EDUCATIONAL BENEFITS GROUP

Providing solutions to make college an affordable reality

Other Money Saving Ideas

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OTHER MONEY SAVINGS IDEAS

According to a report from the College Board **"Trends In College Tuition",** the average tuition for 2004-2005 at a four-year public college and university is $5,826, up form $5,287 in 2003-2004. This is an increase of 10.2%. Private four-year college tuition increased by 5.5%, from $23,740 to $25,123. While tuition has run more than 100% ahead of the Consumer Price Index since 1981, median family income has risen only 27% in real terms. Tuition is, of course, not the only expense associated with attending postsecondary education.

Meanwhile, student financial aid has not kept up with the rise in tuition, and most of the growth in aid has only been in the form of student loans.

For some families financial aid is sometimes a remote possibility. Therefore, proper money management and tax planning is a **MUST** if they are to cut college educational expenses. The following money savings ideas can be very helpful to families that are looking to find money to pay present or future educational costs.

How To Use Your Credit Card To Earn 28% On Your Money!

Let's say you put $100 in the bank and earned 28% (nice thought). In one year, you'd earn $28. If you were in the 34% tax bracket (28% federal + 6% state), that would leave you with an after-tax return of $18.48 ($28 x .34 = $9.52 - $28 = $18.48). But what if you used the $100 to pay off a credit card debt charging you 18.5% interest? Since you are using after-tax dollars, you would save $18.48 in finance charges in the course of the year. That's a return of 18.48% - almost exactly the after-tax return on your 28% investment.

Common Tax Return Mistakes!

Medical expenses:

- Forgetting to deduct the premium charged for Supplementary Medicare (Part B).
- Failing to check auto-insurance policies and dependent's student-fee charges at college. Often, there is a separate charge for medical coverage that can be deducted.
- Overlooking taxi or bus fares to and from the doctor's office.
- Not deducting parking fees and tolls in addition to the per mile rate that can be deducted when you use your car for medical travel.
- Not including trips to the drugstore, optician or other health facility in medical travel.

Interest expenses:

- In the case of buying or selling a home, forgetting to deduct mortgage interest – and real estate tax – on a prorated basis.
- Forgetting to deduct penalties you've paid on premature savings withdrawals.
- Overlooking the mortgage prepayment penalty assessed against you.

Charitable Deductions:

- Neglecting to calculate charitable mileage for you and your spouse for church, school, scouting and other volunteer activities. Deduction for charitable mileage is set at 14¢ a mile (for 2002)

- Not deducting the charitable percentage of **National Geographic, Smithsonian** and similar organization dues in excess of the value of the subscription received.

- Not including the excess of payments for holiday cards and other items purchased from charities over value received.

- Forgetting to document and deduct out-of-pocket expenses incurred on behalf of charitable activities – such as Scout leaders' uniforms, donated purchases.

- Not listing excess cost of attending charitable benefits or of purchasing property for a charity (for example, public television auction) over value received.

Investment expenses:

- Not claiming stock transfer taxes as an itemized deduction on Schedule A. Most people simply include it in the cost basis of their stock because it is included in the net figure on the confirmation slips they get from their broker. This deduction is worth up to 2 ½ times as much if you treat it as an itemized deduction.

- Not counting newspapers or other publications that you buy to keep track of investment information.

- Not deducting the fee for a safe-deposit box holding your stocks, bonds, and other income producing assets.

- Not claiming a deduction for investment counseling fees.

- Overlooking the cost of alarm systems and home safes that are used primarily to protect investments, such as art or coin collections.

Interest and dividend income:

- Not checking to make sure the dividend income you are reporting is fully taxable. Some part of it may be a nontaxable distribution.

- Forgetting to elect to report annual interest earned on Series EE or I Bonds owned by children to take advantage of their low tax bracket.

How To Minimize Taxes On Mutual Fund Sales

Taxes owed after a mutual fund sale depend on your calculation method…

The **average cost** method is easiest to use. Ask the fund to tell you the average cost of all shares you bought. Compare it with the price you received when selling to determine your profit and tax liability.

