

2004 – 2005 Tax Planning Guide

Year-round strategies to make the tax laws work for you



MF Mallah Furman

CERTIFIED PUBLIC ACCOUNTANTS

Brickell Bay Office Tower

1001 Brickell Bay Drive
Suite 1400
Miami, Florida 33131-4938
305.371.6200
Fax 305.371.8726
info@mallahfurman.com

Cypress Park West

6700 North Andrews Avenue
Suite 404
Fort Lauderdale, Florida 33309
954.938.8001
Fax 954.938.0907

Tax planning has never been more important



David P. Rosenbaum, C.P.A.
Managing Director

Other than the Working Families Tax Relief Act of 2004, Congress has not passed any major federal tax legislation in 2004. Nevertheless, we are still feeling the after-effects of the recent spate of new tax laws. While offering many new opportunities to save tax, legislation over the past few years has also created a confusing array of sunset provisions, phase-in/phase-out dates, and changes to limits, exemptions and other rules. To benefit fully, you may need to rethink your current plan and act quickly to seize opportunities before they expire.

This guide explains how to both take advantage of changes in tax law and use proven strategies to minimize taxes on your personal and business income. It will give you many tax-smart ideas about investing, education funding, estate planning and saving for retirement. It will also show how to use special depreciation allowances, writeoffs and business tax credits to increase your company's profitability.

As you review the following pages, you may want to mark those paragraphs that seem especially relevant to your situation or that discuss items you would like to know more about. This will help guarantee that you take advantage of all possible opportunities to reduce your tax liability. Note the charts summarizing various tax rates and limits, and be sure to consult the At-a-Glance Tax Strategizer for quick reference to key tax-saving ideas.

Despite recent tax cuts, reducing your tax liability still requires vigilant planning and timely action. And, as the economy, tax law and your finances become more complex, it becomes more important to get expert guidance in taking steps to minimize your taxes.

Please feel free to contact us for more information about the issues discussed or other tax planning matters. Our experienced professionals would welcome the opportunity to sit down and talk with you about ways to keep more of your money where it belongs — in your hands, not Uncle Sam's.

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Complex laws require proactive planning

EVEN WITHOUT A major tax act this year, the complexity of recent legislation is making proactive tax planning more necessary — and challenging — than ever. To avoid penalties and reduce your tax liability, you not only need a thorough knowledge of tax laws and strategies, you need clear objectives, smart planning strategies and timely action.

As you look for ways to minimize your taxes this year, keep in mind that:

- ▼ The AMT is affecting more taxpayers than ever. Be sure to estimate your liability and do what you can to reduce it.
- ▼ Multiple rates on capital gains are making investment planning especially tricky. Trade carefully, with full awareness of the tax implications of your moves.
- ▼ Stealth taxes — phaseouts that reduce exemptions or deductions — can significantly affect your tax liability. Don't forget about them.

Of course, as this guide shows, you'll also want to think about many other factors, including charitable giving, education funding, retirement, and gift and estate tax implications. Bottom line: You'll need to be more diligent than ever in planning for your 2004 return — and beyond. So you'll find it all the more critical to consult a professional tax advisor about ways to minimize taxes and achieve your financial goals.

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KEY TAX PLANNING STRATEGIES

Situation	Planning idea	Detailed discussion
You expect your 2004 tax rate to be equal to or greater than next year's rate.	Accelerate deductions and defer income but be careful to avoid the alternative minimum tax (AMT).	Page 8
Your miscellaneous deductions may be reduced or eliminated due to the adjusted gross income limitation.	Bunch these deductions into a single year so that the excess over the income limitation will be deductible (while avoiding the AMT).	Page 9
You anticipate being penalized for underpayment of estimated tax.	Withhold additional amounts of tax from your wages by Dec. 31, 2004. Accelerate and/or increase remaining estimated tax payments.	Page 10
You are likely to be subject to the AMT in 2004 but not in 2005.	Defer deductions not allowed against the AMT, such as state and local income taxes, real estate taxes, and investment fees, until after Dec. 31, 2004.	Page 11
	Accelerate ordinary income and short-term capital gains into 2004.	Page 11
You have net realized capital gains this year.	Sell securities with unrealized losses to offset the gains — if the market conditions justify it.	Page 15
You have net realized capital losses this year.	No action is required, but you can lock in gains on securities with unrealized gains by selling them to offset realized losses.	Page 15
You have a concentrated low-basis stock position and want to diversify without paying taxes now.	Consider using a charitable remainder trust so the trust can sell the stock, allowing you to defer the tax over the life of an annuity.	Page 18
You have incentive stock options that you have not exercised, and the price of the stock has dropped considerably.	Consider exercising the options because the depressed price offers the opportunity to acquire the stock without becoming subject to the AMT from the spread at the time of the exercise.	Page 21
Your passive losses exceed your passive income.	Dispose of an activity generating passive losses or add one generating passive income.	Page 26
You want to withdraw funds for personal use from your investment account using margin debt.	Take advantage of the tracing rules by using sales proceeds and income to fund the personal expenses; then use margin debt to purchase replacement securities.	Page 29
You want to make large charitable contributions.	Donate appreciated securities you have held for over one year.	Page 30
	Consider establishing a charitable trust, private foundation or donor-advised fund.	Page 31
You want to provide for your children's or grandchildren's college costs.	Establish a 529 plan and gain the benefit of tax-free earnings if the funds are used to pay qualified higher education expenses.	Page 34
You want to take advantage of the tax-deferred nature of retirement accounts.	Make sure you are maximizing contributions to your accounts and taking advantage of the best plans available.	Page 36
You have an estate that will likely be in excess of \$1.5 million and want to protect your assets from estate tax in case of an untimely death before the scheduled estate tax repeal or the repeal not being extended beyond 2010.	Make \$11,000 annual exclusion gifts.	Page 43
	Pay beneficiaries' tuition and medical expenses directly.	Page 43
	Use a grantor retained annuity trust (GRAT).	Page 45
You want to transfer assets to your eventual beneficiaries during your lifetime.	Set up a family limited partnership (FLP) or family limited liability company (FLLC).	Page 47

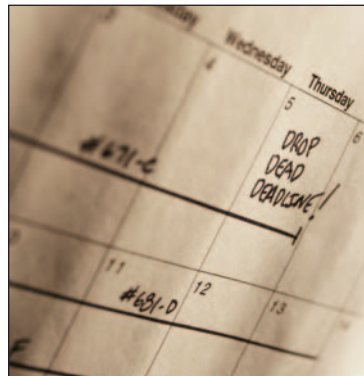
No major legislation likely, but you still need to be aware of changes

AFTER A FEW years of major tax acts, as of this writing it appears that Congress will not pass any significant tax legislation during this presidential election year. So here is a refresher of some of the major changes from 2003 that may affect your 2004 tax liability.

Capital gains and dividends

The centerpiece of the 2003 tax act was the drop in the top tax rate assessed on net long-term capital gains. But because of an effective date of May 6, 2003, your 2003 capital gains were subject to multiple tax rates based on complex netting rules that offset losses from one category against gains from another category according to when the sales took place. The result was mostly confusion when trying to apply these rules to 2003 income tax returns. While the netting rules still exist, as discussed in more detail in the chapter on capital gains (starting on page 14), most net long-term capital gains are now subject to a maximum tax rate of 15%.

The tax rate on most dividends is now 15%, rather than your ordinary income tax rate. This area also created a tremendous amount of confusion in 2003. Why? Dividends received from regulated investment companies — such as money market mutual funds and bond funds — and real estate investment funds are still subject to your ordinary income tax rate, as high as 35%. Also, you must hold the stock paying the dividend for more than 60 days during the 120 days beginning 60 days before the ex-dividend date. Because 1099-DIV forms typically are issued before Jan. 31 of each year and the 60-day holding periods were not always met before the 1099s were prepared, many brokers found themselves issuing corrected 1099s for 2003.



Ordinary income and the AMT

The reduction in the maximum tax rate applied to ordinary income, such as compensation, remains the same in 2004. Therefore, this type of income continues to be subject to a maximum tax rate of 35%. However, due to the ever increasing impact of the alternative minimum tax (AMT), the effective tax rate you pay on your income could increase as a result of the disallowance of some of your most common deductions, such as state income taxes and real estate taxes.

Bonus depreciation and Section 179 expensing

The first-year bonus depreciation was increased to 50% of the cost of qualifying new assets acquired after May 5, 2003. In addition, eligible new and used property placed in service in 2004 qualifies for a \$102,000 Section 179 deduction in lieu of depreciation. Plus the phaseout amount has increased to \$410,000 for qualifying equipment put in service in 2004. These amounts will be indexed for inflation in 2005 but will go back to the way they were before the new law for tax years beginning after 2005 (a maximum annual deduction of \$25,000).

However, the 50% bonus depreciation rule expires on Dec. 31, 2004. Therefore, the timing of new asset purchases should be considered before year end to take advantage of the bonus rule, especially for those companies that make significant new asset purchases and would not otherwise be eligible for Section 179 expensing. ▲

Chart 1

Summary of key tax cuts, benefits and effective dates

Provision	Year initially effective	2004 tax benefit	2005 tax benefit	Year fully effective	Savings or benefit when fully effective
10% tax bracket expansion	2001	Fully effective savings (see last column) — same as 2003	Same as 2004	2003	Married couple: \$700 Single: \$350 Single parent: \$500
Tax rate cuts (except 10% and 15% rates, which remain the same)	2001	Same as when fully effective (see last column) except lowest long-term capital gains and dividend rate is 5%	Same as 2004	2008	Rates of 25%, 28%, 33% and 35%, and long-term capital gains and dividend rates of 15% and 0%
Marriage tax penalty relief	2003	Fully effective savings (see last column) — same as 2003	Same as 2004	2003	15% tax rate applies to twice the income taxed at 15% for single filers and standard deduction is twice that of single filers
Personal exemption and itemized deduction phaseout repeal	2006	None	None	2010	Phaseouts begin to be reduced in 2006 and are fully repealed in 2010
Estate and generation-skipping transfer (GST) tax rate reduction and repeal	2002	Maximum rate cut to 48% from 49%	Maximum rate cut to 47%	2010	Maximum rate cut to 45% in 2007 Repeal in 2010
Gift tax rate reduction	2002	Same as estate tax rate cut	Same as estate tax rate cut	2010	Maximum rate cut to 35%
Estate tax exemption amount increase	2002	Increase to \$1.5 million from \$1 million	Same amount as 2004	2009	Increase to \$3.5 million
GST tax exemption amount increase	2001	Increase to \$1.5 million from \$1.12 million	Same amount as 2004	2009	Increase to \$3.5 million
Gift tax exemption amount increase	2002	Fully effective savings (see last column) — same as 2003	Same as 2004	2002	Increase to \$1 million
IRA maximum contribution increase	2002	\$3,000 — same as 2003 (\$3,500 for ages 50 and up)	Increase to \$4,000 (\$4,500 for ages 50 and up)	2008	Increase to \$5,000 (\$6,000 for ages 50 and up)
401(k) plan maximum contribution increase	2002	Increase to \$13,000 from \$12,000 (to \$16,000 for ages 50 and up)	Increase to \$14,000 (\$18,000 for ages 50 and up)	2006	Increase to \$15,000 (\$20,000 for ages 50 and up)
529 plan distribution tax treatment	2002	Fully effective savings (see last column)	Same as 2004	2004	Tax-free if used for qualified higher education expenses and extended to eligible private education institutions

Note: Cost of living adjustments are not reflected in this chart.

