

## Your Chance For An Audit And Other IRS Trivia

**D**on't play chicken with the IRS. The odds may seem to be in your favor, but every deviation from the rules makes you more likely to become a statistic. *The Internal Revenue Data Book*, an annual report, shows exactly how many people are invited to interact with the agency, as well as the consequences of trying to sneak past the regulations.

According to the 2006 Data Book, the IRS collected \$2.2 trillion in taxes for the 2005 tax year, and paid \$243 billion in refunds to 108 million filers. The IRS received an average of \$16,629 per tax return filed and paid an average refund of \$2,250.

The IRS got 132.3 million tax returns, of which only 1,283,950 were audited. That translates to slightly less than one in every 100 individual returns leading to an audit. Most audits (76%) were handled by correspondence; in the others, the taxpayer had to sit face to face with an IRS employee to answer questions about a return. But almost every time an audit occurred, mistakes were found. Only 17% of correspondence audits and 14% of face-to-face audits resulted in no change to the return.

What happened when there were changes? The IRS assessed \$25.9 million in civil tax penalties, of which \$15.4 million (59.5%) were for

failure to pay. Another 25.4% (or, \$6.57 million) of total penalties involved under-payment of estimated taxes, while only 1% resulted from returns that had "accuracy" problems (for example, a substantial understatement of income tax). But those are just the penalties. When returns are corrected, there are usually additional taxes to pay as well.

When the IRS finishes an audit and presents your new bill, you can attempt to negotiate, and in 2005 taxpayers made 59,000 compromise offers. But the IRS accepted just 15,000, or about one in four. Too often, taxpayers try to low-ball the tax agency. To have a chance of success, a proposal must be reasonable and in the best interests of the IRS.

While a large majority of audits lead to a change (and usually, a higher bill for taxpayers), very few audits send taxpayers to prison. A mere 0.000289% of returns filed (3,907 of 132.3 million) resulted in criminal cases, though most of those (70%) were referred for prosecution. And most of the cases that were prosecuted ended badly for taxpayers, with 2,720 referred cases leading to 2,019 guilty pleas or convictions. Moreover, almost all of those who lost criminal cases, 82% of the total, ended up behind bars. Still, the chance that the average taxpayer will do

jail time is miniscule, with prison sentences for just 1,650, or 0.00125% of all tax returns filed. That's about one prison term for every 80,000 returns.

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## Personal Note From Global Wealth Advisors

**A**s we enter another new year with anticipation, we also reflect on 2007 with the benefit of lucid hindsight. We witnessed unprecedented levels for the price of oil, increasing tensions in the Middle East, falling value of the U.S. dollar, continued short-term volatility in the global equity markets, and significant disruptions in the credit markets. What does all of that mean? Experience reminds us that we always encounter unusual events, plus the customary positive and negative influences on the financial markets. Our view remains positive, especially for the long term. Gross Domestic Product should canter along at about 2.5%, and corporate profits should continue to post favorable results. However, we also anticipate continued volatility, especially in the U. S. markets for 2008. Meanwhile, we will not engage in short-term, reactionary behavior that constitutes market timing, but will continue to maintain the long-term focus that rewards our clients in globally diversified portfolios. We also hope you find the articles in this issue of *Insights* useful and interesting. Call on us with any questions or comments about any of the articles, or any issues you'd care to discuss. Thanks again for your continued confidence and client referrals.

*Jim Knaus Mike Krencicki*

### A Very Few Get Prison Time

*Likelihood that a tax return will lead to a jail sentence.*

Individual tax returns filed	132.3 million	100%
Criminal cases	3,907	0.00289%
Cases referred for prosecution	2,720	0.00206%
Convictions	2,019	0.00153%
Jail sentences	1,650	0.00125%

# A Skeptical View Of Variable Annuities

**V**ariable annuities (VAs) soared from obscurity a decade ago to have \$1.3 trillion in total assets in late 2006, according to the National Association for Variable Annuities. However, many skeptics say VAs are popular not because they're great for investors, but because they're usually great for the people selling them. VAs are often laden with punishing fees that can drain the value of your account.

