without being eroded by taxes until you make a withdrawal.

The rules for *distributions*, in contrast, are extremely complex. In particular, complications may arise as you approach the time for taking "required minimum distributions" (RMDs) from your IRA. Make the wrong moves and your heirs might be forced to receive payouts based on your "ghost life expectancy."

For IRA owners, the "required beginning date" (RBD) for RMDs is April 1st of the year after the year in which they turn age 70½. For instance, if someone reaches that age on June 1, 2013, the RBD is April 15, 2014. The amount of the RMD is based on the value of your accounts on December 31st of the tax year of the RMD—in this example, 2013—and is calculated according to an IRS-approved life expectancy table. And here's where things get complicated.

If you die *before* the RBD and have designated a "qualified beneficiary" such as a child or spouse, the RMDs are generally based on the beneficiary's life expectancy. (Surviving spouses also have the option of rolling over the funds into their own IRAs.) However, if you haven't designated a beneficiary or you named a "non-qualified beneficiary" such as your estate, the IRA must be emptied out in five years. Conversely, if an IRA owner dies *after* the RBD, payments to a beneficiary are still based on the beneficiary's life expectancy, but payments to a non-qualified beneficiary must use the owner's ghost life expectancy.

A ghost life expectancy isn't as scary as it sounds. It's how long the IRA owner would be expected to live—if he or she hadn't already died. But using an older owner's life expectancy table will still drain the IRA faster than usual.

Suppose that Walter Mason, age 80 and single, has $750,000 in his IRA. Walter named his estate as the beneficiary of his IRA. He dies on July 1, 2013 without taking an RMD for the 2013 tax year.

Because Walter designated a non-qualified beneficiary, RMDs for 2013 and future years will be based on his ghost life expectancy. The payment for 2013 under the single-life expectancy table is $40,107. Under this method, payments will be greater than the amounts that would have been required if Walter had designated a qualified beneficiary.

Good planning can minimize the impact of RMDs and help preserve your retirement nest egg. ●

Do You Know Life Insurance Basics?

Most breadwinners recognize the importance of life insurance. If you should die unexpectedly, your family could face a severe financial squeeze, perhaps having to sell the home and give up other lifestyle comforts. With an adequate policy, your beneficiaries may be able to pay off the mortgage (or make a sizable dent in it), take care of funeral expenses, and meet a wide variety of other financial obligations.

But do you really know all you need to know about life insurance? How about the differences between permanent and term insurance? What about other types of policies? What sorts of riders are available? What are the income tax and estate tax consequences?

It's surprising how little some people truly understand about life insurance. How do you stack up? Here's a brief quiz on several basic concepts:

1. Which of the following is true about permanent life insurance?

a) It provides a cash value in addition to a death benefit.
b) It is limited to the spouse with the greater amount of earnings.
c) The policy can never be voided.
d) The death benefit is limited to $1 million.

2. Which of the following is true about term insurance?

a) It cannot be purchased if you are retired.
b) It generally has a lower initial premium than whole life insurance.
c) Underwriting approval is automatic.
d) The death benefit is limited to $1 million.

3. The rule of thumb is to acquire life insurance protection equal to:

a) The value of your home.
b) Your salary multiplied by your number of children.
c) Three times your annual expenses.
d) Five to seven times your annual income.

4. Whole life insurance is best described as a:

a) Type of permanent life

7 Major Tax Changes In The Fiscal Cliff Law

From the edge of the "fiscal cliff," Congress took a step back and approved the American Taxpayer Relief Act (ATRA), a hodgepodge of tax extensions and modifications. But the agreement postponed decisions on spending cuts and failed to continue a 2% "payroll tax holiday" for employees. Moreover, upper-income taxpayers will have to shoulder a greater burden going forward. Here are seven noteworthy changes for individuals.

1. Individual Tax Rates. Across-the-board tax hikes are averted and the "marriage penalty" is eased. Nevertheless, ATRA creates an "extra" top tax rate of 39.6% for single-filers with income above $400,000 and joint-filers with income above $450,000. When you add in the new 3.8% Medicare surtax for certain upper-income investors, which begins in 2013, your effective top tax rate can reach 43.4%!

2. Capital Gains And Dividends. The "Bush tax cuts" for capital gains and dividends are generally preserved. The maximum tax rate remains 15% for net long-term capital gain and qualified dividends (0% for investors in the lowest tax bracket). Otherwise, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket). Even worse, dividends would have been taxed at ordinary income rates. But the upper crust still pays a steep price: a maximum 20% tax applies to single-filers with income above $400,000 and joint-filers with income of more than $450,000.

