

Big Tax Refunds Aren't Worth the Instant Gratification

By Gretchen L. Springer

It's that time of year when many lawyers start to get excited about that big tax refund for which they've been waiting. Visions of HDTVs, new suits, and vacations start dancing through their heads. What they often don't realize is that receiving that huge refund is really a poor financial strategy.

If you opt to have taxes overwithheld from your paycheck so you'll receive a big refund at the end of the year, not only are you making an interest-free loan to Uncle Sam but you're missing out on an opportunity to make that money work for you throughout the year and beyond.

Consider 2009. By overpaying on your income taxes all year long, you missed investing that money where the stock market recovered. If you overpaid taxes, you'll receive a refund that earned you 0 percent. If you had adjusted your 2009 withholding on your W-4 to have your tax payments match your tax liability, you could have invested that money in U.S. large cap stock index funds and earned over 20 percent.

Additionally, when you have too much money withheld from your paycheck, you run the risk of increasing use of credit cards or other debt. Too many times tax refunds are used to pay down debts that could have been avoided, at least in part, if not for the overwithholding. So while it's too late for 2009, you can still adjust your tax withholding for 2010. Here's how:

- **Project your income.** This is easy to do if you are a salaried employee. Consider raises and bonuses that you expect to receive.
- **Project your taxes.** Using your projected income, figure out your annual taxes for 2010. Consider life events (e.g., marriage, divorce, a new baby, or starting a new job) that can affect your tax liability. Hire an accountant if needed, and complete a state income tax projection.
- **Project taxes per paycheck.** Divide your projected taxes by the number of annual paychecks you'll receive. If you are paid twice a month, divide by 24. If you are paid every two weeks, divide by 26. This is the amount of money you should withhold for taxes every paycheck.
- **Resubmit your W-4.** This form determines how much money you withhold for federal and state taxes each paycheck. Ask your human resources department how many allowances that you should claim on the W-4 to equal the amount of money that you figured you need to withhold per paycheck.

Remember that an allowance does not equal a person or your total dependants. It is simply a number that determines the amount of tax your employer withholds from your paycheck throughout the year. The higher the number of allowances, the less tax that is withheld each paycheck. The ideal way to end each year is to receive the smallest refund. Once you have adjusted your withholding, it's time to make some smart choices about how to use the extra money in your paychecks each month.

- **Boost your emergency funds.** If you've been using tax overwithholding as a forced way to save, set up an automatic-deposit system with your bank or employer instead. Transfer those funds directly into savings rather than sending them to Uncle Sam. This can curb your habit of overusing credit cards.
- **Fund savings to spend.** Better plan for events that you know will cost you money every year. Escrow \$50 each month for the \$600 you always spend on during the holidays. Set aside money each paycheck for the vacation you take every February or the law convention you attend every fall.
- **Eliminate debt.** Instead of using your tax refund to pay down your credit card balance every year, use the extra money in your budget each month to cover expenses and not accumulate credit card debt and interest in the first place. You also can make extra payments on your debts to pay them off sooner.
- **Start investing.** Resetting your income tax withholding is a great time to also begin investing for your future. If you are already saving, increase the amount you are putting into your Roth IRA or 401(k) pension plans.

American Bar Association Young Lawyers Division
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By adjusting your tax withholding for 2010 and investing your 2009 tax refund instead of spending it, you will put yourself on the track to financial success in 2010 and beyond.

Keep in mind that not withholding enough or underpayment of estimated taxes may subject a taxpayer to penalty. This information is a general discussion of the relevant federal tax laws. It is not intended for nor can it be used by any taxpayer for the purpose of avoiding federal tax penalties. This information is provided to support the promotion or marketing of ideas that may benefit a taxpayer. Taxpayers should seek the advice of their own tax and legal advisors regarding any tax and legal issues applicable to their specific circumstances.



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