FIFO (first-in first-out) assumes that the first shares you bought – usually at the lowest price – are the first you sold. This can increase your profit – and your tax liability.

Specific identification requires you to tell the IRS exactly which shares you have sold. Picking shares with the highest price will cut your taxable gain, but you must have careful records to back it up.

Divorce And Separation Tax Loopholes

Though the parties in a divorce are often preoccupied with legal and emotional issues, they must understand the tax consequences of the arrangements they're making if they want to minimize their financial discomfort. **Divorce is full of hidden tax traps and loopholes…**

Alimony and child support. Alimony is deductible by the person who pays it and taxable to the person who receives it. Child support, on the other hand, is neither deductible by the payer nor taxable to the recipient.

Loophole I: The distinction between alimony and child support is important where there is a disparity between the spouses' incomes. In such a case, it pays for the higher-earning spouse, who is making the payments, to have as much of them as possible categorized as tax deductible alimony. That spouse can cover the other spouse's tax and still save taxes by paying alimony rather than nondeductible child support.

Example: Assume the husband is in the 38% tax bracket (total of federal and state) and the wife is in the 18% bracket. Instead of paying $10,000 in child support and $10,000 in alimony, he pays the full $20,000 as alimony. In addition, he pays the wife for the tax she'll owe on the extra $10,000 and on the money he's giving her for the taxes – a total of $2,200. The husband's tax savings for the extra $12,200 is $4,600. **Husband's savings:** $2,400 – that is, $4,600 minus $2,200.

Loophole II: Alimony payments do not have to be made directly to the spouse. They can be made on behalf of the spouse, provided they are in cash.

Example: Medical and life insurance premiums…mortgage payments.

Loophole III: In order to qualify as alimony, payments must stop when the recipient remarries. Some agreements provide for a bonus to be paid to the ex-spouse when he/she remarries. That is not considered alimony because it is not paid over a number of years – another requirement for alimony payments.

Worse: The bonus would actually be considered a taxable gift. To avoid this result, the bonus should be made a part of the couple's property settlement agreement. Then it would not be a taxable gift, since property settlements are not subject to gift tax.

Property Settlements. They are not subject to gift tax because of the unlimited marital deduction – one spouse can give any amount of property to the other spouse gift-tax free. Property settlements can be made in a lump sum or periodically. If made periodically, there is no tax effect unless the payments are considered to be alimony. Often, the only difference between alimony and property settlement payments is the label the parties put on them. However, the type of assets being distributed in a property settlement is important.

Trap: Assets are sold by the party who received it, capital gains tax is payable on the difference between the sale price and the tax cost of the asset.

Loophole: The person receiving the property will want to get high tax-cost assets, and the person giving the property will want to give away low tax-cost assets.

Example: The wife get $100,000 in cash and the husband gets stock worth $100,000 that has an original cost of $20,000. The wife's tax cost in her share of the settlement is $100,000. But the husband's tax cost is only $20,000. If he subsequently sold the stock for $100,000, he would have to pay a capital gains tax on the $80,000. This is an unequal distribution of assets.

Filing Status: Normally, if a couple is legally married on the last day of the year, they must file a joint return or separate returns as married people filing separately. But if a person hasn't lived with his/her spouse for the last six months of the year and he/she has a dependent child, that person can file a return as head-of-household. The tax rates for this filing category are lower than the rates for married filing separately.

Exemptions for Dependents: The parent who has custody of the children is automatically entitled to claim dependency exemption for them – unless the divorce agreement says otherwise.

Loophole: The exemptions can be signed over to the non-custodial parent on IRS Form 8332. The release of the exemptions can be made for one tax year, a number of years or all future years. Best: One year at a time. One big reason for this is when the child or children reach the age in which they will attend college, the financial aid application asks for information on the custodial parent (s) only. If the non-custodial parent claims the student as a dependent the custodial parent will lose the potential of receiving the Hope and Lifetime tax credits as well as losing the child as a personal exemption for tax purposes, thus higher taxes.

