

GRAY CERTIFIED PUBLIC ACCOUNTING, P.C.

THE GRAY REPORT

Spring 2006

"The wisdom of man has never yet contrived a system of taxation that would operate with perfect equality."-Andrew Johnson

Dear Friends:

The 2006 tax-filing season is behind us. This just means that the tax-planning season is underway. Most of the tax returns we prepare are thick and complicated, testimony to Washington lobbyists and tax software developers.

Our job is to ensure that the income taxes you pay are minimized through strategic foresight and in-depth understanding of the rules and how to apply them to our client's advantage.

Thanks to our success in protecting our clients' financial interests, we celebrated our fifteenth anniversary this year! Starting in 1991 with two of

us, we are now nine and are reputed to be the best boutique accounting firm at our specialty of tax and financial management. Of course, we would not be

here to pat ourselves on the back if it were not for you, our clients and friends, who have supported us these fifteen years and contributed to our growing ability to serve

you better. Thanks to all of you!



Annie

Beating the Taxman in Retirement: What to Withdraw and When

If you are a working stiff, the April 15 tax-filing deadline makes one thing painfully clear: You are a tax target. Sure, you can take advantage of tax-deferred accounts and make the most of available credits and deductions. But if you have a healthy income, you are basically at Uncle Sam's mercy.

All that changes once you quit the work force. Suddenly, you have a heap of control over your annual income—and the chance to have a little fun at the taxman's expense. Here is how to make the most of your non-working years.

An IRS target. With any luck, you will retire with a pot of money in your retirement accounts and your taxable accounts. But unloading these investments will trigger vastly different tax bills.

If you have a Roth IRA, or if you hold bonds and money-market funds in a taxable account, selling will cost little-to-nothing in taxes. Selling winning

stocks in your taxable accounts will be a tad more painful, with your long-term capital gains docked at a federal maximum of 15%.

The big hit will be levied on your 401(k) and regular IRA. Withdrawals are taxed as ordinary income, which can mean paying as much as 35% to Uncle Sam. Indeed, if you are careless you will get hosed on taxes during retirement, just like you were during your working years.

What to do? The best strategy is to spend down your taxable accounts first, while leaving your retirement accounts to grow tax-deferred for as long as possible. But there is an intriguing exception to this rule.

Say you retire at age 62. At some point in the next eight years, you will want to start taking your monthly Social Security benefit. Up to 85% of that money could be taxable. Similarly, after age 70 1/2, you will have to begin minimum distributions from

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Beating the Taxman in Retirement

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your retirement accounts, and that will also boost your taxable income. Put it together, and it looks like Uncle Sam has you on the ropes.

You will, however, have a little time before you start Social Security and before required minimum distributions kick in. During those years, the stocks and bonds in your taxable accounts will generate dividends and interest, and you may also receive a company pension. But beyond that, how much taxable income you have is at your discretion.

Manipulating income. Want to use this to your advantage? Suppose that, once you are in your 70s, you will likely be taxed at 25% or more, thanks to Social Security and required retirement-account distributions.

To soften that blow, you might tap your IRA and 401(k) even earlier. Our advice: While in your 60s, withdraw enough from your retirement accounts each year so that—when these sums are combined with your other income—you get to the top of the 15% federal income-tax bracket, but no further. That will allow you to shrink your IRA and 401(k), reducing the amount that might get docked at 25% later on.

If you were married filing jointly and take the standard deduction, you could have had gross income of as much as \$75,800 in 2005 and still be in the 15% bracket. Meanwhile, if you were single, the figure would have been \$37,900. If you were age 65 or older, both amounts would have been modestly

higher, because you qualify for a larger standard deduction.

You could, of course, spend these withdrawals. But if you do not need the cash, you might instead convert small chunks of your IRA to a Roth IRA each year. Once the money is in a Roth, it will grow tax-free and not be governed by the minimum-distribution rules that affect 401(k)s and regular IRAs.

Indeed, if you want to make your kids happy, you will leave your Roth untouched and instead bequeath the account to them.

Your children will be subject to minimum-distribution rules. Still, they could spread their Roth withdrawals over their lifetime, giving them years of tax-free growth. The Roth is the best asset one can inherit.

A Roth conversion makes the most sense if you can pay the resulting tax bill with taxable-account money. If you have to dip into your IRA to pay the conversion tax, you can still come out ahead. You should convert only if you are anxious to avoid minimum-distribution rules during your lifetime or, alternatively, if you are sure that whoever empties the Roth—you or your heirs—will be in a higher tax bracket than you are today.

As you gauge how much income to generate in your 60s, do not forget about Social Security. As a rule, you should take reduced Social Security benefits at age 62 if you do not expect to live beyond your early 80s. Meanwhile, those with a better family health history might delay benefits until their full Social Security retirement age, thereby garnering a larger monthly check.

If you were the family's main breadwinner, also factor in your spouse's life expectancy. The reason: If your spouse outlives you, his or her survivor's benefit will hinge on the size of your monthly check.

How does this figure into the strategy described above? Starting Social Security will potentially boost your taxable income. At that juncture, you might want to curtail your annual IRA withdrawal so you do not push yourself into the 25% bracket.



