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Anatomy of a Tax Return

How to diagnose your finances with a 1040

Mitchell Schnurman
Fort Worth Star-Telegram

Millions of Americans will finally do their taxes this weekend, five days before the filing deadline. They'll sift through bank records, mortgage statements, and W-2s and start filling in 1040 forms.

Most will hurry through it all. They'll sign their return and stash everything into a shoe box, not to be seen – or thought of – for another 12 months. But maybe they should keep those papers out a while longer. Not that spending more time with tax records is anyone's idea of fun. But a little study of that much-cursed tax return can be a valuable, worthwhile exercise.

For many people, it's the quickest, most painless way to get a read on their finances, experts say. Is their income keeping pace with inflation? Are they investing enough for retirement? Is their debt too high? Should they shift investments into municipal bonds? Where is all their money going?

Tax forms alone won't answer all these questions. But examining a tax form forces you to consider the issues – and whether you're missing some ways to strengthen the balance sheet.

"Nobody likes to do this, because it's a pain to track all this stuff," says Lynn Niedermeier, a financial consultant and co-author of *Wealth*. "But people are missing million-dollar opportunities. They're making decisions with their income and taxes that are costing them thousands of dollars. "If they'd just study their 1040, they could be way ahead of the game."

Financial planners tell people to annually assess their finances. Add up assets and liabilities; figure net worth; review the performance of investments; rebalance assets.

But few place a priority on such things. It would be easier, though, if they tackled the job while preparing their taxes.

All the records are there. What's needed is a little more time to consider other issues and tally a few more numbers.

"People need a little encouragement before they'll do any financial planning," says Craig Hamilton, partner in charge of tax practice at Arthur Andersen & Co. in Fort Worth. "Having to do a tax return forces them to go over their documents. While they're in the neighborhood, they may as well get a little financial analysis."

Where to start?

How about Line 7, where wages, salaries and tips are totaled? Compare that number with the same line two years before, and see whether your '93 pay is a least six percent higher.

There is one reason, however, to be pleased about a lower wage number: if it declined because you're contributing more to a company retirement plan. Such contributions, along with the money earmarked for child care and medical expenses, can be deducted before they're taxed, lowering your taxable income but making your overall savings much greater.

Hamilton says the wage line is important for another reason: It puts a spotlight on many people's spending.

"If that's up \$5,000, the obvious question is where'd the money go?" Hamilton says.

The best-case scenario: into savings. That would show up either in a nontaxable retirement plan, or on the next line on the 1040: taxable interest income.

Nobody complains too hard about big numbers on Line 8. That means you made a lot on your investments last year.

The issue for more taxpayers is whether there's a better place to park their money.

Interest from municipal bonds is exempt from taxes so it isn't on this line. But for many, taxable investments still offer better returns even after settling with Uncle Sam.

The greatest gain would come from sheltering more money in retirement accounts, Niedermeier says. And because the funds are committed to retirement, that means they should be invested more aggressively, she says.

Why? Because you won't pull the money for years, and [historically], stocks [have far outperformed] safer, less volatile investments. *[While past performance does not guarantee future results, one should consider this to help decide on investments for the long-term.]*

The impact: \$30,000 in a taxable one-year CD nets \$1,400 less than the same sum in an average stock fund that's tax-deferred. After 30 years of compounding, the difference is \$143,000, Niedermeier says.

"If it's long-term money, you need to treat it that way," she says.

Adds Burk Rosenthal, a financial planner in Fort Worth: "Too many people put money in short-term investments when they're planning to use it for retirement. The problem is that taxes eat it up."

Using Line 24a, for IRA deductions, helps resolve that problem. Roughly half of Americans are still eligible for the deduction, or for a similar retirement contribution on Line 27, which is for the self-employed.

If your return is empty here, it's worth a second look. Contributions to IRAs are deductible if your company does not have a pension plan, or if individual income is less than \$35,000.

One item that receives plenty of attention from taxpayers is itemized deductions, tallied on Schedule A. What do they say about your finances?

Maybe that your debt is too high, maybe that too much of it is nondeductible. One guideline: Many mortgage companies reject loans if an applicant's total debt tops 36 percent of income.

Strategies: Focus on paying down debt and, if you refinance a mortgage, use extra cash to reduce nondeductible loans, from cars to credit cards.

Another item to examine on the schedule: real estate taxes. If they're much lower than past years, Hamilton says, it may be because figures were left off your mortgage statement. That's more common when refinancing.

If the taxes are higher than usual, you may be able to lower them by negotiating with the taxing district.

Total deductions are worth considering a second time, because people often discover their value is lower than they thought. A married couple automatically gets a \$6,200 standard deduction so itemizing only helps for the amount above that.

"Look at Schedule A and ask yourself whether you're really getting your money's worth," says Nancy Anderson, co-editor of *H&R Block 1994 Income Tax Guide*. "A lot of people feel good about those deductions, but they lose sight of reality. The government already gives them a healthy deduction, and most have to spend another \$1 to get back 28 cents."

Line 37, taxable income, appears soon after deductions. Along with the tax table, this helps you determine your marginal tax rate – the amount of tax that must be paid for each additional dollar earned.

To figure the rate, look in the tax table to see how much your taxes would increase if your taxable income was \$1,000 higher.

That information is essential in evaluating tax-free investments. It's also useful in weighing the payoff from working overtime or taking a second job.

The last line to mull over, and perhaps the most important, is Line 62, the amount of money to be refunded to you.

The bigger the number, the less to celebrate, financial experts say.

What it means is that Uncle Sam has received an interest-free loan. Instead, taxpayers need to adjust their withholding and use the money for better purposes, including paying off credit-card debt.

If discipline is a problem instruct your employer or bank to withdraw the money automatically and earmark it for investments or a retirement account.

A \$450 annual refund, if invested every year rather than spent, would total \$50,000 after 30 years, assuming it earned 7 percent interest, Niedermeier says.

The last area to review is your tax records. On a separate sheet, total your investments, both retirement and nonretirement (the latter will be on Schedule B if they earned more than \$400).

Compare their value with last year's to see whether they performed up to speed. And review whether the holdings are still allocated in the way you intended. If stock funds, for instance, grew at faster rate than bonds, you may want to trade some shares to restore the right mix.

A final equation: Throw in the mortgage, car loan and credit card statements, and pretty soon you will be a calculator away from knowing your net worth.

The value of knowing that figure: Compare it with last year's and next year's to see whether you're getting where you want to be.

"People think of financial planning as a painful process, and they'll do anything to avoid it," says Andres Markezine, a contributor to *The Ernst & Young 1994 Tax Guide*. "But it's not a big deal when you have everything out lying on the table. All you need to do is look at the numbers, and you'll find out where you stand."