Medical Expenses For Dependents: If the parent who does not claim the exemptions for the children and makes medical insurance payments on behalf of the children, the payments can be deducted as a medical expense on that person's tax return. For the purpose of the medical expense deduction, a child who is supported by one of the parents can be considered to be a dependent of both parents.

Life Insurance: Often, as part of a divorce agreement, the husband takes out a life insurance policy that names the ex-wife as beneficiary.

Trap: When the husband dies, the life insurance proceeds are included in his estate – and may be taxed.

Loophole: Have the ex-wife own the policy on the husband's life. Have the husband pay additional alimony or nondeductible property settlement amounts to cover the insurance premiums the wife must now pay. If the husband does not want the ex-wife to own the policy, he can set up an irrevocable life insurance trust. This will enable him to own the policy while keeping the policy out of his taxable estate.

Retirement Accounts: The divorce agreement may call for splitting up a retirement account. This can be done if the couple gets a qualified domestic relations order as part of the divorce settlement. The recipient of a share of a retirement account can roll it over tax free into and IRA.

Loophole: If the retirement account's payout is made pursuant to a qualified domestic relations order. It is not subject to the 10% early distribution penalty for payouts to individuals who are under age 59 ½.

Legal Fees: Part of the legal fees in connection with a divorce is deductible as a miscellaneous itemized expense (subject to the 2% floor on deductibility). The deductible part of legal fees is that which relates to tax advice and obtaining taxable income such as alimony. Be sure to get an itemized bill from your lawyer that clearly specifies what portion of the bill is for tax advice.

Nine Ways To Avoid Paying Capital Gains Taxes

Sometimes it pays to bite the bullet – pay the capital gains tax and reinvest the proceeds. If you have a winning investment record, this may be the thing to do. You may quickly regain the tax you paid. There are other times when it makes sense to avoid tax on your gains entirely. And there are times when it makes sense to defer the tax, such as when you child is ready to go to college. Here are nine perfectly legal ways to avoid and defer capital gains tax:

Offset Capital Gains With Capital Losses. This is an elemental avoidance technique. Capital losses offset capital gains dollar for dollar, thereby avoiding tax on the gains. You may want to repurchase the securities you sell at a loss. (You can do this if you wait 31 days to avoid the "wash-sale rule"). By repurchasing the securities, which you expect to appreciate in value, you're deferring tax on the appreciation until sometime in the future. So the repurchase is a deferral technique.

Donate Appreciated Property To Charity. From a tax standpoint, securities make the best gifts for this purpose. You get an income tax deduction for the securities' full fair-market value and you avoid paying tax on the appreciation in value since the date of purchase. These tax breaks enable you to make a large charitable contribution at little cost to yourself. If you are making regular contributions to your church or other charities, this is a great idea to give appreciated non-taxable property – get a tax deduction and use the regular contribution you were gifting and use this money to reinvest.

Example: Suppose you have a stock or mutual fund that's worth $10 and for which you originally paid $1. If you sold that stock, you'd have a gain of $9 on which you would have to pay tax. But if you donated the stock or mutual fund to charity, you'd get a tax deduction for $10 and you would not pay income tax on the $9 of gain. Now use the contributions you were giving the church or other charities and reinvest in the same stock or mutual fund using dollar-cost-averaging.

Problem: The new limitation on itemized deductions somewhat reduces the tax benefits upper-income individuals get from charitable donations. So check with your CPA or financial planner.

Let Your Heirs Inherit The Property. Your heirs inherit it at its "stepped-up" date-of-death value. The gain in the property's value between the time you bought it and your death is not taxed – it escapes tax permanently. If your heirs later sell the property, they'll pay tax only on the gain between the date-of-death value and the value at the time they sell it.