3. Alternative Minimum Tax. The onerous alternative minimum tax (AMT), which has steadily been casting a wider net each year, is overhauled. Under ATRA, exemption amounts have been increased and nonrefundable personal credits can be used to offset AMT liability in full. In addition, the exemption amounts will be indexed for inflation in the future. Because the changes are retroactive to the 2012 tax year, it's been estimated they will save as many as 60 million taxpayers from the clutches of the AMT.

4. Itemized Deductions And Personal Exemptions. Two other "back-door" tax increases may affect taxes of wealthier individuals. Due to the revival of the "Pease rule," most itemized deductions are reduced by 3% of the amount of adjusted gross income (AGI) above a specified threshold, beginning in 2013 (but the overall reduction can't exceed 80%). At least ATRA establishes higher thresholds of $250,000 for single-filers and $300,000 for joint-filers. A comparable provision begins to phase out the tax benefits of personal exemptions at the same thresholds.

5. Education Tax Breaks. ATRA generally extends several valuable tax incentives relating to higher education. Significantly, it allows parents to claim the maximum $2,500 American Opportunity Tax Credit (AOTC) for another five years, subject to a phaseout based on modified adjusted gross income (MAGI). It also extends the above-the-line deduction for tuition and fees, also phased out based on MAGI, through 2013. This deduction may be claimed in lieu of a higher education credit. The tuition deduction extension is retroactive to 2012. Finally, ATRA permanently extends enhancements for Coverdell Education Savings Accounts (CESAs), the tax exclusion for employer-provided education assistance and the student loan interest deduction.

6. Extensions Of Other Rules. Besides those already mentioned, ATRA extends a host of other tax provisions for individuals, many of them retroactive to the beginning of 2012 (i.e., for provisions that technically expired). Most of the extended tax breaks are limited by dollar amounts. This includes:

- Optional state sales tax deduction (in lieu of state income tax)
- Enhanced child tax credit, dependent care credit and adoption credit (and tax exclusion for adoption program assistance)
- Credit for energy-saving at home
- Monthly tax exclusion for certain commuting benefits
- Deduction for mortgage insurance premiums
- Deduction for classroom expenses of educators
- Tax exclusion for mortgage debt forgiveness
- Tax benefits for donating real estate for conservation purposes
- Tax-free distributions of IRA funds to charity by those age 70 ½ or over

7. Estate And Gift Taxes. At long last, there's greater certainty in estate planning. Beginning in 2013, the unified estate and gift tax system permanently retains a $5 million exemption and will be indexed annually for inflation ($5.25 million in 2013), instead of plummeting from $5.12 million in 2012 to $1 million. The top estate tax rate, which was scheduled to jump from 35% in 2012 to 55% in 2013, is bumped up to 40%. ATRA also retains the provision allowing "portability" of estate tax exemptions between spouses and coordinates various other aspects, including implementation of the generation-skipping tax.

These are just some of the highlights of the fiscal cliff law. We will be offering further guidance on the tax law changes, but please don't hesitate to call us about how the changes affect you personally. ●

insurance policy.
b) Type of term life insurance policy.
c) Contract with an insurer to provide future payments.
d) Retirement plan sponsored by an insurer.

5. Universal life insurance is best described as a:
a) Type of permanent life insurance policy.
b) Type of term life insurance policy.
c) Contract with an insurer to provide future payments.
d) Retirement plan sponsored by an insurer.

6. An annuity is best described as a:
a) Type of permanent life insurance policy.
b) Type of term life insurance policy.
c) Contract with an insurer to provide future payments.
d) Retirement plan sponsored by an insurer.

7. A permanent life insurance policy may be:
a) Sold before the insured's death.
b) Used as collateral on a car loan.
c) Exchanged tax-free for a mutual fund investment.
d) Voided due to a disability.

8. Life insurance proceeds paid to a beneficiary are:
a) Treated as a taxable gift.
b) Treated as a tax-free gift.
c) Exempt from federal income tax.
d) Exempt from federal estate tax.

Answers: 1-a; 2-b; 3-d; 4-a; 5-a; 6-c; 7-a; 8-c

How To Choose Trustees For Your Trust

Many high-net-worth people rely on trusts to minimize taxes and keep wealth in the family. But who should serve as trustee? A survey by Spectrem Group shows many wealthy investors who create trusts designate themselves or a family member as the trustee. But are family members the best choice?