Source: U.S. Internal Revenue Code

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Your effective tax rate may be higher than you think

MANY TAX RATES went down last year, but income reported on a federal income tax return still can be subject to several effective federal income tax rates, ranging from 5% to 38% (adjusting the 35% rate to include the tax cost of limitations on itemized deductions) and increasing to more than 50% for self-employment income and premature retirement plan distributions.

Many factors determine the tax rate you will pay on each piece of income — as well as the benefit you will receive from your deductions. These include whether:

- ▼ It is ordinary income or capital gain income,
- ▼ The alternative minimum tax (AMT) applies,
- ▼ The income is subject to employment taxes,
- ▼ The income is from a tax-deferred retirement account withdrawal, and
- ▼ Itemized deduction limitations and personal exemption phaseouts apply.

This chapter provides a tax rate overview. Later in the guide we will discuss these rates in more detail, along with related tax saving strategies.



Chart 2
2004 federal tax rate schedule

Taxable income	Base tax	Marginal tax rate (tax on next dollar)
Married filing jointly or qualifying widow(er)		
\$0	\$0	10%
\$14,300	\$1,430	15%
\$58,100	\$8,000	25%
\$117,250	\$22,788	28%
\$178,650	\$39,980	33%
\$319,100	\$86,328	35%
Single		
\$0	\$0	10%
\$7,150	\$715	15%
\$29,050	\$4,000	25%
\$70,350	\$14,325	28%
\$146,750	\$35,717	33%
\$319,100	\$92,593	35%
Married filing separately		
\$0	\$0	10%
\$7,150	\$715	15%
\$29,050	\$4,000	25%
\$58,625	\$11,394	28%
\$89,325	\$19,990	33%
\$159,550	\$43,164	35%
Head of household		
\$0	\$0	10%
\$10,200	\$1,020	15%
\$38,900	\$5,325	25%
\$100,500	\$20,725	28%
\$162,700	\$38,141	33%
\$319,100	\$89,753	35%

Source: U.S. Internal Revenue Code

Rates on ordinary income

Ordinary income includes wages and self-employment income, interest, taxable retirement plan distributions and more. All but the two lowest rates on ordinary income — 10% and 15% — went down last year, so the rates range from 10% to 35% for 2004. (See Chart 2.)

One way to reduce taxes on ordinary income is to wisely time income and deductions. Turn to the next chapter, “Timing Income and Deductions,” for ideas on how you might benefit from this strategy.

Rates on capital gains and dividend income

Capital gains and dividend income can be advantageous because they often are subject to lower maximum tax rates. This is discussed in detail in the “Capital Gains and Losses” chapter starting on page 14, but here’s a brief look at the basics.

Beginning last year, net long-term capital gains and corporate dividend income are taxed at 15% for both regular tax and AMT — with several notable exceptions discussed in the “Capital Gains and Losses” chapter. To benefit from long-term capital gains treatment, you must have held the asset for more than 12 months. Net short-term capital gains



Chart 3

Social Security and Medicare taxes

	Maximum income subject to tax	Tax rates/2004 maximum tax cost	
		2004	Employer and employee
Social Security	\$87,900	6.2%/\$5,450	12.4%/\$10,900
Medicare	No limit	1.45%/No limit	2.678% ¹ /No limit

¹ The tax rate is actually 2.9%, but only 92.35% of self-employment income is subject to the Medicare tax.

Source: U.S. Internal Revenue Code

are subject to the same tax rates as ordinary income and, therefore, could be taxed at a rate as high as 35% in 2004.

Certain types of dividend income also are still subject to the higher ordinary income tax rates. The key types of dividend income subject to these rates are from:

- ▼ Money market mutual funds that are not receiving corporate dividends,
- ▼ Real estate investment trusts (REITs) to the extent they do not represent distributions in excess of income subject to tax at the REIT entity level over the amount of tax for the preceding year,
- ▼ A regulated investment company (RIC) in excess of the amount of qualifying dividends received by the company (if the dividends are less than 95% of its gross income), or
- ▼ Equities to the extent the securities are offset by margin debt.

AMT an even bigger threat

Ordinary income subject to the AMT is taxed at a maximum rate of 28%. This rate is lower than the highest regular tax rate of 35%, but it typically applies to a higher taxable income base and thus can result in unpleasant tax surprises.

There is a greater likelihood you will now face the AMT. See the chapter “Alternative Minimum Tax” starting on page 11 to learn how the AMT could affect you.

Employment taxes continue to take another bite

You also must pay Social Security and Medicare taxes on your wages and self-employment income. The amount of income subject to Social Security tax is limited, but all earned income is subject to Medicare tax.

If you are considered to be self-employed, your liability doubles, because you also have to pay the employer portion of these taxes. (See Chart 3.) As a result, self-employment income can be taxed as high as 48% compared to about 43% for income from wages. Why only five percentage points higher? Because you receive a deduction against adjusted gross income (AGI) for 50% of the self-employment tax you pay.



Early retirement plan withdrawals still can mean higher tax rates

Taking distributions from your tax-deferred retirement plan before age 59½ (with a few exceptions — see the “Retirement” chapter starting on page 36) can boost your effective tax rate further. Not only are your withdrawals taxed at your regular income tax rate, rather than the more beneficial long-term capital gains rate, but you also have to pay a 10% penalty. This means the effective rate on premature withdrawals can approach 50%.

TAX PLANNING TIP 1 BE PREPARED FOR STEALTH TAXES

A married couple with four children, filing jointly, will see their tax liability increase by as much as \$6,510 if their personal exemptions are fully phased out. (That is, their adjusted gross income — AGI — is in excess of \$336,550.) The itemized deduction phaseout can be even more expensive. For example, if this couple’s AGI is \$1 million, they will lose the benefit of \$25,719 of their itemized deductions at a tax cost as high as \$9,002 — the combined stealth taxes will increase their tax by \$15,512.

Also watch out for the mandatory 20% federal income tax withholding on eligible rollover distributions from qualified retirement plans. Such withdrawals often occur when a taxpayer changes jobs. To avoid the withholding, never personally receive the funds. Instead, use a trustee to roll them over into an IRA or a qualified retirement plan sponsored by your new employer.

And don’t forget stealth taxes

The following phaseouts, to be repealed starting in 2006 under the 2001 tax act, are the most common stealth taxes:

Personal exemptions. You begin to lose the \$3,100 reduction (for 2004) of your taxable income for each of your exemptions once your AGI exceeds:

- ▼ \$214,050 if you are married filing jointly,
- ▼ \$142,700 if you are single,
- ▼ \$107,025 if you are married filing separately, or
- ▼ \$178,350 if you are head of household.

Reduction of itemized deductions. You must reduce many of your itemized deductions by 3% of your AGI if your AGI exceeds \$142,700 (\$71,350 if married filing separately). But, the reduction cannot exceed 80% of these deductions.

These reductions can significantly increase your tax liability. (See Tax Planning Tip 1.) ▲

T I M I N G I N C O M E A N D D E D U C T I O N S

To defer or to accelerate, that is the question

CONTROLLING WHEN YOU pay deductible expenses and receive income can allow you to defer a portion of your tax to next year or later and give you, rather than the IRS, use of the funds in the interim. There are also significant opportunities to permanently reduce your taxes — especially if you are subject to the alternative minimum tax (AMT) in one year but not another. Thus, before year end, you need to project (as much as possible) your tax for both this and next year so you can identify your tax bracket, determine whether the AMT will likely affect you, and time income and deductions accordingly.

AMT — yes or no?

If the AMT *is not* a factor in this year or next and you *don't* expect your taxable income to change significantly next year:

- ▼ Prepay deductible expenses this year,
- ▼ Defer income to next year,
- ▼ Take capital losses to offset net capital gains, and
- ▼ Properly bunch miscellaneous itemized deductions into a single year to exceed the 2% of adjusted gross income (AGI) floor and maximize your benefit.



If the AMT *isn't* a factor and you *do* expect your taxable income to change a lot next year:

- ▼ Pay deductible expenses in the year your tax bracket is higher,
- ▼ Control receipt of income so you receive it in the year your tax bracket is lower, and
- ▼ Take capital losses to offset net capital gains, unless the short-term gains would otherwise be taxed at a lower rate next year.

If the AMT *is* a factor in one year, turn to the “Alternative Minimum Tax” chapter starting on page 11 for timing strategies.

Controlling expenses

Here are some of the most common deductible expenses you can easily prepay (by Dec. 31, 2004) — or defer if appropriate:

State and local income taxes.

Remember these

key deadlines: Jan. 18, 2005, for fourth quarter 2004 estimated tax payments, and April 15, 2005, for projected 2004 balance due or equivalent extension payment. In addition to accelerating the deduction, the tax benefit of protecting the deduction (if you may be in the AMT in 2005) will easily outweigh the lost earnings on the funds.

Real estate taxes. Paying 2005 taxes early can be an especially useful strategy should you end up owing the AMT next year.

Mortgage interest. You can deduct mortgage payments due in January 2005 that you prepay — up to the amount of interest accrued in 2004.

Margin interest. Make sure you pay the interest before Dec. 31, 2004, because interest accrued at year end is deductible only if actually paid (subject to a net investment income limitation).

Charitable contributions. You generally can deduct charitable gifts totaling up to 30% (appreciated capital gain property) and 50% (cash) of your AGI, depending on several factors. (See the “Charitable Giving” chapter starting on page 30 for specific charitable gifting strategies.)

Losses. Generally interest holders in partnerships, limited liability companies (LLCs) and S corporations can deduct losses from the entity only to the extent

TAX PLANNING TIP 2 DON'T
DEFER OR ACCELERATE UNTIL
YOU'VE CONSIDERED THE AMT

they have tax basis and are at risk. If you have such losses, you may want to make a capital contribution (or additional loan if an S corporation) before year end to allow you to deduct the losses. Losses may still be limited by the passive activity rules. (See the chapter "Passive Activity Limitations" on page 26.)

Controlling income

Timing income can be more difficult than timing deductions, but you may be surprised at what you can control:

Cash salaries or bonuses. You can defer these, but only if they are not made available to you in 2004. (Be careful if the payor is a related party.)

Consulting or other self-employment income. For cash-basis businesses only, delay billing until January 2005 for services you already performed. You can get the added benefit of deferring self-employment taxes.

U.S. Treasury bill income. Early in 2005, buy bills with a maturity date after Dec. 31, 2005. This will give you the flexibility to recognize the income in either 2005 or 2006.

Real estate or other nonpublicly traded property sales. If you sell at a gain and use the installment sale method to report the income, you recognize the gain only as you receive payments, so you can defer most of it to future years. You'll also receive interest payments on the note the buyer gives you (or it will be imputed if the note doesn't provide for interest).

Retirement plan distributions. If a) you are over age 59½, b) you need to take distributions from your retirement plan, and c) your tax rate will be lower this year than next year, consider accelerating these distributions. Conversely, if your tax rate is higher this year, consider deferring them.