Borrow Against An Asset Instead Of Selling It. Selling it generates a taxable capital gain. Borrowing is not a taxable transaction. You may put yourself further ahead by borrowing than you would if you sold the asset and paid tax on your gain.

Selling Your Principal Residence. You can exclude from tax up to $250,000 of your gain ($500,000 in a joint return). This is an absolute exclusion – you totally and forever avoid paying tax on the gain. To qualify for this tax break, you must have owned and occupied the residence for two out of the previous five years.

Swap Business Or Investment Property For Similar Property. This is known as a **"Like-Kind Exchange,"** and it avoids current taxation. Your gain will not be recognized for tax purposes until the replacement property is sold. **"Like-Kind "** refers to the nature, character or class of property – not to the property's quality. The exchange of an office building for raw land would qualify as a Like-Kind exchange because it's an exchange of real estate for real estate. Similarly, the exchange of one investment-grade coin collection for another would qualify as a Like-Kind exchange. Exchanging a life insurance policy for an annuity or exchanging an annuity for another annuity is other examples. But you cannot exchange an annuity for a life insurance policy – **STRANGE!**

Caution: Only property held for productive use in a trade or business or for investment is eligible for this tax break. Furthermore, the Like-Kind exchange rules don't apply to property held primarily for sale, such as stocks, mutual funds, bonds and notes.

Use Installment Sales To Defer Tax On Gains. When you sell property on the installment basis, taking the purchase price in installments over a number of years, your gain is reported only as you receive the payments. On a five-year installment sale, you'd pick up one-fifth of the capital gains in each of five years. By spreading the gain out, you defer tax on much of it until later years. Spreading out the gain may also lower the total tax you pay. You may avoid a higher tax bracket by reporting only a portion of the gain each year. And you may benefit from lower capital gains rates in the future if Congress passes a rate cut.

Use Suspended Passive Losses To Shelter Passive Gains On The Sale Of An Investment. Gains and losses on investments, which you don't participate in materially, are "passive". The rule is that passive losses can be written off only against passive gains. But losses that accumulate because you don't have gains to write them off against can be brought into play when you sale the investment. The accumulated (suspended) losses can be used to offset the gain on sale.

Sell **"Short Against The Box."** This is the term for an investment maneuver that gives you a short-term deferral. The way to execute a short sale is to borrow from your broker the same number of shares of a particular stock as the number of shares you own. You sell the borrowed shares now and then complete the transaction next year by delivering you own shares to your broker.

The gain is not recognized for tax purposes until you deliver your shares to cover the short position. What you've done, then, is to nail down your gain and defer tax until next year. However, under the new law, deferral only works if you meet certain limits. Don't sell short against the box without talking to your CPA or tax advisor.

How To Deduct Your Hobby

For your own bottom line, it can make a huge difference whether you operate a hobby or a sideline business. As a hobbyist, your tax deductions are pretty much limited to the amount of income the activity generates. But if you run the hobby as a business, all your expenses are deductible to the extent that when they are added to your other business expenses the total exceeds 2% of AGI – even if they exceed business income.

Problem: The distinction between a hobby and a business is very fine. When you deduct losses from a business that the IRS could label as a hobby, you must be able to prove that you intended to make a profit.

Hobby Or Business

As far as the IRS is concerned, a business is an activity engaged in for profit. There's no law, however, that says you must actually make a profit. The only rule is that you must intend to make a profit.

Presumption of law that aids taxpayers: If you show a profit in three of any five consecutive years (two out of seven for breeding, showing, training or racing horses), it is presumed you are engaged in an activity for profit. Although the IRS can challenge the presumption, normally it will not.

