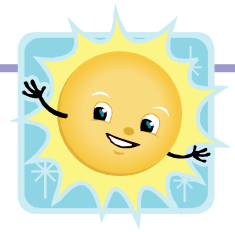


# The Knightly News



## Wishing You A Happy Summer

As another summer comes and goes, I hope that this newsletter finds you and your family healthy and happy. My goal is for this newsletter to become an invaluable

source of information for you regarding your personal finances and taxes. If there's ever a topic you want covered, please let me know and I'll be happy to add it to my

next newsletter. As you can see on the table of contents to the right, this issue focuses on several current issues in the financial world.

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## New Tax Law Takes Effect in May



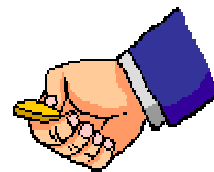
Somewhat under the radar in a flurry of other political activity, there has been a big change in tax law this summer. As the rest of us have been busy with family and friends, the legislature has been busy with H.R. 4297, *the Tax Increase Prevention and Reconciliation Act of 2005*. This law, which went into effect on May 17th, 2006, contains provisions that may change the way you make investment decisions. Some of the highlights were:

\$ Extends the 15% tax rate on eligible dividends and capital gains through 2010. After that, dividends will be taxed at the taxpayer's ordinary income tax rate and the long-term capital gains will increase to 20%.

\$ Beginning in 2006, the "kiddie tax" will apply to unearned income of children under age 18, rather than the previous age of 14. "Kiddie tax" means that income will be taxed at the parents' typically higher tax rates.

\$ Without congressional intervention, 2010 will bring income tax brackets back to previous highs, IRA contribution limits will lower back to \$2,000/year, and 401(k) and 403(b) plan limits could return to \$10,500.

So, what does this mean for you? In a period of uncertainty such as this, you should work closely with 2 professionals, a CPA and a financial advisor. By making a move now, such as selling investment property when you can take advantage



*Read on to learn about tax changes enacted this summer that may save or cost you big bucks.*

of low capital gains rates, planning transfers to your children carefully, and stocking up on retirement savings now in anticipation of future limits being lower, you may save yourself a shocking amount.

### Items to Listen For in the News:

- ♦ Taxpayers will be eligible to file for refunds of all excise tax they have paid on long-distance service billed to them after Feb. 28, 2003. Interest will be paid on these refunds
- ♦ No word yet on estate tax solutions, but changes are on the way.

## Who Benefits from Tax Planning?

With tax laws changing so rapidly, how can you keep up? An important tool is tax planning, but the most common question I get is “How do I know if I can benefit from tax planning?”

Here’s a few examples of prime triggers for a tax planning need:

**\$ Change In Income:** This includes the transition from working to retirement or a significant salary increase or decrease.

**\$ Starting a Business:** In the first year of a business it is very hard to judge your income and therefore your tax liability. A tax planning appointment can help you work through your questions and get you started on the right track.

**\$ Inheritance:** There’s a lot of tax saving tools available *before* you sell inherited property, but very little after the fact, so tax planning can prove invaluable.



*“How do I know if I can benefit from tax planning?”*

**\$ Paying Estimated Taxes:** If you are subject to estimated taxes, tax planning can help you pay just the right amount without paying too much and giving the IRS an interest-free loan, or worse, not paying enough and subjecting yourself to interest and penalties.

The trick is to *plan ahead*, rather than wait for April!

## To Fear or Not to Fear: 2005 IRS Audit Statistics

Earlier this year, the IRS published its 2005 Data Book for tax returns dated October 1, 2004 through September 30, 2005. This information can be found online at [www.irs.gov](http://www.irs.gov), but I have pulled out what I feel are the most relevant statistics.

Results are detailed in terms of TPI (Total Positive Income), which is the sum of all positive amounts of income, thus excluding net losses.

For individuals with TPI under \$25,000, 1.48% of returns were audited. For taxpayers with TPI between \$25,000 and \$50,000 that

number drops to .60%. For those between \$50,000 and \$100,000, it drops to .57%. For TPI’s between \$100,000 and \$200,000, the percentage jumps again to 1.41% of returns being audited. In what I believe goes against conventional wisdom, the highest TPI ranges of \$200,000—\$1,000,000 and over \$1,000,000 are audited only .44% and .65% of the time, respectively.