Making the Switch

Here are four reasons retirees may want to convert their regular IRA to a Roth IRA.

- If you are in a low tax bracket, the income-tax bill will be **modest**.
- You get **tax-free growth** thereafter.
- **No distributions** are required during your lifetime.
- If you convert to a Roth and pay necessary taxes, you will **reduce your taxable estate** and be able to bequeath a pool of income-tax-free money to your heirs.

Roth IRAs for Kids

Getting teenagers to take an interest in financial matters can be a hard sell for parents. But if you can persuade your youngsters to deposit at least part of the money they earn from babysitting or bagging groceries into a Roth IRA, they may thank you later.

Although it is a retirement account, a Roth IRA can be opened at any age by anyone with earned income below \$110,000 for single filers, and \$160,000 for joint filers. Contributions to a Roth IRA are nondeductible, but earnings within the account accumulate tax free, and qualifying distributions are also tax free. Because they seldom make enough to owe tax on their income, children are usually better off with a Roth IRA, than a tax-deferred traditional IRA. In 2005, your child was allowed to contribute \$4,000 (or earned income, whichever was less) to a Roth IRA. This contribution limit applies until 2008, when up to \$5,000 may be set aside in a Roth IRA. Thereafter, the contribution limit will be indexed annually for inflation.

The reward for getting an early start on saving for retirement can be substantial. Suppose your 15-year-old daughter were to use \$1,000 she earned from tutoring jobs to purchase a Roth IRA. If she makes no additional contributions and the funds grow at 8% annually, she will be able to withdraw over \$50,000 tax free at age 65. Or suppose your son opens a Roth IRA when he is 15-years-old, and contributes \$2,000 for only 10 years. The estimated value of his tax-free fund balance at age 65 will exceed \$700,000, if the annual growth rate is 8%.

A Roth IRA offers the greatest potential for growth if the account is left untouched until the

holder reaches the age of 59 1/2, when earnings can be withdrawn tax free provided the account has been owned for five years. The IRS does, however, permit penalty-free early withdrawals to pay for higher education, though taxes may be levied.

Before you rush to open a Roth IRA for your child, there are a few issues you should consider. Bear in mind that you cannot stop the child from withdrawing money from the account whenever he or she wants after the child reaches the age of 18. If you are uncertain about your child's ability to handle money, opening an account in his or her name may not be the best choice.

You should also be aware that the only type of income that can be sheltered tax free in a Roth IRA is taxable compensation income. In general, paying your children for doing chores around the house does not qualify as compensation income, as this is

an intrafamily transaction that is not usually reported to the IRS. If you own your own business, however, you are permitted to hire your minor children to do certain jobs. Provided you pay your children a fair market wage for the services they perform, the money they earn would be considered compensation income.

The good news is that, if your teenager goes out and blows his paychecks on a new cell phone and skateboard, all is not lost. If, for example, your son earned \$2,500 over the course of the summer but spent the money, *you* could still deposit the amount equivalent to his taxable earnings as a gift into a Roth IRA on his behalf.



What to do with the Mystery Refund Check? by Jeanette T. Townsend, CPA

You are excited because when you open your mail there is an unexpected refund check from the IRS! As you plan how to spend your new found riches, we have one piece of advice—Do *not* cash the check until you call us!

We have seen it first hand; a taxpayer cashes a mystery refund check from the



IRS or New York State and a few years later the government sends a bill for taxes *plus* interest and penalties (which can sometimes be more than the tax!)

Call us and we will investigate to make sure you are entitled to the refund.

Then, you can cash it with piece of mind.



GRAY CPA

Financial Clarity

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Our Newsletter is Now Available Via Email!



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Clear the Clutter: How Long to Retain Records

Some of you are pack rats. Others are determined dumpers. The best strategy is to keep tax-related records only as long as necessary.

The IRS typically has three years to audit tax returns; but it has six years if it suspects that the return understates income by more than 25%. No statute of limitations applies if fraud is involved or a person fails to file.

Here is a handy record-retention list, based on legal as well as tax considerations.

| Record Retention Schedule | | | |
|-------------------------------------|--------------------------|-----------------------------|---------------------------|
| Copies of tax returns | Forever | Sales records and journals | 6 years |
| Tax/legal correspondence | Forever | Employee expense records | 3 years |
| Audit reports | Forever | Personal investment records | 6 years after sales |
| Contracts and leases | 6 years after expiration | IRA records | 6 years after withdrawals |
| Real estate records | 6 years after sale | Canceled checks | 3 years |
| Corporate minutes and stock records | Forever | Paid vendor invoices | 3 years |
| Bank statements | 6 years | Employee payroll records | 3 years |
| General ledger and journals | 6 years | Depreciation schedules | 3 years |

CLIENT REFERRAL FORM

Thank You!

We cannot thank you enough for your referrals. It is always nice to be thought of in a positive light by our satisfied clients. If you know of anyone who might benefit from our services, please continue to let us know. You may mail or fax this referral form or call/email us. You can be sure that your referrals will be in very good hands.

Your Name _____

Referral Name _____

Address _____

Address _____

E-mail _____

E-mail _____

Telephone _____

Telephone _____