Trustees have many complex responsibilities. The primary obligation is to distribute assets and trust income according to the wishes of the grantor - the person who establishes the trust. But the job also involves keeping records, investing assets, filing tax returns, and resolving conflicts.

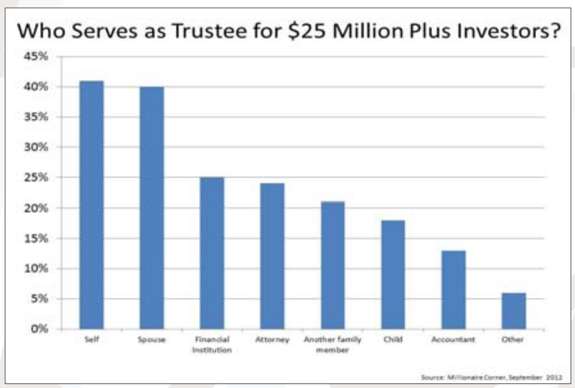
Among affluent investors, Spectrem reports, 41% serve as their own trustee, 40% name their spouse, 21% name another family member, and 18% name their child. Just 25% name a financial institution, while 24% name their attorney and 13% appoint their accountant. (The numbers add up to more than 100% because some grantors name more than one trustee, known as co-trustees.)

Many investors appoint family members because they believe they will serve the interests of the beneficiaries. Also, family members often are paid little or nothing for their service.

However, trust experts say family members often have problems trying to administer a trust. They may not understand legal and regulatory issues, and sometimes may grant distribution requests too freely, draining the assets.

An outside professional can provide the expertise needed, along with an objective viewpoint. Sometimes the best solution is to appoint a family member along with a trust expert as co-trustees. The professional ensures the trust is properly handled, while the family member may be in a better position to deal with family issues.

Here are four reasons to consider appointing a trust professional as trustee or co-trustee:



- A corporate trustee will continue as administrator for the term of the trust—even if that covers multiple generations. Any family member appointed as trustee eventually will die or become unable to continue. Grantors usually appoint a back-up, but that person, too, won't be able to serve indefinitely.
- A corporate trustee is held to an even higher standard under state and federal regulations than regular trustees. All trustees must interpret all trust documents to serve the best interests of the beneficiaries. The trustee works for the grantor, not the beneficiaries, and is guided by the trust documents.
- Trust specialists have the knowledge and experience required to comply with all legal and regulatory requirements.

A corporate trustee brings objectivity and ensures that any conflicts or questions are resolved in a legally appropriate manner.

Charles Schwab now offers trustee services. Please call us for details and to determine whether it makes sense for you. ●

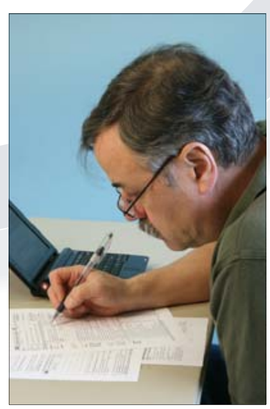
Reasons For The IRS

(Continued from page 1)

7. Business use of cars. Another area ripe for abuse by taxpayers is the use of a vehicle for business purposes. The annual amount you can claim via depreciation deductions for the vehicle, based on percentage of business use, is limited by so-called "luxury car" rules. IRS agents have been trained to ferret out taxpayer records that don't measure up. Another danger signal is a claim for 100% business use of a vehicle, especially if another vehicle isn't available for personal use.

8. Hobby losses. As a general rule, you can deduct expenses for a hobby only up to the amount of the income it produces. You normally can't claim a loss for the activity, unless your involvement rises to a level of abona fide business. Usually, an activity is presumed not to be a hobby if you show a profit in any three out of the past five years, but the IRS can rebut this presumption.

9. Foreign bank accounts. The IRS has started clamping down on taxpayers with offshore accounts in "tax havens" in which banks may not disclose account information. Failure to report foreign income can trigger steep penalties and interest. If you have foreign bank accounts, make sure you properly report the income when you file your return.



10. Cash businesses. Finally, if you operate a small business in which you're generally paid in cash—for example, if you own a car wash, restaurant or tavern, or a hair or nail salon—the IRS is more likely to examine your return. Past history indicates that cash-heavy taxpayers may underreport their income or, in some cases, not report any income at all. Accordingly, the IRS remains on high alert.

These red flags certainly don't mean you should shy away from claiming the tax breaks you rightly deserve. Just be prepared to defend your turf if the IRS ever comes calling. ●