**The results are in: audit risk increases if your income is < \$25,000 or > \$100,000.**

As a taxpayer, what does this mean for you? I don’t believe that you should omit deductions from your tax return because you fear being audited. While the IRS claims to be increasing their compliance efforts each year, I feel that as long as you file a “clean” return with appropriate backup, then you have nothing to worry about. On the other hand, if you have used estimations in the past and don’t keep all records for at least 7 years, then you may want to change your practices immediately to protect yourself in case you become a statistic!

## Energy Savings & Vehicle Credits: Going, going, gone

I am often asked about the current credits available for adding energy saving improvements to your home or buying hybrid vehicles, and I want to spread the word about the great benefits currently available. But, beware! They are disappearing almost as fast as they arrived on the scene.

The Energy Policy Act of 2005 provides a credit for taxpayers who purchase certain energy efficient vehicles (primarily hybrids), ranging

from \$3,150 for a Toyota Prius to \$650 for a Honda Accord Hybrid AT. However, these credits phase out as each manufacturer sells 60,000 qualified vehicles. As of now, Toyota has reached that cap, but Ford and Honda have not. Therefore, credits for Toyota are decreased to 50% of the original amount, and they will continue to decrease.

For household improvements made during 2006 and 2007, you

can take a credit of 10% of the cost of qualified energy efficient products, up to \$500. Examples of qualified products include windows, skylights, insulation, air conditioning and heat.



*Which credits do you qualify for?*

# When Does a Business Have a Profit Motive?

For those who find it hard to distinguish between a business and a hobby, a recent case (David M. Sears V. Commissioner, T.C. Summary 2006-47) helps draw the line. For most businesses, this isn't an issue, as they are clearly being run with a distinct goal of making a living for the owner. However, if you're running a side business such as selling your art, distributing Mary Kay, or offering occasional consulting advice, your profit motive may come into question.

According to tax guidelines, you can take losses from small business activities (usually on Schedule C) as long as you are operating for profit.

If a small business is run like a hobby, you must still claim your annual income, but can deduct your expenses only to the amount of income you receive from the hobby. In other words, without a full-fledged profit motive, you should not take any losses from business activities.

If the IRS questions your profit motive, what do they look for? They focus on the manner in which you carry on your business, including the expertise of you and your advisers, the time and effort spent on the activity, previous success in the industry, the financial history of the business including past profits and losses, and the elements of personal pleasure or recreation. Make sure to keep these in mind each year as an unfavorable decision could cause you to lose valuable deductions.

## Mortgage Refinance Basics, by Jeff Tompkins, Teachers Funding Group

As rates continue to go the way of gas prices, which is to say much higher than they really need to be, the question inevitably comes up... "when is a good time for me to refinance my home?" Let's look at a few key things to keep in mind when considering a refinance.

### 1) Are the interest rates currently offered higher than what I have already?

Refinancing has slowed over the last year for the simple reason that most people took advantage of the low rates and refinanced a few years ago, so today's rates are not as attractive. If you can get a lower rate than what you currently have, then it might make sense to refinance, but the rate should be at least 3/8 lower than what you have now to make much of a difference. For example, on a \$200,000 loan amount, a 6% rate is a principal and interest payment of about \$1199 a month. If you drop that rate 3/8 to 5.625%, the monthly payment drops to \$1151 a month. Not a huge savings (\$48) when you consider closing costs you will have to pay simply to do the loan (up to \$4000).

### 2) Am I currently in a loan that

### will be adjusting soon, making my payment and rate higher?

During the refinance boom of the last few years, a lot of people chose adjustable rate mortgages (ARM's) to take advantage of the lower rates. These ARM's however can adjust at some point during the life of the loan, meaning the rate and the payment can go up. If you anticipate this rate/payment going higher than what is currently offered

on the market, you might consider refinancing that loan. This is particularly true with home equity lines of credit (HELOC's) that are based on the prime rate. As the Federal Reserve Board continues to raise rates (currently at 8.25%), the rates and payments for the HELOC's will go up as well. It might be time to put a cap on it by refinancing to a fixed second mortgage.