Profit Motive

If you don't meet the presumption, the IRS may challenge your deductions as hobby losses. It will be necessary for you to prove your good intentions. Here is a checklist of things you should be prepared to show the IRS if your business losses are challenged:

- **You operate in a businesslike manner**
- **Keep accurate books and records**
- **You instituted new operating procedures to correct past business practices that resulted in losses.**
- **You act professionally**. Show that you hired or consulted with recognized experts in the field, and that you followed their advice.
- **You made a serious effort**. Show that you hired qualified people to run your day-to-day operation. Remember, no rule says you must devote 40 hours a week to your sideline business.
- **There is a profit potential**. Even if your business continually produces losses, you can still prove a profit motive by showing that assets you have acquired are expected to appreciate.
- **You have had past success**. It may help establish a profit motive if you show that in the past you were successfully involved in your current activity.

Doing Business

The IRS will look for tangible indications that you have really embarked on a business enterprise…**Suggestions:**

Register your business name by filing a "Doing Business As" statement with your local county clerk.

- Use business cards and stationery

- Take out a company listing in the **Yellow Page.**

- Keep a log of the business contacts you've seen during the year.
- Advertise in local papers
- Send promotional mailings to prospective customers
- Set up a business bank account
- Get a business telephone
- Buy a postage meter and a copying machine
- Hire at least some part-time help, family members!

Tougher Questions

The IRS could argue that, since you had other sources of income and could afford to lose money, you could not have had a profit motive.

Your Defense: Nobody goes into business expecting to lose money. Even with your tax deductions, you would have been better off had you done nothing and never started the venture in the first place.

Suppose your business occasionally generated small amounts of income. You can prove a profit motive if you can also show and opportunity to earn a substantial profit in your business. If the IRS can show that you derive personal pleasure from your business, it will count this against you. Businesses that involve horse racing, farming, car racing and antiques are particularly vulnerable to this kind of attack. Don't let the IRS bulldoze you. The courts have consistently held that enjoying what you do is not proof that you lack a profit motive.

Starting a business a year before your child starts to college can save you hundreds or even thousands of dollars in taxes that now can be used to help pay for college expenses. But once again, make sure you follow the rules of operating a business. Make sure you keep good records and document – document – document!

As we have said before, you do not have to make a profit to deduct legal business expenses. Your goal is to make money and in some situations the money you make could be **tax free** due to the business deductions that you qualify to take. There are thousands of businesses that you could start and make a profit. But, do not start a business just for the tax benefits. You will find yourself in hot water with the IRS.

Before, starting a business consult with your CPA to make sure everything is organized correctly. Talk to your tax advisor on a regular schedule to make sure that you are doing everything according to the tax laws and regulations.

Deducting Investment Expenses

Deducting investment expenses include property taxes, depletion, depreciation, and any other expenses directly related with the production of investment income. The following are a few examples:

- Fees for tax preparation or advice.
- Fees for investment advice
- Magazines, publications, books dealing with investments or taxes
- 50% of meals and entertainment with your broker or banker when discussing your investments
- Related travel cost which is tied directly with your investments.
- Cost of a safe-deposit box
- Custodial fees for IRAs and self-employed retirement accounts
- Legal and professional fees
- Depreciation on a computer used exclusive to manage investment accounts.

When you itemize your deductions don't forget the 2% floor. Miscellaneous expenses (which includes most investment expenses) are not fully deductible. You must subtract 2% of your adjusted gross income after listing your miscellaneous expenses. For example: If your adjusted gross income is $60,000 and your investment expenses are $2,000, your deductible expenses are only $800 ($60,000 X 2% = $1,200 - $2,000 = $800).

However, if your miscellaneous expenses include both investment and non-investment expenses the law requires you to apply the 2% floor to the non-investment expenses first.

Example: Your adjusted gross income is $60,000. Your miscellaneous non-investment expenses are $800. Your investment expenses are $2,000. The 2% floor is $1,200 ($60,000 X 2% = $1,200). It is first applied to the $800 of non-investment, leaving only $400 to be applied to investment expenses.

A total deductible investment expense is $1,600 ($2,000 - $400 = $1,600).

This does not affect your total deduction for miscellaneous expenses, but it could affect your net investment income and therefore, your deduction for investment interest.