VAs are not all bad. Indeed, some individuals can benefit from a VA. It provides tax-deferral for investments, just as a 401(k) or IRA does. Unlike an IRA, there's no limit on contributions and no mandatory withdrawals. You can put your money in a wide range of professionally managed subaccounts, very much like mutual funds. And if you happen to lose money and die while the account is down, your beneficiaries could receive a death benefit. In addition, many VAs offer a "living benefit" rider that promises minimum lifetime income regardless of investment performance. With all these benefits, VAs make for a great sales pitch, and that makes it especially important to be aware of the drawbacks.

Bells and whistles can make a VA seem complicated, but the basic structure is simple. An insurance component provides a benefit upon your death and allows a VA its tax-deferred status under

U.S. tax law. You decide how you want your account invested, dividing money among a menu of mutual fund-like subaccounts. Like other tax-deferred accounts, VAs permit penalty-free withdrawals after age 59½. Before that, there's a 10% tax penalty on your policy earnings. All withdrawals of earnings, whenever they're made, are taxed as regular income.



The biggest problem with VAs is that fees tend to be extremely high. They impose insurance and administrative expenses on top of management fees for the subaccounts. Fees can be in excess of 2% of your assets annually. There may also be annual contract charges and sales loads on investment subaccounts.

Meanwhile, the death benefit isn't likely to be much. There are scenarios in which it would be valuable—for example, if you died shortly after making a large investment and the market had dropped sharply. But that just doesn't

happen very often. According to LIMRA International, an insurance research group, only three of every 1,000 VA contracts are surrendered because of death or disability.

Taxes are another shortcoming. When money comes out, it is taxed as income at rates of up to 35%. Compare that with the top rate of 15% on most long-term capital gains and qualified dividends in taxable accounts. Several states also impose additional taxes on VAs. And while the tax advantage for mutual funds may be partially offset by tax-deferred compounding within a VA, it could take many years of tax-deferral for a VA to come out ahead.

There's also the tax treatment of inherited VAs. Heirs, like any other account owner, are subject to tax at income rates on withdrawals. In contrast, the tax basis of an inherited mutual fund is stepped up to its value when it passes to your heirs, so that gains you earned during your lifetime aren't taxed at all.

The final indignity? If you experience buyer's remorse after purchasing a VA, you'll probably have to pay a surrender charge of as much as 7% to get your money back. While VAs may be right in some circumstances, we are here to serve as your trusted advisor in evaluating such sales pitches. ●

## Tax Law Now Allows Those Inheriting Retirement Plan Assets

**M**ost 401(k)s and other employer-sponsored retirement plans are bequeathed to spouses, and with good reason. Until a recent change in rules, only a spouse could inherit a retirement plan other than an IRA and avoid immediate taxes. Now, although the process must be handled carefully, any beneficiary should be able to receive a retirement plan and enjoy the same tax-postponing benefits that a husband or wife always could.

Under the old rules, if your husband got the money, fine; he could roll over the windfall into his own IRA and make withdrawals over the course of his expected lifespan. Though each year's

required distribution would add to his taxable income, the rest of the account would continue to compound, and there might be a sizable balance left at his death.

But your daughter? Most employer plans require an account to be emptied within five years of an employee's death. She would have had to take the money and, not being allowed to move it into an IRA, would have been stuck paying income tax immediately—and likely would have lost a third or more of her inheritance to taxes in the process.

The new rules are much kinder to non-spouse beneficiaries. Now, should you choose to leave your 401(k) to a

child, a same-sex partner, or anyone else, that person may roll over the inherited plan to an IRA. But the law is prickly about the process. To make a successful rollover, your heir must:

- Open an inherited IRA to take the money. A spouse who inherits a 401(k) can merge the account with her own IRA, but others must set up a new account specifically created to receive funds transferred from the deceased's retirement plan.

- Be sure to title the new account correctly. For instance, Dad IRA (Deceased) FBO Daughter.

- Make sure the money goes directly from the company plan to the

# How Long Should You Plan To Live?

Is age 95 the new 85? With Americans living longer than ever before, experts now say you should build a retirement plan that lasts well into your 90s.

Consider these actuarial realities: A 65-year-old man today is likely to live to 81; his 65-year-old wife, to 84. And the math doesn't stop there. There's an almost 40% chance one of those 65-year-olds will be alive at 95.

