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Writing a Check to Uncle Sam

Carry-forwards, Credits, and Deductions, Oh My!

By Kevin Bourke

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Dear Kevin,

I'm preparing my taxes and I'm terrified to make a mistake. Any red flags I should look for?

Leslie in New Orleans

Dear Leslie,

There are several common mistakes people make when preparing their taxes that can be costly when it comes time to write **that check to Uncle Sam**.

First, let's look at loss carry-forwards. Even though we are finishing five decent years in the stock market, there are still investors who have **losses to carry forward** from the dot-com crash of 2000-2002, and sometimes they forget to take those losses on their taxes.

For example, let's look at what happened to someone I met recently, Mary (not her real name). Mary invested a $100,000 inheritance in the technology markets in the late 1990s. Her $100,000 investment more than doubled on paper at one point, **but then gave up all those gains and then some**. She finally cashed out her position for less than $10,000. This gave her a realized loss of over $90,000.

Could Mary take a $90,000 loss on her taxes? Probably not, because she would need to have $90,000 in realized capital gains to offset the losses. So Mary's only option is to take **a $3,000 deduction against her income until she has written off all $90,000**. At $3,000 per year, this could take 30 years, so you can see the possibility of Mary forgetting to take that deduction. Often times, people forget to factor in their past losses.

It would be good for Mary to remember that she has this large loss to carry forward for another reason, too. Let's assume that in 2007, Mary sold a stock or mutual fund for a $10,000 capital gain. She could offset the entire gain by using some of her loss carry-forward. By being alert to taking her $3,000 deduction annually, **and by offsetting any capital gains she incurs**, she can take advantage of this $90,000 loss for many tax periods to come.

The IRS makes us pay taxes on capital gains in the year incurred, but allows losses to be carried forward. This is **a rare kindness from the taxman** and should not be forgotten. Don't lose track of those losses!

Another common mistake people make is to forget to calculate tax credits. **Tax credits are different from deductions**, in that a tax credit reduces income tax due on a dollar for dollar basis. For example, if you owe $1,000 in tax, but you have a $50 tax credit, you owe $950 in taxes.

Contrast that with a deduction. A deduction is used to reduce taxable income, and then income tax is due on the amount remaining. For example, **if you make $50,000/yr income, a $50 deduction would reduce that to $49,950**. So, you still pay tax on $49,950. As you can see, that won't make much of a difference in your tax bill.

Deductions are worth only a fraction of what tax credits are worth. Do some research and see if you can factor in **Earned Income Credits, Child Tax Credits, Child and Dependent Care Credits, Adoption Credits (for parents who adopted an eligible child), or the Hope and Lifetime Learning Credits among others**.

Lastly, **don't forget deductions for state taxes**. You can elect to deduct state and local general sales taxes, or state and local income taxes, but not both. If you made a major purchase in 2007, perhaps a car, you undoubtedly paid sales tax. You might save money on federal income tax by taking a deduction for the sales tax you paid on that and other purchases. You can figure out which method will save you the most by using the IRS worksheet at this link.

Leslie, this information is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. I suggest that you discuss your specific tax issues with a qualified advisor. It's worth checking out your options as **we have just scratched the surface**. My experience is that a good tax professional can offset their fee in tax savings, but every person's situation is different.

Good Luck!

Kevin Bourke is a registered principal with and offers securities through LPL Financial, Member FINRA/SIPC.