Bunching deductions

Miscellaneous expenses are deductible for regular income tax purposes only if they exceed, in aggregate, 2% of your AGI. Bunching these expenses into a single year may allow you to exceed the floor. If your miscellaneous itemized deductions — most of which are not deductible for AMT purposes — already

A married couple subject to the maximum ordinary tax rate of 35% takes these steps before Dec. 31, 2004, to maximize tax deferral:

Defers billing of consulting fees earned in 2004 to Jan. 1, 2005	\$25,000
Pays mortgage (interest portion) due Jan. 1, 2005	3,500
Pays first half of 2005 real estate tax	9,000
Pays charitable contributions intended for 2005	10,000
Pays fourth quarter 2004 state estimate due Jan. 18, 2005	20,000
<hr/>	
Total reduction of taxable income	\$67,500
Federal tax rate	35%
Tax deferred to next year	\$23,625

But, if the couple has to pay the alternative minimum tax (AMT) in 2004 (and not in 2005), these year-end strategies will cost them \$12,600 in additional taxes. Why? First, the deferred consulting fees will be subject to the couple's regular marginal tax rate of 35%, rather than the lower 28% if collected in 2004 — resulting in a \$1,750 tax increase. Second, the prepaid real estate taxes and fourth quarter 2004 state estimate will generate no tax benefit (because such expenses are not deductible for AMT purposes) rather than providing a \$29,000 deduction if paid in January 2005 — resulting in \$10,150 in unnecessary taxes. Finally, the charitable contributions made in December 2004 will generate a smaller tax benefit of only 28% rather than 35% if made in 2005 — resulting in a lost tax benefit of \$700.

exceed the 2% floor, carefully record and prepay these expenses by Dec. 31, 2004:

Deductible investment expenses. These include investment advisory fees, custody fees, safe deposit box rentals and investment publications.

Professional fees. These typically include tax planning and preparation, accounting, and certain legal fees (to the extent deductible).

Unreimbursed employee business expenses. These include travel, meals, entertainment, vehicle costs and publications, all exclusive of personal use. You must reduce expenses for business entertainment and meals (including those while away from home overnight on business) by 50% before the 2% floor applies. ▲

Are you paying too much in quarterly payments?



IF YOUR WITHHOLDING is not enough to cover at least 90% of your actual tax liability, you must pay adequate estimated taxes on a quarterly basis or you will be assessed a nondeductible interest charge, referred to as a penalty. There are several ways you can avoid this penalty and minimize quarterly payments instead of overpaying the IRS.

Avoiding the penalty

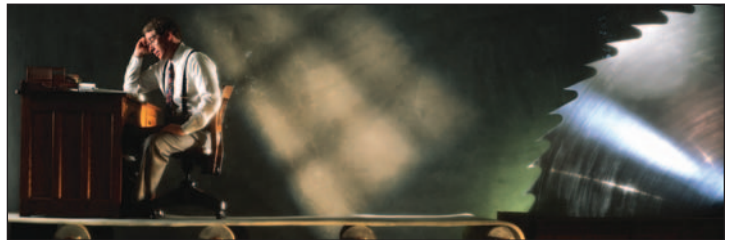
You will not be subject to the penalty if your withholding plus timely filed quarterly estimates for 2004 are at least:

- ▼ 90% of your actual tax for 2004, or
- ▼ 110% of the tax on your 2003 return, or
- ▼ 100% of the tax on your 2003 return if your adjusted gross income in 2003 was \$150,000 or less (\$75,000 if married filing separately).

You also can avoid the penalty if you compute and pay the tax using the annualized income installment method. (See Tax Planning Tip 3.)

But don't automatically make your scheduled Jan. 18, 2005, estimated tax payment that is sitting on your desk if it was prepared on a safe harbor

exception based on 110% (or 100%, if applicable) of your 2003 actual tax. If your year end tax planning indicates you have already met the 90% test above, give yourself use of the funds rather than the IRS, because you will not be subject to the penalty.



Year end tactics

If you determine at year end you don't meet any of the requirements above, you can still reduce or eliminate your penalty by taking the following steps:

- ▼ Increase your tax withholding through the end of the year. The additional withholding is deemed to have been paid evenly throughout the entire year.
- ▼ Withhold more than the bonus rate of 27% if you receive a bonus at year end.
- ▼ Increase your Jan. 18, 2005, estimated tax payment and make it earlier to eliminate penalties for the fourth quarter.

Finally, using some of the year end tax planning ideas identified in this guide can help you lower your 2004 tax and thus reduce the amount of the underpayment. ▲

TAX PLANNING TIP 3 PROJECT YOUR TAXES QUARTERLY TO DEFER TAXES AND AVOID PENALTIES

Certain types of income, such as capital gains and bonuses, typically are not realized or earned evenly throughout the year. If you receive such income, you likely can reduce your earlier quarterly estimates by preparing actual quarterly tax projections. By computing your year-to-date tax, after tax withholding, you can pay the net amount without incurring a penalty — even if this amount is significantly lower than the amount due based on your prior year's tax. Later in the year you can catch up by increasing your estimates as you earn income.

The AMT threat is escalating, but you can minimize its impact



ORIGINALLY, UNCLE SAM intended the alternative minimum tax (AMT) to snare only the wealthiest taxpayers who were sheltering income. And in the past, most taxpayers have avoided the AMT because of its generally lower rate and separate exclusion amount.

Even before the 2003 tax act, the AMT had begun to affect more taxpayers, and now its impact is much greater. Bottom line: AMT planning is more important than ever.

Learn the AMT triggers and rates

Many deductions and tax credits you can use to calculate your regular tax do not apply to the AMT. And some income differences might trigger or increase your AMT liability rather than reduce it. (See Chart 4.) Common AMT triggers include:

- ▼ State and local income taxes, especially if you live in a high-income-tax state,
- ▼ Miscellaneous itemized deductions, such as investment advisory fees and employee business expenses,
- ▼ Long-term capital gains and dividend income, which are taxed at 15% for both regular tax and the AMT but can increase non-AMT-deductible state and local income taxes,
- ▼ Incentive stock option (ISO) exercises that increase your AMT income on the basis of how much the acquired shares' fair market value exceeds the exercise price (see the chapter "Stock Options and Restricted Stock" starting on page 20),
- ▼ Personal exemptions,
- ▼ Credits for child and dependent care expenses and education credits that are allowable in computing your regular tax liability but disallowed in computing your AMT (starting in 2004), and

- ▼ AMT rates that have not decreased and exclusion amounts that have not increased significantly compared to lowered regular tax and inflation-indexed personal exemption amounts.

A 28% maximum tax rate applies (after any allowable exclusion) to ordinary AMT income in excess of \$175,000. For ordinary AMT income of \$175,000 or less, the AMT rate is 26%. Long-term capital gains are taxed at the same rate (generally 15%) for the AMT as for regular tax.

You may be allowed an AMT exclusion, up to \$58,000 for 2004 if married filing jointly, \$40,250 if single or head of household, or \$29,000 if married filing separately. But a phaseout will continue to affect the exclusion, which will be fully eliminated when your AMT income reaches \$382,000 if married filing jointly, \$273,500 if single or head of household, or \$191,000 if married filing separately. And in 2005, absent congressional action, the exclusion will revert to 2000 amounts: \$45,000 if married filing jointly, \$33,750 if single or head of household, and \$22,500 if married filing separately.

3 AMT scenarios to plan for

When you have a fairly good idea of whether you will be subject to the AMT, you can try to reduce your tax liability accordingly. Here are three possible scenarios to plan for:

1. You're subject to the AMT this year. First, defer until 2005 deductions you can't take for AMT purposes, such as state and local income taxes. Next, even if you can deduct expenses against your AMT income, postpone them to next year, when the deductions may be more valuable. Also, accelerate ordinary income or short-term capital gain income

Chart 4

AMT vs. regular tax — what’s the difference?

Description	Deductible in computing			Other AMT differences
	Regular tax	AMT	Taxable for AMT only	
State and local income taxes	▼			
Real estate taxes	▼			
Investment interest expenses	▼	▼		
Charitable contributions	▼	▼		
Investment advisory fees	▼			
Employee business expenses	▼			
Mortgage interest on:				
▼ Qualified acquisition debt	▼	▼		
▼ Equity debt (up to \$100,000) not used to buy, build or improve your residence	▼			
<i>Note: Equity debt over \$100,000 subject to interest tracing rules to determine deductibility</i>				
Medical expenses:				
▼ Over 7.5% of adjusted gross income (AGI)	▼			
▼ Over 10% of AGI	▼	▼		
Personal exemptions (subject to phaseout)	▼			
Exercise of incentive stock options (fair market value over exercise price)			▼	
Tax-exempt interest on certain private activity bonds			▼	
Depreciation (subject to different AMT rules)				▼
Gain or loss on disposition of certain assets				▼
Passive activity adjustments				▼
Child and Dependent Care credit	▼			
Education credits	▼			

Source: U.S. Internal Revenue Code

to this year to benefit from the lower AMT rate — especially if you think you’ll end up in a higher regular tax bracket next year. Last, delay exercising any stock options if the spread between the fair market value and the exercise price is large or you may get hit with AMT liability on the spread.

2. You’re not subject to the AMT this year, but you probably will be next year. In this case, take the opposite approach. For instance, defer income to next year, as you’ll probably pay a relatively lower

AMT rate. And prepay your state income tax this year because that deduction won’t help you next year. Also, make sure you don’t own any private activity bonds.

3. You’re not subject to the AMT in either year. Congratulations on avoiding the AMT, but you still need to lessen your regular tax liability. Turn back to the “Timing Income and Deductions” chapter starting on page 8 to see how to minimize your taxes.

The AMT credit: A silver lining

If you pay the AMT in one year, you may be entitled to a tax credit against your regular tax in a subsequent year. You may qualify for an AMT credit based on “deferral items” that contributed to your AMT liability. The most common deferral items are depreciation

adjustments, passive activity adjustments and the tax preference on the exercise of ISOs. For example, AMT depreciation is a deferral item because it is generally calculated using a different asset life and method than used for regular tax depreciation. But because the 50% bonus depreciation applies to both regular tax and the AMT, there is no AMT adjustment for this special depreciation allowance. The AMT in Tax Planning Tip 4 would not create an AMT credit because none of the adjustments are deferral items.

Look to your business activities as well. For example, you can qualify for the AMT credit on the basis of passive activity adjustments, most commonly from depreciation adjustments that over the years resulted in lower suspended losses for regular tax purposes than for AMT purposes.



AMT can sometimes save you taxes

In a year you're in the AMT, you may have the opportunity to realize additional income and pay a much lower effective tax rate. By accelerating ordinary income into the AMT year, you pay a maximum tax rate of 28% rather than the 35% that would otherwise apply (for 2004). But other opportunities also exist. One such scenario can occur if you sell stock that you purchased through the exercise of an ISO in an earlier year.

For example, let's assume you exercised an ISO to purchase 10,000 shares at an exercise price of \$15 per share when the stock was selling for \$25 per share. Your tax preference item was \$100,000 (10,000 shares times the \$10 per share spread). However, assume you had substantial ordinary income so you didn't have an AMT liability that year. A year later, you find yourself subject to the AMT and you decide to sell the shares for

\$40 per share and realize a long-term capital gain of \$250,000 (10,000 shares at a gain of \$25 per share). This gain increases your regular tax by \$37,500. But because you are now in the AMT, you pay only the AMT tax of \$22,500 based on the AMT gain of \$150,000 (10,000 shares at \$15 per share). The result of the sale is that you pay an effective tax rate of only 9% (\$22,500 tax on a gain of \$250,000). ▲

TAX PLANNING TIP 4 ANTICIPATE POTENTIAL AMT LIABILITY TO SAFEGUARD YOUR DEDUCTIONS

As this example demonstrates, failing to consider the alternative minimum tax (AMT) and incorrectly timing the payment of some of your deductions can be costly. Let's say before Dec. 31, 2004, you paid a \$10,000 state estimated fourth quarter tax payment, \$9,000 in real estate taxes (not due until January 2005) and \$10,000 in charitable contributions you initially intended to make early next year. Here's a projection of the impact of these payments on your regular and AMT liability (if married filing jointly) when included with your other income and deductions:

Income	Regular tax	AMT
Salaries	\$300,000	\$300,000
Interest	10,000	10,000
Dividends	5,000	5,000
Long-term capital gains	175,000	175,000
Total income	\$490,000	\$490,000
Itemized deductions (with prepayments)		
State and local taxes	\$30,000	\$0
Real estate taxes	25,000	0
Mortgage interest	35,000	35,000
Charitable contributions	40,000	40,000
Investment advisory fees and other miscellaneous itemized deductions	30,000	0
2% disallowance	(9,800)	0
Phaseout of itemized deductions	(10,419)	0
Net itemized deductions	\$139,781	\$75,000
Taxable income	\$350,219	\$415,000
Total federal tax liability	\$65,269	\$89,300

Because you must pay the higher of the two taxes, you will incur \$89,300 in AMT liability — that's \$24,031 more than the regular tax.