"You need to plan through your mid-90s," says Dan Veto, senior vice president of Age Wave, a think tank focusing on adult life stages. "But most people still just kind of show up for retirement. They spend more time planning a trip to Disneyland."

The longevity bonus comes as 78 million baby boomers, who have redefined every other life stage, approach retirement. "If we start taking care of ourselves in our 40s and 50s, the chance of being well during our 80s, even our 90s, is very high," says Howard Stone, founder of 2young2retire.com. "That means taking a grown-up look at the money you have, the way you're living now, and how you want to live the next 30 years. The traditional idea of retirement, created in the 1930s, is no longer relevant. What used to be retirement is now a fulfilling third of your life, a time when you still have vitality, flexibility, and curiosity."

But living longer means your income has to live longer, too. As a result, experts are reassessing financial planning fundamentals. Here's what that could mean for you:

**A new approach to retirement income.** Historically, people have tended to convert to an income-based strategy when they retire—essentially jettisoning stocks for bonds. Today, though, a retirement portfolio may require significant growth, and that could mean living with more volatility. "The classic 'just buy bonds' math doesn't work anymore," says Veto.

At the same time, simply keeping more stocks, with their potential to provide higher returns, isn't the whole answer. For stocks to work in a portfolio, they need to be held over a long period, and that begs the question of where to find income. With private-sector pensions blowing up and Social Security in doubt, there's a new focus on "longevity protection," with insurance and annuity products that can substitute for pensions. With a typical annuity, you trade a lump sum for an insurance company's promise to provide lifetime income.

"Annuities are complex, and for years they were overpriced and oversold," says Moshe A. Milevsky, executive director of the non-profit Individual Finance and Insurance

Decisions Centre in Toronto. "So you have to ask tough questions. But the right products can help you manage the unique risk you face in retirement. They've morphed into pensions."

**Different ideas about spending, too.** Traditionally, retirement planners have started with a guess about the income you'll need each year, multiplied it by the average number of years you're expected to live, factored in inflation, and come up with an estimate of what must be saved for retirement. But that formula no longer adds up, suggests Bob Curtis, who heads MoneyGuidePro, a maker of financial planning software.

First, it doesn't make sense to plan for life expectancy averages, Curtis says. Just because the average healthy 65-year old today might live 20 years does not mean that such a person should plan to live until 85. Even though only a small percentage of today's 65-year olds may live until age 95, you may still want to fund your expenses and plan to live that long.

Further, your financial plan should be built around you and your spouse as a couple, with assets designed to last through the surviving spouse's life span. Next, keep in mind that interests, activities, and priorities are likely to change as you age. Also, spending tends to jump a lot from year to year, so you can't just base a plan on withdrawing the same amount every year and increasing it for inflation.

Also misleading is the popular assumption that you'll need only 70% of your pre-retirement income to live on. Veto, in fact, says it's likely baby boomers' income needs will rise when they enter retirement. "The healthiest, wealthiest, and most educated generation ever is about to retire," he says. "To think they are going to watch 43 hours of TV a week, as today's retirees do, is foolish. This is about biking across Europe or starting a business. There is no magic number. It's incredibly important to come up with numbers that fit an individual's particular ideas about retirement." We're here to help you. ●

## To Retain Tax Deferral Much Longer

heir's new IRA. If your beneficiary touches the money, he or she will be immediately taxed.

Keep in mind that it doesn't matter when the account owner dies as long as the beneficiary postpones the rollover until 2007 or later. So if the account owner died in 2006, an heir can benefit from the new rules as long as the rollover is made in 2007.

If you've ever changed jobs, you may already have transferred retirement funds from your former employer to an IRA. Until the rules changed, that was the only way to ensure favorable tax treatment for a non-spousal heir. And even now, a rollover

is often advisable. IRAs tend to offer a wider range of investment options than you get in a typical 401(k), and it's easier to monitor investments in a single account.

