NATIONAL ENDOWMENT FOR FINANCIAL EDUCATION

NOW IS THE BEST TIME TO PREPARE FOR NEXT YEAR'S TAX SEASON

Planning Ahead Can Save You Money and Stress

ENGLEWOOD, COLORADO—Ah, summertime. It evokes images of picnics, baseball, lazy afternoons, vacations…and taxes?

Yes, taxes.

"People still may be recovering from completing their 2002 tax returns, but now is a great time to begin planning for 2003," says William L. Anthes, Ph.D., president and CEO of the Colorado-based National Endowment for Financial Education® (NEFE®). NEFE is an independent nonprofit foundation whose mission is to educate Americans about personal finance. Anthes advises that there are a lot of tax strategies you shouldn't postpone implementing until the end of 2003 or April of 2004. "To make filing next year's returns as painless as possible," he says, "you need to take action now."

Identifying Your Own Tax Mistakes

One of the first steps Anthes recommends is to look back at your 2002 tax return, while it's still fresh in your mind, and think about what you might have done differently. Did you need to file an extension because you weren't finished by April 15? Did you receive a large tax refund? Were you frustrated because you didn't have all the right documentation? Do you sense that you missed out on legitimate tax deductions? Are you worried about an audit for the deductions you did claim?

Consider, for example, a large tax refund. According to the IRS, the average refund for the 2002 tax year was running just under $2,000 shortly before the April 15 deadline. Why is getting back a large refund a problem? "It means you've extended Uncle Sam a big tax-free loan during the year—money you could have invested or used for critical expenses that you may have covered with a loan instead," says Anthes.

For some taxpayers, of course, overpaying taxes during the year works like a forced savings program. But the money doesn't stay "saved" for long. When people receive their refund, usually they either invest it or spend it anyway. So why wait? Instead, reduce the amount of federal income taxes being withheld from your paycheck by increasing the number of allowances you claim on your W-4 form. Take that extra money that otherwise would have gone toward taxes each paycheck and invest it, perhaps in a tax-deductible retirement account (which will save you still more in taxes).

Did you suffer the opposite problem on your 2002 return? Did you end up owing money—perhaps so much money that you had to pay penalties and interest? If this was the result of a large bonus at the end of the year that wasn't taxed sufficiently, it's something you might be able to adjust for in 2003 by decreasing the number of W-4 allowances on your year-end paychecks. Or did you owe money because you neglected to pay or underpaid estimated taxes on money not subject to withholding, such as income from consulting or retirement distributions? You can avoid estimated payment penalties next year by making sure that your quarterly estimated payments, or a combination of estimated payments and withholding, will equal at least 90 percent of your 2003 total tax bill or 100 percent of last year's tax bill. (The minimum "safe harbor" is higher than 100 percent for high-income earners.) For example, imagine your total tax liability for 2002 was $6,870. For 2003, if you have withholding and/or estimated payments of at least $6,870, you will incur no penalties for underpayment of estimated tax, regardless of what amount you might owe for this year. Alternatively, paying 90 percent of your tax liability through estimated payments and withholding will provide protection from underpayment penalties. Thus, if your 2003 tax liability is $7,000, you will meet this exception if you pay at least $6,300 (90 percent of $7,000).

Keeping Accurate Tax Records

Did you find that when you prepared your 2002 return, you had difficulty putting your hands on necessary financial documents or receipts, or that some records were missing altogether? Did this cause you to file in a hurry or perhaps even late?

"Keeping complete and organized tax records during the year is crucial to making filing easier and more accurate," says Anthes. "But more important to most taxpayers, good record keeping can save you money."

The General Accounting Office released a report in 2002 estimating that one million people annually overpay their income taxes by nearly $500 a year because they fail to itemize their deductions. While some expenses can be calculated and deducted easily when you sit down to prepare your taxes, many need to be tracked during the year. Otherwise, you'll either forget about some deductible expenses, or you won't be able to document a deduction you want to claim. For example, claiming charitable deductions, such as donated clothing and household items, requires receipts that prove you gave the items to a qualified charity. If you don't collect the receipts or can't find them, you can't claim the deduction.

Another example of a costly tax mistake that occurs when you don't keep good records involves the buying and selling of taxable mutual funds: those funds you're not holding in tax-favored retirement accounts. Say you sell a mutual fund you've held for three years and, despite declines it may have suffered from the bear market, you still made a profit and now face capital gains taxes on your profit. Unthinking taxpayers might calculate their gains based on the difference between what they originally paid for fund shares (their basis) and the amount for which they sold them. Smart taxpayers would add any reinvested capital gains and dividends distributed by the fund (on which they paid taxes in the year of distribution). Transaction costs and load fees would be reflected in the purchase or sales information reported by the mutual fund company. Thus, the true basis for the shares you're selling, which you'll subtract from the value of what you sold, would be the value of the original purchase plus reinvested dividends and capital gains. For example, imagine that three years ago you purchased 1,293.661 shares of a mutual fund at $7.73 per share. You reported the following amounts of income dividends, all of which were reinvested:

Year	**Amount**
2000	$727
2001	$414
2002	$109

During 2003, you sold all of your fund shares for $10,500. Your gains and losses are calculated as follows:

Sales price	$10,500
Original cost	$10,000
Reinvested dividends (727+414+109	1,250
Total basis	$11,250
Loss on sale	$750

Had you not included the reinvested dividends in your fund basis—a common mistake—your taxable gain would have been incorrectly overstated by $1,250.

But you can't get an accurate picture of that basis if you don't keep your mutual fund statements reflecting those additions. Paperwork? Yes. Money saved? Definitely.

Monitoring Your Financial and Personal Situations

Now and in the coming months is also a good time to review changes in your personal and financial circumstances that might affect your tax liabilities. For example, imagine that you've sold some stock this year that made a profit. You can offset some of those profits by selling off some losers. (Or vice versa: offset a realized loss by selling winners.) Investment experts don't recommend making investment decisions based solely on tax savings, but if it makes *investment* sense to sell, it's something to consider. To make it work, however, you have to think about it soon and sell before the end of the tax year. This concept, often referred to as loss harvesting, takes advantage of the netting of capital gains with capital losses. Offsetting an otherwise taxable gain with a capital loss effectively shields the gain from current taxation.

Did you receive a substantial raise this year? Divert some or all of that money into your retirement accounts, if you aren't already contributing the maximum. That will help offset a higher tax bill due to increased income, while simultaneously building a bigger nest egg. If you happen to turn 70 ½ this year, you may need to start taking minimum withdrawals from your retirement accounts. That means a higher tax bill you'll need to cover with increased estimated tax payments.

Another deduction strategy that can be accomplished only during the tax year is to "bunch" expenses. In the case of medical deductions, for example, taxpayers can deduct only those medical expenses that exceed 7.5 percent of their adjusted gross income (AGI). A person with a $65,000 AGI, for example, couldn't deduct the first $4,875 in medical expenses, but he or she could deduct for every qualified dollar above that. To exceed that 7.5 percent threshold in a given year, you may want to bunch voluntary medical expenses, such as orthodontia and elective surgery, into a single year.

You'll also want to keep a close watch on your personal circumstances, as these can affect your financial situation as well. For instance, you'll be able to take a tax exemption for a child born in 2003 even if the birth is as late as December 31. That exemption will lower your taxes for the entire year, so if you are expecting a child, you might want to increase your W-4 allowances now in order to have less tax withheld.

"It's never fun to think about your taxes on a warm summer Saturday afternoon, but the effort can save you a lot of headaches and, potentially, a lot of money when you're laboring over your taxes on a wet spring day next year," says Anthes.