Gain tax savings with smart investment planning

SUCCESSFUL INVESTING MEANS more than just knowing the market's daily ups and downs. It calls for careful long-term planning as well — especially when managing capital gains and losses. Gains are subject to many different rates (see Chart 5), but the key maximum tax rates that apply to most capital gain transactions are 35% on assets held 12 months or less (the same rate that applies to ordinary income such as compensation and interest) and 15% on assets held more than 12 months.

Because you can pay more than double the tax on a short-term capital gain as on a long-term gain, it is important to plan your capital gain transactions. Many investors believe you should always hold assets with unrealized gains for more than 12 months and sell assets with unrealized losses within 12 months. But this general rule has too many exceptions to be valid.

The factors that can affect the actual tax rate that applies to the sale of capital assets, in addition to the holding period, include:

- ▼ Nature of the property sold,
- ▼ The netting rule (see Tax Planning Tip 5),
- ▼ Depreciation subject to recapture on the sale of real estate property, and
- ▼ Exclusion and rollover provisions on the sale of some assets.

Beware of the AMT

A separate tax calculation that disallows some deductions, the alternative minimum tax (AMT) can increase your tax if your regular income tax liability is too low. The maximum federal tax rate of 15% on long-term capital gains applies to both the regular tax and the AMT. However, because substantial net long-term capital gains can increase your deductible state (and local) income taxes, they may also have the adverse effect of triggering the AMT. If so, you

will lose the benefit of some or all of the deduction for additional state income taxes. (See the previous chapter, “Alternative Minimum Tax.”)

And capital gains are subject to the same maximum tax rates for the AMT as for regular tax, with the following notable exception: 28% for assets held 12 months or less (rather than 35%).

Trade cautiously as the year draws to a close

As year end approaches, determine your year-to-date net capital gains or losses. If you have net capital gains, you can reduce your current year's tax by taking unrealized losses. If you have net capital losses, consider locking in gains on appreciated securities by selling them to offset the losses. But before you execute any year-end trades, consider:

The trade date. Many investors focus on the settlement date. But the trade date on the sale of publicly traded securities determines the year that you recognize the gain or loss.

Excess net losses. You must net excess losses from one holding period against the capital gains of the other holding period, potentially changing the tax rate on the gain or loss. (See Tax Planning Tip 5.)

Investment conditions and selling expenses. The big picture is especially important at year end. Survey the market outlook and evaluate whether you want to remain in a position before realizing losses or gains. Also, consider transaction costs before you execute the sale.

Excess capital losses. Only \$3,000 per year (\$1,500 if married and filing separately) of capital losses exceeding gains can reduce your ordinary income. Excess losses are carried forward indefinitely (but not back) until used. But you can carry back some losses on regulated futures contracts against income from similar contracts. (See the end of this chapter.)

And it's important to sweat the details. For example, when determining your

year-to-date net capital gain or loss, include mutual fund long-term capital gain distributions that may be paid in December. (Your statement may refer to them as dividends.) Also look for gains and losses from pass-through entities, such as partnerships, S corporations and limited liability companies (LLCs). Gains and losses on mark to market assets such as S&P index options and regulated futures contracts can also affect your gains and losses.



Chart 5
Capital gains regular tax rates

Holding period	Maximum tax rate (regular tax)					
	35%	28%	25%	15%	14%	5%
Held 12 months or less	▼					
Held more than 12 months				▼		
<i>Exceptions to the 15% rate:</i>						
Collectibles such as artwork		▼				
Gain attributable to depreciation on real property			▼			
Qualified small business stock held more than 5 years					▼	
Gain that would be taxed at 15% or 10% based on your regular income tax rate						▼

Also consider the netting rules before deciding which securities you want to sell at year end. (See Tax Planning Tip 5.) Follow these simple rules to help determine the losses or gains you should consider realizing:

- ▼ If you have net capital gains, take losses equal to the net gain, plus \$3,000, or
- ▼ If you have net capital losses, consider locking in some gains by selling securities with unrealized gains up to the amount of your net loss, less \$3,000.

If you are married, filing separately, substitute \$1,500 for \$3,000 in the above points.

Identify lots, save even more

If you bought the same stock at various times, you usually want to sell the lot with the highest cost. But brokers typically identify the lots bought first as the shares to be sold — regardless of their relative cost — to ensure long-term rather than short-term treatment. Avoid this mistake by instructing your broker in advance to identify the highest cost lots with a long-term holding period as the lots you want sold first. But make sure you consider the netting rule as you approach the end of the year.

If you trade on the Internet, beware that some online trading firms still don't segregate your individual lots by purchase date. This will usually hamper your efforts to identify lots. Clarify your identification strategy with your online firm.

Realize losses but maintain your position with a bond swap

You can realize capital losses by selling bonds with unrealized losses and replacing them with similar bonds, regardless of the 30-day "wash sale" period discussed below. This technique is referred to as a bond swap, because your net position after the sale and purchase is similar to your position before it. This swap can be done on all bonds in your portfolio with unrealized losses. The wash sale rule, as it applies to bonds, permits greater freedom in choosing a replacement bond than a similar sale of stock would. For example, the replacement bond is not considered a substantially identical security (the wash sale test) if it is issued by a different agency or has a materially different stated interest rate or maturity.

But make sure you don't sell bonds that have appreciated since you purchased them, such as a bond purchased at par that has a stated interest



rate greater than the current yield. If you sell these bonds, most likely you will end up with a capital gain and effectively accelerate future interest income into a current-year taxable capital gain. This can occur even if you sell tax-exempt bonds.

Don't get caught by the wash sale rule

The wash sale rule prohibits you from realizing a loss on a security if you buy the same or substantially identical security (or option to buy such a security) within 30 days before or after you sell it. This requires you to be out of the position, and at an investment risk, if you want to take a loss on the security but also want to retain it for future growth potential. If you fail the wash sale rule, your loss will be realized only when the replacement security is sold.

TAX PLANNING TIP 5 CUSHION YOUR GAINS FROM TAXES BY UNDERSTANDING THE NETTING RULE

Let's say you determine that your year-to-date net capital gain is \$40,000, resulting from an \$80,000 short-term capital loss and \$120,000 of long-term capital gains. If you take no year end action, you will pay a tax of \$6,000 (\$40,000 at 15%). To eliminate this tax, first try to sell securities at a loss that you have held long-term rather than short-term. Why? Because securities held either short-term or long-term sold at a loss of \$40,000 will have the same effect of eliminating the tax. If the year-to-date position were reversed, with net short-term gains of \$120,000 and net long-term capital losses of \$80,000, a year end long-term capital loss of \$40,000 would save you \$14,000, since the 35% rate applies because you reduced your net short-term gains. The result in both situations is the opposite of what you might initially think, because a short-term loss in the first situation would give you only a 15% benefit and the long-term loss in the reversed situation gives you a 35% benefit.

But if you don't wish to risk being out of the position for more than 30 days, several alternatives may help you. For instance, you can buy securities of another company in the same industry or shares in a mutual fund that holds securities similar to the one you sold. In doing so, you sell the security and take the loss without significantly changing your investment portfolio. And you can then sell the alternative security or mutual fund after 30 days and use the proceeds to buy back securities in your original company, if you prefer.

Stop short before selling short

The reverse of the wash sale rule — the “selling short against the box” rule — prevents you from selling an identical security short to lock in the appreciation on it without recognizing any taxable gain. The two positions are deemed to be a constructive sale and you must realize gain as if the appreciated security was sold for its fair market value on the date of the short sale, thereby preventing you from deferring the gain to a future year.

An exception to this rule allows you to close the short sale within 30 days after the end of the tax year if you keep your appreciated position open and at risk for at least 60 days following the close of the short sale.

Don't fall into the mutual fund trap

Avoid purchasing shares in an equity mutual fund just before it declares a large distribution, typically at year end. If you own the shares on the record date of the distribution, you will be taxed on the full distribution amount even though it may include significant gains realized by the fund before you owned the shares.

Worse yet, you will end up paying tax on those gains in the current year, even if you reinvest the distribution in the fund and regardless of whether your position in the fund has appreciated. In effect, part of your initial investment is immediately converted into taxable income. (See Tax Planning Tip 6.)



TAX PLANNING TIP 6 REMEMBER THE TAXING EFFECT OF MUTUAL FUND DISTRIBUTIONS

Typically, distributions from mutual funds are reinvested in the fund. But the distribution itself does not change your value in the fund. It simply increases the number of shares you own, yet now at a lower per-share value. Unfortunately, the distribution can cost you taxes. For example, let's say you purchased 2,500 shares of an equity mutual fund on Dec. 1, 2004, at \$50 per share. The next week, the fund makes a capital gain distribution of \$8 per share. You end up with capital gain income of \$20,000 (2,500 shares at \$8 per share), reportable on your 2004 return. It doesn't matter whether the actual value of the shares has increased or even decreased since you purchased them.

Warning: Switching mutual funds, other than money market funds, is considered a sale of the initial fund with potential capital gain or loss results, even if the new fund is in the same family of funds.

Large yearly capital gain distributions from mutual funds have the same effect on your tax return as if you sold some, or all, of the shares and realized a taxable capital gain. But if instead you directly own similar stocks, you can control the timing of the realization of the capital gain. This gives you the advantage of deferring the tax on the gain, possibly for many years, or realizing the gain in a year that allows you to minimize the tax. However, direct ownership of stocks may sacrifice some of the diversity that may be available in a mutual fund.

When you sell mutual fund shares, don't forget about reinvested dividends. Investors often overpay taxes when they don't add reinvested dividends to their original cost when determining capital gain.

Take losses for worthless securities and bad debts

Fortunately, you get a tax break when an investment or business deal truly goes bad. For instance, a worthless security is treated as a capital loss in the year it becomes totally worthless. For determining whether the loss is long-term or short-term, the investment is deemed to be sold on Dec. 31. A

nonbusiness bad debt, typically an uncollectible loan, is similarly deductible as a capital loss in the year it becomes entirely worthless. The loss is treated as a short-term loss regardless of how long the debt was outstanding. But be careful that it is not a loan you have simply forgiven. A forgiven loan will be treated as a gift made by you, and it will go against your annual gift tax exclusion, or even your lifetime gift tax exemption. (See the chapter on “Gift and Estate Planning” starting on page 42.)



Make sure you review your investments before year end to determine whether you have any securities or nonbusiness bad debts that are fully worthless. To be considered worthless, a security must have absolutely no value. Even if it has a negligible value, you will be prevented from claiming it as a worthless security. To avoid any concern that the security can be deemed to have some value, you can sell the security through a bona fide sale to an unrelated party for a nominal amount. If you complete the sale before year end, you will be able to take the loss in 2004. The same concept applies to nonbusiness debt.