There is at least one advantage to keeping money in a 401(k), however. If you retire, you may begin taking distributions from an employer plan at age 55 without incurring the 10% early withdrawal penalty you would owe for withdrawing assets from an IRA before age 59½. Under the new rules, you can have the penalty-free early access of a 401(k) while also accommodating non-spousal heirs. ●



# What To Do When Identity Thieves Strike

**M**aybe you notice an unfamiliar transaction on your credit card statement. Or perhaps you're rejected for a loan for no apparent reason. Whatever tips you off, if you think you may be a victim of identity theft, act immediately to limit further damage to your financial resources and reputation. Set up a plan of action and keep a record of everything you do. Here are several essential steps.

- File a police report, and get a copy as proof of a crime against you. If your local police department is reluctant to make the report, try the state police or the state attorney general's office.

- Contact the fraud department at any of the three major credit reporting agencies—Equifax (800-525-6285); Experian (888-397-3742); or TransUnion (800-680-7289) and ask to have a fraud alert on your file. That agency will notify the other two, and you'll receive free credit reports you can review for signs of fraudulent activity. An initial alert, active for at least 90

days, goes on when you suspect you may be a victim—if your wallet has been stolen, for instance. Once you provide proof a crime has been committed, the agency may activate an extended fraud alert that remains on your account for up to seven years. A fraud alert lets creditors know to contact you before making changes to existing accounts or opening new ones in your name. Keep in mind that if you place a fraud alert on your account, you may be required to approve big changes or call your credit card company to okay individual transactions.

- Close any accounts you believe may have been tampered with or opened fraudulently. Make sure to document the accounts and keep a record of fraudulent charges. Just a phone call will get some credit card companies to initiate charge dispute investigations on your behalf, while others may require you to fill out a fraud dispute form. The company may also request a copy of a police report and for you to fill out an affidavit about the crime. In most

cases, Visa and MasterCard limit your losses to \$50 no matter when the fraud occurred.

- Contact all financial institutions where you have accounts and review your statements for fraudulent activity. If you suspect your bank account has been tampered with, you have 60 days from the date your statement is sent to you to make a written report to the bank. But the more vigilant you are, and the more quickly you take action, the smaller your losses are likely to be. A loss reported within two days of the fraud could limit your liability to \$50. Letting the bank know after two days but before 60 days could leave you liable for at least \$500 of what the thief has taken. After 60 days, you may have to bear the burden of the entire loss.

- Be sure to let the Federal Trade Commission (FTC) know when you suspect you've been victimized. Call 877-ID-THEFT. The agency maintains an identity theft database that is used by federal law enforcement agencies. ●

## Your Chance For An Audit

*(Continued from page 1)*

Individuals aren't the only ones who have to worry about audits, however. The IRS also scrutinizes the tax returns of small businesses, estates, and trusts, though those entities are audited at much lower rates than individuals. Fiduciary audits (of estates and trusts) were least common for the 2005 tax year, with only 0.1% of returns catching the eye of the IRS. Partnerships and S Corporations were next, with audit rates of 0.36% and 0.38%, respectively. Individuals, with a 1% rate, were almost three times as likely as partnerships or S Corporations to be audited. One reason is that audits of individuals are much easier to conduct than those involving small

businesses or estates.

Major corporations, on the other hand, face a relatively high likelihood of extra attention from the IRS, and the bigger the company, the better the chance of an audit. While only 0.8% of businesses with assets of less than \$10 million were audited, tax returns filed by companies with assets beyond that threshold were audited at a rate of 18.6%. Larger corporations often use sophisticated accounting practices that may have substantial tax implications. The IRS is on the lookout for impropriety at big corporations, especially in the wake of the Enron implosion. At the time of its failure, that company hadn't paid federal income taxes in years, despite

## Will You Hear From The IRS?

*Audit rates (percentage of total returns) for individuals, fiduciaries, and small businesses in the 2005 tax year.*

Individual	Fiduciary	Partnership	S Corporation
0.97%	0.10%	0.36%	0.38%

posting significant and growing profits.

As these statistics show, most taxpayers never interact with the IRS. Of the 132.3 million returns filed in 2005, only a handful led to a second look. A few audits left nothing changed, and most resulted in a civil penalty and the payment of additional taxes. The threat of prosecution—and jail—is remote, and such situations are easy to avoid. Follow the rules, and like most people, you will be nothing more than a stack of paper to the IRS. Trying to “win” the tax game, though, can send you down the road of the few. ●