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Tax Returns A Taxing Matter

In his recent State of the Union address, President Clinton spoke of the wonderful conditions that exist in our society today. Yes, unemployment is low, worker productivity is up, and we live in an era of world peace.

The speech painted such a rosy picture that Thomas Donlan of Barrons recently compared the address to that of Calvin Coolidge's State of the Union address in 1928, a few months before leaving office and less than a year before the stock market crash of 1929.

The big difference of course between then and now is the Federal Reserve Board (Fed). Alan Greenspan understands the proper role of monetary policy as it affects the economy. Today, less restrictive government policies and a freer global marketplace should prevent a repeat of the economic debacle that ensued during the 1930s.

One major difference today however that dwarfs the 1920s period of prosperity is income taxes.

During the 1920s, only the wealthiest paid income taxes; today almost everyone does. On top of the increased levels of taxation that have attacked the middle class over the last half-century is the complexity of the system that sometimes confuses both government officials and professionals alike. Former IRS Commissioner Fred Goldberg has been quoted to say, "Our income tax system has been destroyed by complexity; a complexity caused largely by well-meaning efforts to achieve theoretical purity, eliminate every real and imagined abuse, and address nontax policy objectives."

Until new tax programs can be developed to generate as much tax as the present system, we must continue with this annual ritual of tax return preparation.

Regardless of one's knowledge of the tax code, each taxpayer is responsible for filing a correct tax return by April 17 (extended two days since the 15th falls on a Saturday).

Many taxpayers make the process of tax filing more difficult by not keeping a simple filing system throughout the year. This sounds so basic, yet so few people complete this most fundamental organizational task.

Besides collecting statements received from institutional sources that document reportable income or allowable deductions, there still remains the confusion over the investment reporting of dividends, interest, and capital gains.

Each taxpayer must keep track of the cost basis for their stocks, bonds, or comparable mutual funds. When sold, the gain must be reported as short (held less than one year) or long (held more than one year). For many investor/taxpayers, this becomes a daunting task due again to lack of adequate record keeping.

Fortunately the IRS allows investors to report their gains using various methods; the average basis, the first-in-first-out (FIFO) method, or the specific share method. It does not matter which method is chosen, but it is important not to change methods in subsequent reporting years.

For mutual fund shares, the average cost basis works best. It is not necessary to record all of the share prices bought or reinvested. It is easier to calculate, as cost basis, the "dollars" purchased throughout the years, including reinvested dividends, interest, and capital gains. For example, the cost basis of a mutual fund purchased in 1994 for \$10,000 that had annual distributions (dividends, interest, and capital gains) in subsequent years of \$5,000 would be \$15,000. With this information, other detail can be determined.

The easiest tax preparation method, however, is not to do the work personally, but to pass the work onto an accountant.

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