Defer capital gains tax on highly appreciated securities

If you have appreciated securities you are reluctant to sell because of the capital gains tax, consider creating a charitable remainder trust (CRT) to defer the tax and increase your annual income stream. Highly appreciated securities contributed to a CRT can be sold by the trust without incurring a capital gains tax at the time of the sale. You then receive an annuity based on the securities' fair market value at the date of contribution and pay taxes only as you receive the annuity. But the remainder at the end of the trust's term goes to your designated charity.

That annuity typically will exceed the income you previously were receiving from the contributed securities. Also, the CRT can then take the proceeds from the sale of the securities and purchase other securities, giving you a more diversified portfolio. (For more information, see the “Charitable Giving” chapter starting on page 30.)

Avoid capital gains tax through outright charitable giving

You can avoid paying capital gains tax on appreciated securities held long-term if you use them to make

your charitable contributions. (For donations to private nonoperating foundations, the securities must be publicly traded.) You receive the same contribution deduction as if you had used cash to make the contributions, subject to limitations based on your adjusted gross income, and you never pay tax on the appreciation.

This can be even more beneficial if you front load a private foundation with appreciated long-term securities to fund contributions you intend to make over a period of future

TAX PLANNING TIP 7 SPREAD OUT YOUR GAIN WITH INSTALLMENT SALE REPORTING

You sell a building you own by agreeing to give the buyer a 10-year mortgage for 75% of the net selling price of \$1.2 million. The first payment on the mortgage is due in January 2005. You initially paid \$600,000 for the building but the accumulated depreciation has reduced your tax basis to \$360,000, resulting in a capital gain of \$840,000.

If the buyer took a mortgage from a bank instead, you would report the full \$840,000 gain this year at a maximum federal tax cost of \$126,000 (before applying the 25% rate on the portion of the gain attributable to depreciation recapture). However, because the buyer gave you a note, you are eligible to elect installment sale reporting. As a result, your tax for 2004 (without regard to the 25% depreciation recapture rate) is \$31,500 because you pay tax based only on the amount of cash you received in 2004. Your taxable gain for 2004 would be \$210,000 (\$300,000 down payment at the gross profit ratio of 70%, which is the ratio of the total gain of \$840,000 compared to the selling price of \$1.2 million). The remaining tax of \$94,500 gets deferred, payable only as additional principal payments are received.



years. (For more information, see the “Charitable Giving” chapter.)

Know the benefits of installment sale reporting

An installment sale can be a very tax efficient method to realize gain on the sale of an asset with significant unrealized gain, such as real estate. If you are contemplating selling real estate or nonpublicly traded property, such as stock in a privately held C corporation or S corporation, or an interest in an LLC or partnership, consider using the installment sale method of reporting the gain. By doing so, you can defer much of the tax to future years. To be eligible, you must receive one or more payments after the year of the sale. So, for example, to defer the related tax by a full year, all you need to do is simply defer one payment until January 2005. (See Tax Planning Tip 7.)

The installment method allows you to report gain only as you receive principal payments. The gain retains the same nature on future payments that it had when sold. Therefore, an asset that is sold with a long-term holding period will be taxed as a

long-term gain in all future years. You will also be entitled to interest payments on the mortgage or loan. The interest payments are taxable as ordinary income when received.

You can use the installment sale method whether you own the asset directly, or through an entity you hold an interest in (subject to a limitation if your installment receivables exceed \$5 million).

Trade your way to better property

If you exchange investment or business property for property of a like kind (same nature or character), you do not realize taxable gain at the time of the exchange, except up to the amount of any cash or other boot received (such as other unlike property). The like-kind exchange gives you the opportunity to defer taxes that would otherwise be payable on the gain until you sell the property that you receive in the exchange.

Like-kind exchanges typically are used when contemplating the sale of real estate, and the benefits can be substantial. Even though the definition of like-kind property allows for some flexibility, such as permitting an exchange of land for a building if both are held for investment, specific and complex rules govern like-kind exchanges. These rules include a requirement that you identify the replacement property within 45 days after the sale. Like-kind exchanges do not apply to the sale of stocks, bonds, other securities and other intangible assets such as a partnership interest.

Handle with care: Regulated futures contracts

Do you invest in regulated futures contracts, non-equity options (including stock index options) or dealer equity options? If so, learn their complexities. For instance, these contracts are automatically treated as 60% long-term and 40% short-term when sold, regardless of the holding period. Any unrealized gain or loss on contracts at year end is taxable in the current year as if sold, with an adjustment to your basis for the gain or loss realized. ▲

Avoiding the tax traps of these forms of executive compensation

YOU MUST CAREFULLY decide when to exercise options and whether to sell or hold shares received from an option exercise. Although the applicable tax rules are complex, they also offer opportunities to minimize your taxes. The two most common types of stock options are incentive stock options (ISOs) and nonqualified stock options (NQSOs). The tax treatment of ISOs is considerably different from that of NQSOs. Restricted stock as a form of compensation has recently made a comeback, and proper planning for this benefit is also critical.

ISO tax consequences

ISOs allow you to buy company stock in the future at a fixed price determined when the options are granted. This price cannot be less than the stock's fair market value at the time of the grant date. Therefore, the stock must appreciate before the ISOs have any value. When they do — and once you've satisfied the applicable holding periods — you can buy shares at a price below what they are trading for.

The key tax consequences related to granting and exercising ISOs include:

- ▼ No tax cost when the options are granted,
- ▼ No regular tax cost when the options are exercised — though

TAX PLANNING TIP 8 ENJOY AN AMT CREDIT WHEN YOU SELL SHARES PURCHASED VIA ISO EXERCISE AT A GAIN

You were granted an incentive stock option (ISO) to buy 40,000 shares of your company stock at \$15 a share, exercisable over four years. At the grant, the stock was trading at \$13 per share. One year later when eligible, you begin annually exercising 10,000 shares at the trading price of \$25 each year. Within four years, you will have exercised all 40,000 shares. Assuming you hold the stock for an additional year and then sell it for \$30 per share, your tax consequences would be as follows:

- ▼ No regular tax cost when the options were granted or exercised,
- ▼ An alternative minimum tax (AMT) preference of \$100,000 at each annual exercise (10,000 shares selling at \$25 per share, reduced by your cost of \$15 per share) with a tax cost as high as \$28,000 each year to the extent the AMT applies, and, when you sell the shares, an identical negative preference amount that could offset your AMT in that year or in any future year you are subject to the AMT, and
- ▼ A long-term capital gain of \$600,000 when you sell the shares (40,000 shares at \$30 per share less your basis of \$15 per share), resulting in a maximum federal tax cost of \$90,000 (at the long-term capital gains tax rate of 15%).

Your net cash benefit of the exercise and sale would be:

Proceeds from the sale	\$1,200,000
AMT (maximum amount)	(112,000)
Capital gains tax	(90,000)
AMT credit ¹	112,000
Net proceeds after taxes	1,110,000
Cost to purchase the shares	(600,000)
Net cash benefit	\$510,000

¹You will realize the AMT credit only to the extent your regular tax exceeds your tentative AMT liability in any year.

a tax preference item is created on the difference between the fair market value of the stock and the exercise price, which can create an alternative minimum tax (AMT) liability (for more about the AMT, see the earlier “Alternative Minimum Tax” chapter starting on page 11),

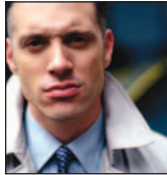
- ▼ Long-term capital gain treatment (taxed at a maximum rate of 15%) if the exercised shares are held for more than one year, and
- ▼ A disqualifying disposition with any gain taxed as compensation at ordinary income tax rates reaching 35% if the stock is sold within one year after the grant is exercised.

3 steps to prudent exercising

To make the right decision on when to exercise your options and how many shares to purchase:

1. Calculate both your regular tax and AMT for the year to determine the number of shares you can exercise without incurring current-year AMT liability,
2. Determine how much cash you have available to exercise the options and, if necessary, consider supplementing that with a cashless exercise — using your own existing shares — to allow you to maximize the total number of shares you will eventually own, and

3. Project multiple future scenarios based on different stock prices and ascertain whether you should exercise a large block of shares now and incur the AMT with the potential for greater future tax savings.



Should you exercise early?

Exercising your grant before the expiration date can be advantageous, but you must also consider potential tax cost. On the plus side, exercising early may start your holding period immediately, so you can receive long-term capital gain treatment sooner. Also, you may be able to reduce or eliminate your AMT liability if you exercise the grant when the spread between the fair market value and the exercise price is small or when the market price is close to bottoming out. Exercising annually may also produce good results, because you'll buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.

On the negative side, exercising early accelerates the funds you need and exposes you to a loss if the value of the shares drops below your exercise cost. Also, you create a tax cost if the preference item from the exercise generates AMT liability.

TAX PLANNING TIP 9 WATCH OUT FOR THE AMT PREFERENCE PITFALL IF STOCK PRICE DROPS AFTER AN EXERCISE

A falling stock price can result in costly tax consequences if the sale of stock purchased through exercising an incentive stock option (ISO) is not planned properly. Take the facts in Tax Planning Tip 8 but assume the price per share fell back to \$15 after your initial exercise of 10,000 shares. Because the exercise resulted in a tax preference of \$100,000 (10,000 shares at \$10 per share based on the trading price of \$25 at exercise), you could have been subject to an alternative minimum tax (AMT) liability as high as \$28,000. So if the AMT applies, you'll pay tax even though the selling price of your shares is equal to the price you paid for them.

What can you do? If you sell the shares before the end of the year in a disqualifying disposition, you will eliminate the AMT completely. This alternative may apply even if the selling price is greater than your purchase price. Let's say the stock is selling for \$20 per share. If you are in the AMT, you can sell the stock before the end of the year and realize ordinary income of \$50,000 at a maximum tax of \$17,500. But because you eliminate the AMT of \$28,000, you have a net tax savings of \$10,500. Because the wash sale rule (see the previous chapter, “Capital Gains and Losses”) does not apply on securities sold at a gain (regardless of any AMT benefit you receive), you can then repurchase the shares in the open market, even if at a lower price.

TAX PLANNING TIP 10 TAKE NQSO DIFFERENCES INTO ACCOUNT BEFORE AN EXERCISE OR SALE

If the 40,000 shares from exercise of the incentive stock option (ISO) in Tax Planning Tip 8 were instead from the exercise of nonqualified stock options (NQSOs), you would have recognized \$400,000 of total taxable compensation from the exercise (10,000 shares annually at \$25 per share fair market value less the \$15 exercise cost). At the time of the sale of the stock, you would have recognized a capital gain of \$200,000 (40,000 shares at \$30 less your basis of \$25 per share). The total maximum federal income tax cost of the exercise and subsequent sale of the stock would be:

Proceeds from the sale	\$1,200,000
Cost to exercise the shares (40,000 at \$15 per share)	(600,000)
Tax on exercise of options (\$400,000 at 35%)	(140,000)
Tax when you sell the shares (\$200,000 at 15%)	(30,000)
Net cash benefit	\$430,000

The net cash benefit is less than in Tax Planning Tip 8 for ISOs because of the amount taxed at the ordinary income rate of 35%. Exercising the options before the market value increased would have allowed you to shift appreciation to long-term capital gain treatment, taxed at 15%. But this also would have accelerated the tax on the compensation portion.

What if the stock price drops?

If the stock price of shares you hold through the exercise of ISOs has dropped substantially, the best course of action depends on the circumstances surrounding the exercise. If the trading price is lower than your exercise price, you can sell the stock and realize a capital loss.

If the trading price is higher than your exercise price but lower than the trading price at the time of the exercise and you exercised the ISOs earlier in the current year:

If you do not expect to be in the AMT, treat the stock the same as any other stock you purchased.