### 3) Is my home's equity available at a cheaper rate than I am paying on other debts?

Many people refinance to take the equity out of their homes in the form of cash, to use for a myriad of reasons including paying off other debts, paying for college, making home improvements or additions, etc. When does this make sense? Let's say you can get a home loan for 6% using some of your home's



*Mention Michele Knight for flat rate closing cost of \$700!*

equity. And, you have credit card debt, accruing interest at between 18-24%. Wouldn't it make sense to pay that credit card debt off with a 6% loan, saving you about 12-18% on interest every month? Of course it would.

When considering a refinance, make sure it makes sense in the long run, counting all the costs of the new loan and how much it would actually save or help you. You can always get an impartial third party opinion from a trusted CPA or financial planner before you ask your mortgage broker. And finally, get all the facts from your mortgage broker (and find a trustworthy one who is concerned about your financial well-being more than his/her own profit) to make sure the refinance will meet your needs.

Jeff Tompkins is owner and president of Teacher's Funding Group, LLC, a Colorado mortgage broker that specializes in providing home financing to those in the education industry and all those who need it. Feel free to email Jeff at [jeff@teachersfunding.com](mailto:jeff@teachersfunding.com) if you have any mortgage/financing questions. Visit <http://www.teachersfunding.com/> for more information.

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## **A Bit About Knight & Knight, LLC**

*Knight & Knight, LLC is co-owned by Michele & David Knight. We love the mountains and reside in Fairplay (aka South Park), but travel throughout Colorado to meet our client's needs.*

*Knight & Knight, LLC offers the following services:*

- *Tax Preparation & Planning*
- *Estate Planning (Wills, Trusts & Estate Taxes)*
- *Bookkeeping, Payroll, Medical & Customer Billing*
- *Budgeting, Business Plans*
- *Accounting System Implementation*
- *Customized Software and Website Design*

*If you know anyone who can benefit from our services, we greatly appreciate the referral! And, now through March 15th, 2007, any tax preparation referral will earn a \$25 referral bonus!*

## **Are You in the "Market" for a Financial Planner?**

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*A First Class Experience*

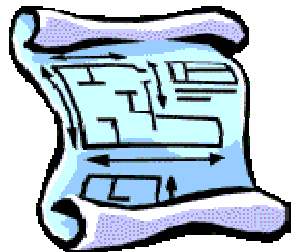
Knight & Knight, LLC gives Townsend Retirement Specialists the highest recommendation. They offer services including Retirement and Wealth Management, 401(k) Assistance, College Savings Plans, and 72(t) Distributions. Townsend offers free education workshops throughout the year, and also free, no-hassle, no-obligation consultations. Don't hesitate to give Terri a call at 303-452-5986 for a First Class Experience!

## **Who's Afraid of the AMT?**

In recent years, a scary, scary term has crept into the average taxpayer's vocabulary: the Alternative Minimum Tax (a.k.a. AMT). This tax is both confusing and severe...making it a source of frustration to many taxpayers, and also of critical importance.

The AMT is actually a separate tax system, originally developed to force the wealthy to pay their share of taxes, many of whom previously paid less tax as a percentage than lower and middle class folks because they hired lawyers and CPA's to help them take advantage of more deductions. As it was developed the AMT is calculated via Form 6251, which is then attached to the 1040. In effect, you are simply

adding back some tax deduction and income exclusions to your regular taxable income to arrive at your alternative minimum taxable income, which is then subject to different tax tables (26% on the first \$175,000 of income).



*Should you be worried about the Alternative Minimum Tax?*

now affecting Mr. John Doe, middle

class taxpayer who has relatively high itemized deductions for reasons such as medical expenses or unreimbursed employee expenses.

However, as incomes rise and inflation affects the U.S. Dollar, the AMT is creeping into the everyday vocabulary of far more taxpayers than it was intended for, as it was never designed to account for inflation over time. This tax, previously aimed at the uber-wealthy, is

class taxpayer who has relatively high itemized deductions for reasons such as medical expenses or unreimbursed employee expenses.

In simple terms, calculating the AMT requires you to prepare your normal 1040, then fill out Form 6251. On 6251, you add back specific itemized deductions, including investment expenses, employee business expenses, medical/dental expenses, and state and local taxes. Your new taxable income is then calculated based on AMT rules, and if its higher then your previous taxable income, you must pay the higher tax. It sounds simple, but it is an easy step to overlook in tax preparation, especially as it continues to affect more and more people each year!