If you expect to be in the AMT, consider disqualifying the position. If you sell the stock before the end of the year, the exercise is disqualified and you pay ordinary income tax only to the extent the selling

price is greater than your exercise price. If the selling price has dropped below your exercise cost, you can take a short-term capital loss. Either way, you eliminate the AMT tax preference and avoid paying the AMT on phantom appreciation that no longer exists.

If you exercised the ISOs in a previous year and have held the stock more than 12 months:

If the AMT applied in the year of exercise but not the year of sale, an AMT credit will be available, if not already used. (See the “Alternative Minimum Tax” chapter.) You can hold the stock yet receive a tax credit equal to the excess of your current year regular tax over the tentative minimum tax, not to exceed the actual amount of AMT you paid due to the exercise.

If the AMT applied in both the year of exercise and the year of sale or neither year, treat the stock the same as any other stock you purchased.

If the AMT did not apply in the year of exercise but applies in the year of sale, consider selling the stock. Even though you were not subject to the AMT in the year of exercise, your tax basis for AMT purposes is

the trading price at the time of exercise, not your purchase price. Therefore, you would have a loss for AMT purposes that could offset your AMT liability.

And if you still have options you can exercise and think the stock will appreciate, the depressed stock price can offer a buying opportunity. Because the price is lower, you can exercise more options before you are pushed into the AMT. Even if the exercise triggers the AMT, you’ll pay less than you would have had you exercised an equal number of shares when the stock price was higher.

NQSO tax advantages

The main difference between ISOs and NQSOs is how they are taxed. Unlike ISOs, the exercise of NQSOs creates taxable ordinary income rather than an AMT preference. (For an in-depth look at these differences, see Tax Planning Tip 10.)

**TAX PLANNING TIP 11 CONSIDER
THE ADVANTAGES OF SECTION 83(B) ELECTION
IF RESTRICTED STOCK IS OF NEGLIGIBLE VALUE**

This taxable ordinary income equals the excess of the stock's fair market value at exercise over the exercise price. The granting of an NQSO does not result in taxable income unless its value is readily ascertainable, which it usually is not.



Restricted stock issues

If you receive compensation in the form of stock subject to a substantial risk of forfeiture, you can defer the recognition of income until the restricted stock is no longer subject to that risk or you sell the stock. But you can elect, under Internal Revenue Code Section 83(b), to recognize ordinary income when you receive the stock. This election, which you must make within 30 days after receiving the stock, can be extremely important if the income at the grant date is negligible. Why? Because the election allows you to:

1. Convert future stock appreciation from ordinary income into long-term capital gain income taxed at the much lower capital gains tax rate, and
2. Defer substantial ordinary income on the unrealized appreciation at the time the restrictions lift.

If you don't make the election, you pay taxes at a rate as high as 35% on the appreciation when the restrictions lift, regardless of whether you sell or hold the stock. (See Tax Planning Tip 11.)

You receive 20,000 shares of restricted stock with a fair market value of \$2 per share. As a result of an initial public offering (IPO), a reverse stock split gives you 100,000 shares. The stock is offered at \$6 per share after the IPO, and you sell your shares after the lock-up period expires when the stock is selling at \$8 per share.

If you make an Internal Revenue Code Section 83(b) election:

- ▼ You report \$40,000 of compensation in the current year (20,000 shares at \$2 per share) with a maximum tax cost of \$14,000,
- ▼ Your basis in the stock is \$.40 per share after the reverse split,
- ▼ Your holding period begins on the day you receive the stock,
- ▼ You realize a long-term capital gain of \$760,000 (100,000 shares at \$8 per share less your basis of \$.40 per share) when you sell the stock, at a maximum federal tax cost of \$114,000, and
- ▼ You defer the tax you would have to pay when the company goes public to the time when the stock is sold.

If you don't make the election:

- ▼ You don't have any compensation income this year,
- ▼ You have compensation of \$600,000 (100,000 shares at the IPO price of \$6 per share) when the company goes public (and the substantial risk of forfeiture no longer exists) at a maximum federal tax cost of \$210,000, and
- ▼ You have a long-term capital gain of \$200,000 when you sell the stock (100,000 shares at \$8 per share less your basis of \$6 per share) at a maximum federal tax cost of \$30,000.

Income tax comparison

If you don't make the election	\$240,000
If you make the election	\$128,000
Tax savings by making the election	\$112,000

The disadvantage of making a Section 83(b) election is that you prepay tax in the current year. However, this is typically a small liability if the stock is restricted and the company is in the earlier stages of development. Any taxes you pay because of the election can't be refunded if you eventually forfeit the stock or the stock's value decreases. But you will have a capital loss when you sell the stock. And of course, you'll gain no tax benefits if the stock doesn't appreciate. ▲

S M A L L B U S I N E S S S T O C K

Boost your portfolio's health with a dose of small business stock

GENERALLY, A DIVERSE portfolio is a healthy portfolio. So along with your blue-chip companies, consider the advantages of small business stock. Whether these investments will grow depends, of course, on many factors. But if you buy some types of small business stock, you may qualify for preferential tax treatment.

This may include:

- ▼ Conversion of capital loss to ordinary loss on the stock sale,
- ▼ Exclusion of sale gains, and
- ▼ Tax-free gain rollovers, if you use the proceeds to buy other qualified small business stock.

Interested? Parlaying your investments into tax savings — no matter their performance — is key to managing your finances. And small business stock offers these advantages in spades.

Claim ordinary — not capital — losses

If you sell small business stock at a loss, you can treat up to \$50,000 (\$100,000 if married filing jointly) as an ordinary, rather than a

capital, loss — regardless of your holding period. Ordinary loss treatment allows you to reduce your taxes by as much as 35% of the loss rather than 15% if you held the stock long term.

And you can avoid capital loss limitations that could prevent you from getting any current year tax benefit if your capital losses exceed your capital gains. Remember, ordinary losses are not subject to the capital loss limitations.

To qualify for this treatment under Internal Revenue Code Section 1244, you must have bought the stock at the issue date and continuously held it until you sold it. And the issuing corporation must have been a small business company at the time the stock was issued.

The company must also have had an initial capitalization of \$1 million or less and derived less than 50% of its income from investment activities (such as interest, dividends, royalties, rents, annuities, and sales or property exchanges) during the preceding five years. Other restrictions may also apply.





Gain rollovers

A tax-free rollover allows you to indefinitely defer the tax on the gain from the QSB stock sale. A qualified small business (QSB) is a corporation (other than an S corporation) that originally issued the stock after Aug. 10, 1993, did not have gross assets exceeding \$50 million at any time before or immediately after issuing the stock, and actively engages in a qualifying trade or business.

But exercise care. Certain businesses, such as hotels, financing, professional services and mining, don't qualify for this treatment.

You can use the tax-free rollover if, within 60 days of the sale of QSB stock, you buy other QSB stock with the proceeds. For determining long-term capital gain treatment, the new stock inherits the holding period of the stock you sold. Nonrecognized gains from the rollover reduce your basis in the new stock.

If the stock is held by a pass-through entity of which you are a partner or shareholder, the entity can buy replacement stock and elect a tax-free rollover of the gain. Or it can notify you of the gain and you can buy

the replacement stock directly as a tax-free rollover. The 60-day rule still applies, beginning on the day the entity sells the QSB stock — not when it notifies you of the sale.

TAX PLANNING TIP 12 DEFER GAIN BY INVESTING IN SSBICs

A specialized small business investment company (SSBIC) is a partnership or corporation licensed by the Small Business Administration. You can defer any gain realized on the sale of these publicly traded securities, subject to several restrictions, if you reinvest the proceeds within 60 days in other SSBIC common stocks or in an SSBIC itself.

You can roll over gains up to \$50,000 annually (\$500,000 during your lifetime). Any nonrecognized rollover gains reduce your basis in the newly acquired SSBIC stock or qualifying entity.

If you fail to meet the 60-day replacement period, you may be eligible to exclude 50% of the gain from the sale of QSB stock. However, the actual tax benefit you will receive is only 1% of the gain — the difference between the 15% maximum long-term capital gains rate and the actual tax rate on the sale of 14%. Why 14%? Because the taxable portion is subject to tax at 28%, and thus the 50% exclusion results in a tax rate of 14%. ▲

PASSIVE ACTIVITY LIMITATIONS

9 Turn passive losses into active savings

ARE YOU INVOLVED in a trade or business in which you don't materially participate? Then remember that passive activity rules can limit your deductible losses. Passive activity losses are deductible only against income from other passive activities or when you dispose of the activity. You can carry forward disallowed losses to the following year, subject to the same limitations.

3 passive loss planning points

To qualify as materially participating in an activity and avoid passive activity treatment, typically you must participate more than 500 hours during the year, or demonstrate that your involvement constitutes substantially all of the participation in the activity. If you don't pass this test, you can take steps to parlay the losses into tax-saving opportunities:



1. Rid yourself of the activity. Dispose of any passive activity with current or suspended passive losses. You are allowed to deduct all the losses — including any loss on disposition (subject to capital gain limitations) — when you dispose of the activity. But watch out for the phantom income trap. (See Tax Planning Tip 13.)

2. Participate more. For an activity generating losses, increase your involvement to more than 500 hours, if possible, so it is no longer subject to a passive loss limitation.

3. Increase income-producing passive investments. For an activity generating income, limit your participation to less than 500 hours, if feasible. Or, invest in an income-producing trade or business that will be passive to you. Under both strategies, you will have passive income that can offset your passive losses.

Special real estate rules

Losses from real estate activities are passive by definition — unless you are a real estate professional. Then you can deduct rental real estate losses in full. To qualify, you must annually perform more than 50% of your personal services in real property trades or businesses, and more than 750 hours of service in these businesses during the year.

TAX PLANNING TIP 13 FIND OUT WHETHER YOU'LL TRIGGER PHANTOM INCOME

Phantom income can be triggered when you dispose of a passive activity — even if you receive little, or no, cash from the sale — because you may have to recapture losses that were deducted in previous years. This typically occurs on the sale or foreclosure of real estate, because accelerated depreciation deductions are often funded by mortgage debt. You can have phantom income on an activity that you hold via a pass-through activity if either the entity disposes of the property or you dispose of your interest in the entity. However, to the extent losses were suspended, you would have an ordinary loss to offset this income.

If you fail either test and you have passive losses, try to increase your hours to meet the test and convert current year passive losses into deductible losses. If you actively participate in a rental real estate activity but are not a real estate professional, you can deduct up to \$25,000 of losses each year, subject to a phaseout of the benefit when your adjusted gross income (before the loss) reaches \$150,000. ▲

S A L E O F P R I N C I P A L R E S I D E N C E

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Will your home pass the tax exclusion test?

MANY INVESTORS ARE finding comfort in real estate investments after the performance of the stock market in recent years. Thanks to the tax law, your home could be one of your most tax efficient investments. In fact, married taxpayers filing jointly can exclude as much as \$500,000 (single filers, \$250,000) of gain (excluding the portion attributable to home office or rental use) from the sale of a principal residence.

Pass the tests and save

To qualify for the gain exemption, you must have:

- ▼ Owned the home for at least two years,
- ▼ Used the home as your principal residence for at least two years, in the aggregate, during the five-year period ending on the sale date, and
- ▼ Not have excluded the gain on a home sale within the last two years.

If you fail these tests, a pro-rated exemption is allowed equal to the portion of time you used and owned the house as your personal residence within the past two years.

If you are married filing jointly, things can get a little more complicated if you want to be eligible to exclude the maximum \$500,000 of gain:

- ▼ Either you or your spouse must meet the two-year ownership test.
- ▼ Both you and your spouse must meet the two-year use test. If only one spouse meets the test, the exemption is limited to \$250,000.
- ▼ Both you and your spouse must meet the two-year exclusion test. This can be an issue when a person sells his or her home and marries a homeowner, and then the couple jointly sells that home within two years. The

spouse meeting the tests is still eligible for the \$250,000 exemption, and the spouse failing the tests is eligible for a pro-rated exemption.

Exemption doesn't solve all tax problems

Because you can no longer defer the gain from the sale of your home by rolling it into the tax basis of a new principal residence, a large gain that previously could have been tax free now could exceed the exemption and create costly tax liability. This is especially true if you have owned your home for a long time. To support the highest accurate tax basis possible, be sure to maintain thorough records, including information on your original cost and subsequent improvements.



A loss on the sale of a personal residence also can cause tax problems because it is not deductible. But if part of your home is rented or used for your business, the loss attributable to that portion will be deductible, subject to various limitations. ▲

How to use debt to your advantage

INTEREST EXPENSE CAN reduce your tax bill — if it's deductible — and help you make the most of your money. Deductibility depends on the nature of the debt, how you used the funds and limits based on the amount of debt. (See Chart 6.) Before incurring any new debt, review options available to maximize deductibility. Also, periodically review your debts to see if you can replace nondeductible interest with deductible interest.

\$1 million (\$500,000 if married filing separately) unless it was incurred before Oct. 14, 1987. You can also incur this debt from refinancing an existing acquisition debt, but only up to the remaining principal

of that debt unless you use the excess proceeds to substantially improve your home. Qualified residence interest does not include interest paid on loans from individuals, such as your parents, if you do not secure the debt with the home.

Home equity debt. When secured by any qualified principal residence, interest on the debt up to the amount used to substantially improve your home plus \$100,000 (not to exceed the equity in your home) is deductible as qualified home equity debt, regardless of how you use the proceeds. But the interest on any portion of the debt not used to substantially improve your home is not allowable as an AMT deduction.

Minimize your stock market costs

Investment interest expense is interest on debt used to buy assets held for investment, such as securities. But debt used to buy securities that pay tax-exempt income, such as municipal bonds, does not generate tax-deductible interest. (Be careful of a rule that requires prorating interest expense on debt incurred on taxable investments if you also hold municipal bonds, even if in a separable account.) Margin debt that allows you to buy securities is a common example of investment debt. Your pro rata share of investment interest expense incurred by a pass-through entity — that is, partnership, limited liability company (LLC) or S corporation — is treated the same way as if you paid the interest.

Chart 6
Interest expense deduction

Nature of debt	Not deductible	Itemized deduction	Above-the-line deduction
Consumer or personal	▼		
Qualified residence ¹		▼	
Taxable investment		▼	
Tax-exempt investment	▼		
Trading activities			▼
Business activities			▼
Passive activities			▼
Education loans			▼

¹ Including a second home.

Note: Other rules may limit your ability to deduct the various types of interest expense.

Source: U.S. Internal Revenue Code

Home in on qualified residence interest

Debt used to acquire or improve your home creates deductible qualified residence interest, subject to several limitations. The types of debt are:

Acquisition debt. You incur this on the acquisition, construction or substantial improvement of your principal residence and your second home (if used for personal purposes). The debt must be secured by the residence and is limited, in the aggregate, to

TAX PLANNING TIP 14 MAXIMIZE ABOVE-THE-LINE DEDUCTIONS

The amount of investment interest expense you can deduct is limited to your investment income, which generally includes taxable interest, dividends and short-term capital gains (but not long-term capital gains), reduced by investment expenses such as investment advisory fees. Any disallowed interest is carried forward, and you can deduct it in a later year if you have excess net investment income.

Be careful of the rule that limits your ability to qualify for the maximum 15% tax rate on qualifying dividends. You will not be eligible for this preferential rate if you have margin debt on the securities that pay dividends. This rule is intended to prevent you from getting the benefit of the 35% tax rate for deductible margin interest yet paying only a 15% tax rate on the dividends generated because of the margin debt.



Look at passive interest expense

Passive interest expense is interest on debt incurred to fund passive activity expenditures, whether paid by you directly or

indirectly through the capital requirements of a pass-through business entity. This interest expense becomes part of your overall passive activity income or loss subject to limitations. (See the “Passive Activity Limitations” chapter on page 26.)

If your ability to deduct this interest is being limited due to passive losses, you can replace this debt with margin debt in the same way as replacing consumer debt, discussed at right. Whether you should consider converting this debt depends on the nature of your passive activity income. If you have positive passive income, rather than a net loss, it would be more beneficial to have passive interest expense because the deduction would be allowed in full above the line — that is, against your adjusted gross income. (See Tax Planning Tip 14.) Also the interest expense would not be subject to the investment interest expense limitations discussed above or to any other limitations on itemized deductions, including those placed by various states.

Interest expense you can deduct above the line gives you a greater tax benefit than interest treated as an itemized deduction. Why? Because it reduces itemized deduction phaseouts based on your adjusted gross income (AGI) and can lower your state income taxes, especially if you live in a state that doesn't allow itemized deductions in full. Interest expense eligible for this favorable treatment includes:

- ▼ Business interest on debt traced to your business expenditures — including debt used to finance the capital requirements of a partnership, S corporation or limited liability company (LLC) involved in a trade or business in which you materially participate,
- ▼ Trading interest incurred in actively trading personal property, such as taxable securities, that commonly passes through a trading partnership or LLC, though as a limited partner or member you will still be subject to the investment interest limitation,
- ▼ Passive interest expense to the extent you have net passive income, and
- ▼ Interest you pay on qualified education loans. (See the “Education” chapter starting on page 34.)

Avoid getting personal with interest

Consumer or personal interest expense includes interest on debt used to pay for personal expenses, buy consumer goods (including cars) and satisfy tax liabilities. To the extent possible, convert this debt to home equity debt or investment debt so the interest becomes deductible. Plus, you'll benefit from the generally lower interest rate on those types of debt.

Rather than using the proceeds from the sale of securities to buy other securities, use them to pay off your personal debt. You can then use margin debt, if available, to buy new securities. Your total debt remains the same, but you now get a tax deduction for the interest (assuming you don't have an investment income limitation or tax-exempt securities). Warning: Don't use margin debt to directly pay off your personal debt, because tracing rules will make the interest nondeductible. ▲

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More for charity means less tax

NEEDLESS TO SAY, giving to charity is a reward in itself. But because gifts are made at your discretion, you can control when and how they are made to also enjoy the rewards of a lower tax bill. For starters, by using long-term appreciated property to fund the gifts you can avoid capital gains taxes too. And you can time your contributions to maximize their value by giving when you will be in a higher tax bracket. More sophisticated vehicles, such as charitable trusts, exist as well. These allow you to combine estate and gift planning with your charitable desires.

Use long-term appreciated property

To the extent possible, always use appreciated publicly traded securities you have held for more than one year, rather than cash, to make your contributions. In addition to receiving a tax deduction equal to the securities' full fair market value, you will also avoid paying capital gains tax on the appreciation. (See Tax Planning Tip 15.)

But be careful when donating property. Some forms of property donations can reduce the charitable contribution deduction you are eligible to receive:

Securities with a fair market value less than your cost. Never use these to fund a contribution because your deduction will be limited to the lower fair market value of the stock and you'll permanently lose the capital loss tax benefit.

Tangible personal property. The charitable organization must use this property in its exempt function (such as a painting given to a museum) for you to get the property's full fair market value as a deduction, regardless of your holding period. Otherwise, your deduction is limited to the lesser of your basis or the property's fair market value.

Ordinary income property. Some property types, such as stock held 12 months or less, give you a charitable deduction equal only to the lesser of their fair market value or your basis. Ordinary

income property also includes property subject to depreciation recapture and inventory items, regardless of how long you have held them.



Time your contributions

Always consider your current year and projected future maximum tax rate before deciding when to make contributions. It may vary significantly in a year

of unusual financial events. More common, though, is the effect of the alternative minimum tax (AMT) on your contributions. If you are likely to be subject to the AMT in one year but not another, proper timing can increase your tax benefit by more than 10% of the contribution amount. If made in a year you are subject to the AMT, the contribution will provide a maximum federal tax benefit of only 28%. In years when the AMT does not apply, your tax benefit can equal the maximum tax rate of 35%.

If you don't expect your maximum tax rate to increase next year or in the foreseeable future, accelerate charitable contributions (if feasible and desirable) to gain the advantage of using the tax-deferred funds. Again, consider the AMT when projecting your maximum tax rate.

But make sure you satisfy the legal transfer requirements for contributions of securities or other property that you make at year end. And arrange for the securities to be transferred directly from your investment account to the charity's investment account, thereby accelerating the process.

Choose a vehicle to steer your contributions

Using an effective investment vehicle to fund your future contributions can enable you to accelerate the tax benefit of future contributions to the current year. And it can increase the donations that eventually go to your charities.

For example, a donor-advised fund — a simpler, less costly alternative to a private foundation — allows you to finance future charitable contributions and obtain a current year tax benefit. You can designate the contribution to the fund into an account (which can bear your name) for future charitable distributions. Typically, the fund will follow your charitable preferences — though it is not legally obligated to do so.

Consider a private foundation

Though they're more costly and complex than donor-advised funds, and they require annual tax filings, you should still consider establishing a private foundation. Why? Because they offer many benefits that can outweigh these disadvantages.

By setting up a foundation, you can:

Obtain a large charitable deduction in the current year. And you also can avoid paying capital gains tax on appreciated stock held more than one year. The foundation is subject only to either a 1% or 2% tax on its earnings, including capital gains.

Retain complete control of the timing, amount and recipient of future charitable contributions. The foundation must annually distribute a minimum of 5% of the average value of its assets to charities. Typically, the actual earnings and appreciation of the assets in the foundation are greater than the 5% minimum distribution.

Maintain management control of the foundation's investments. You can use your investment expertise and resources as well as your personal beliefs to ensure the foundation fulfills your charitable desires.



TAX PLANNING TIP 15 GIVE APPRECIATED SECURITIES, NOT CASH

Instead of donating cash, you use appreciated securities to make a contribution of \$75,000 before year end. You bought the stock years ago for \$25,000 and were planning to sell it because its growth had peaked. By using the stock rather than cash, you save \$7,500 in federal taxes (assuming maximum tax rates) that you would have paid on the appreciation of \$50,000 when you sold the stock.

	Cash contribution	Stock contribution
Tax savings on contribution (at 35%)	\$26,250	\$26,250
Capital gains tax if stock was sold (at 15%)	(7,500)	0
Net tax savings	\$18,750	\$26,250

Involve family members. A private foundation can provide intangible benefits by involving family members in a joint enterprise. Your family can benefit from the responsibility of making management decisions and formulating a mission statement to satisfy the family's overall charitable desires. These responsibilities can be passed down from one generation to another, perpetually keeping the foundation in your family's name.

Of course, learn as much as you can before forming a foundation — complexities abound. For instance, extremely high or even prohibitive excise taxes can be assessed on some transactions, such as income from unrelated business activities and various acts of self-dealing.

Meet many objectives with charitable trusts

You can use two types of charitable trusts — charitable remainder trusts (CRTs) and charitable lead trusts (CLTs) — to meet estate and gift tax objectives and satisfy your charitable desires. You can set up either of these trusts as an annuity trust (CRAT or CLAT) or a unitrust (CRUT or CLUT). The annuity trusts pay a fixed percentage based on the initial trust value, resulting in a fixed dollar annuity

Chart 7

Charitable contribution deduction limits

The deduction for the aggregate of your charitable contributions is subject to a limitation based on your adjusted gross income (AGI). To the extent that your deduction is limited, you can carry the disallowed contributions forward for five years, subject to the same annual percentage limitations.

Contributions made to	AGI limitation	
	Cash and ordinary income property	Appreciated capital gain property
Public charities	50%	30% ¹
Nonoperating private foundations	30% ²	20% ³
Operating private foundations	50%	30% ¹

You can increase the ceiling amounts to:

¹ 50% by electing to reduce your contribution to the property's cost. This is advisable only if your contributions would otherwise be limited and it's unlikely that you will benefit from the carryover in the future.

² 50% if the foundation makes qualifying contributions out of its corpus within 2½ months after the end of its taxable year, equal to 100% of the contributions it received that year.

³ 30% if the foundation makes qualifying contributions out of its corpus within 2½ months after the end of its taxable year, equal to 100% of the contributions it received that year.

Source: U.S. Internal Revenue Code

amount. The unitrusts pay a fixed percentage of the trust's annual fair market value at year end. The trusts allow you to:

Diversify your portfolio and defer capital gains

tax. You can do so by having a CRT sell low basis shares of stock you've contributed to the trust.



Shelter returns from tax. Enjoy tax-sheltered asset returns with the benefit of an annual income stream payable to you or your beneficiaries (CRT) greater than the current income you receive from the assets.

Pass appreciation to your beneficiaries. Increase the amount of assets passing to your beneficiaries by giving the annuity to charities and retaining the remainder interest for your beneficiaries (CLT).

Obtain a current year income tax deduction. This applies to the present value of the remainder interest for a CRT and can apply to the lead interest for a CLT.

As you can see, charitable trusts are quite powerful tools. Now let's look more specifically at each trust type.

Deepen and diversify with a CRT

A CRT enables you to diversify your portfolio and increase your annual income stream. If you contribute highly appreciated securities, such as a concentrated position in low basis stock, the CRT can sell them without incurring a current capital gains tax. You will not only diversify your portfolio and reduce market risk, but also receive an annuity based on the securities' fair market value. And that annuity likely will exceed the income you are receiving from the contributed securities.

On the other hand, if you had sold the securities, you would have been able to reinvest only the after-tax net proceeds. The CRT's assets will grow tax deferred because you pay tax on the annuity payouts only as received. The taxable nature of the annuity is based on the trust's undistributed accumulated income at year end, subject to an ordering rule requiring the distribution of ordinary income first, then short-term capital gains, long-term capital gains, nontaxable income and, finally, the trust's corpus. The remaining assets at the end of the trust's term go to your designated charities.

If you have the annuity paid to your beneficiaries instead of yourself, you must consider gift tax

consequences. You will pay a gift tax on the annuity's present value that you are giving to your beneficiaries. But this may result in lower overall gift and estate taxes because IRS tables are used for determining present value. These tables may show a gift amount that is less than the actual present value of the annuity payouts, assuming higher growth rates. You can also reduce overall family income taxes if the beneficiary's tax rates are lower than yours.

Also bear in mind these CRT finer points:

- ▼ The term of the trust cannot exceed 20 years and the trust must be irrevocable,
- ▼ The annual annuity income payout to the beneficiary must be at least 5% but not greater than 50% of either the initial amount transferred to an annuity trust or the annual year end fair market value of the assets for a unitrust, and
- ▼ The value of the remainder interest to the charity generally must be at least 10% of the trust's initial fair market value.

Lead the way with a CLT

The CLT is basically the reverse of the CRT. The annuity is paid to the charity and you or your beneficiaries receive the remainder interest at the end of the trust's term. But the income tax implications are complex, because you are allowed a charitable deduction only if the CLT is structured as a grantor trust (with you reporting the annual income). If the trust is set up as a nongrantor trust, you don't get a charitable deduction but you also are not taxed on the income the trust earns.

Despite these complexities, a CLT can be an effective gift and estate tax planning tool because you are subject to gift tax only on the present value of the remainder interest you are giving away. This allows you to gift a much greater interest in assets, such as stock in an early stage company, and pay little or no gift taxes. If the stock value grows significantly, your beneficiaries will enjoy the excess appreciation because the growth will be greater than the IRS tables for determining the present value of the remainder interest.

TAX PLANNING TIP 16 CREATE A CRAT AND REDUCE SINGLE-STOCK EXPOSURE RISK AS WELL AS TAXES

Your portfolio consists of \$1.5 million in a single publicly traded stock (from when your company went public) with a tax basis of \$200,000 and other securities valued at \$300,000. You feel the time is right to diversify your portfolio, but you've been reluctant to do so because of the tax you'd have to pay on the gain. By contributing the stock to a charitable remainder annuity trust (CRAT), you can have the trust sell the stock without paying any current capital gains tax on the \$1.3 million gain. The trust can use the sale proceeds for other investments which, in turn, helps diversify your portfolio because of your annuity interest in the trust. You can also use your annuity payments to make investments to further diversify your portfolio.

Assuming the CRAT comes with a 10% payout rate, you will receive \$150,000 of taxable income annually for the term of the trust, much of which will be eligible for the net long-term capital gains tax rate of 15%. You will also receive a current year charitable deduction for the present value of the remainder amount going to charities.

Remember, though, that the family loses the remainder value because it will pass to the designated charities at the end of the trust's term.

Beware of requirements for higher valued property

Different requirements take effect when you donate property worth more than \$5,000. You must obtain a qualified appraisal and complete and attach Form 8283, "Noncash Charitable Contributions," to your tax return, including the appraiser's signature and an authorized signature from the donee organization.

Contributions of similar items of property with an aggregate value exceeding \$5,000 are subject to the same requirements. For example, if you contribute clothing valued at \$3,000 to one charity and your spouse contributes clothing valued at \$2,500 to another charity, you need to obtain qualified appraisals for both contributions. The appraisal requirements do not apply to contributions of cash, publicly traded securities or nonpublicly traded stock worth less than \$10,000. ▲

13

Hit the books and reduce your tax liability

CAN YOU PUT a price on a good education? You may not be able to, but colleges can. And the price has been skyrocketing. Fortunately, many ways exist to help fund these substantial expenses at a tax advantage.

Greet the future with a 529 plan

The best college funding method is usually the Section 529 plan (also called a qualified tuition program or QTP). These plans offer many benefits:

- ▼ Although contributions aren't deductible, distributions used to pay qualified education expenses are tax free for federal purposes. (This provision will expire in 2010 unless Congress extends it, and distributions may be subject to individual state taxes.)
- ▼ You have complete control as account owner, even after the beneficiary reaches legal age. This permits you to switch the beneficiary to another family member, including yourself, at any time and for any reason. So, if the original beneficiary doesn't go to college or excess funds remain in one child's account, you can simply switch the beneficiary to another child or yourself.
- ▼ You can roll over plan funds every 12 months to a new plan within or outside the original state.
- ▼ You can set up multiple plans for a single beneficiary in one or more states.
- ▼ Age restrictions don't apply to the account owner or beneficiary and, unlike other tax incentive education plans, you can have a 529 plan regardless of your income.



In addition, 529 plans have other significant benefits. For instance, you can use distributions to pay for qualified expenses at any accredited

college, university or graduate school and most community colleges and certified technical training schools in the United States. That means you can select the best state plan available — not just the one sponsored by the state you live in. This gives you more investment options and possibly higher contribution ceilings. For example, some states allow maximum contributions in excess of \$250,000 per beneficiary.

Also, “family member” is defined to include first cousins of the original beneficiary — this is particularly useful for grandparents. Plus, these plans typically don't adversely affect financial aid because the plan accounts are treated as the account owner's asset, not the beneficiary's (except as discussed below for private prepaid tuition plans).

Any money deposited into a 529 plan for the benefit of another person is considered a gift for gift tax purposes. However, you can use five years of annual gift exclusions up front, allowing you to gift up to \$55,000 per beneficiary (\$110,000 if married) without incurring a gift tax. This also ensures the plan's assets are excluded from your taxable estate.

Private educational institutions can also offer a prepaid tuition program if they satisfy Section 529 requirements. Distributions from these private plans used for qualified education expenses are also tax free, and tuition credits from these programs will generally be transferable to another plan. The tuition

credits accumulate in the same way as funds in a state program. Also, distribution and rollover rules are the same. But the prepaid tuition plan has been interpreted as a resource reducing the student's financial needs on a dollar-for-dollar basis.

Of course, 529 plans have their disadvantages. You lose direct control of most future investment decisions, though you do retain some investment option flexibility. You may also prefer to use your annual gift tax exclusions to transfer other assets with greater potential for appreciation. And even though you can withdraw 529 plan funds for uses other than qualified higher education expenses, you'll pay a 10% penalty on the earnings.

Gain limited benefits with an ESA

Coverdell Education Savings Account (ESA) contributions are nondeductible and subject to an adjusted gross income (AGI) limitation. The annual contribution limit is \$2,000 per beneficiary. The allowable contribution starts to phase out once AGI reaches \$190,000 for married couples filing jointly (\$95,000 for single taxpayers) and is fully phased out once AGI reaches \$220,000 (\$110,000 for single taxpayers).

For most taxpayers, ESAs are less attractive than 529 plans. Because you cannot contribute more than \$2,000 annually, the tax-free income benefit generally won't amount to much. But consider one if you intend to fund qualified education expenses for elementary and secondary public, private or religious schools.

Get a credit where one is due

You may be able to claim a Hope or Lifetime Learning credit for qualified education expenses. The credits phase out based on modified AGI between \$42,000 and \$52,000 for single or head of household filers and \$85,000 and \$105,000 for married couples filing jointly.

The maximum Hope credit — available for the first two years of postsecondary education with enrollment on at least a half-time basis in a program

TAX PLANNING TIP 17 LET YOUR CHILD TAKE CREDIT — A HOPE OR LIFETIME LEARNING CREDIT

If income limitations prevent you from taking the Hope or Lifetime Learning credit, have your children claim the credit instead. You must forgo the dependency exemption that you are entitled to, but you would probably lose the benefit of it anyway because of a phaseout for high-income taxpayers. Your child can use the tax credit to reduce his or her own tax liability even though he or she still won't be able to get the benefit of the exemption.

leading to a degree — is \$1,500 per student annually. The maximum Lifetime Learning credit — available for an unlimited number of years of postsecondary, graduate and certain other courses — is \$2,000 per taxpayer. Expenses that qualify for either credit include tuition and fees, but not room and board.

Deduct what you can

You may be able to take a deduction against gross income for qualified higher education expenses. The deduction is limited to \$4,000 in 2004 (\$1,000 more than in 2003) for taxpayers with AGIs not exceeding \$65,000 (\$130,000 if married filing jointly). You cannot deduct expenses that are paid with funds from a 529 plan or ESA or that are used to claim the Hope or Lifetime Learning credit.



Even if school was a long time ago, its cost isn't if you are still making student loan payments. At least you may be able to annually deduct up to \$2,500 of interest paid on loans, subject to a phaseout based on modified AGI. The interest is an above-the-line deduction against gross income and is, therefore, available to you even if you don't itemize.

The modified AGI phaseout range for eligibility to deduct the interest is between \$50,000 and \$65,000 for single taxpayers and \$100,000 to \$130,000 for married taxpayers filing jointly. ▲

RETIREMENT

14

Why you should max out your retirement plan contributions

THE MAIN BENEFIT of investing in most retirement plans is that typically contributions are excluded from current taxable income (or deductible above the line) and grow tax-deferred until withdrawn. Some plans don't exclude your contributions but instead exclude your withdrawals. Either way, you can have more available for retirement — or for your heirs. (See Tax Planning Tip 18.) And some employers match employee contributions in part or in full. Bottom line: Don't miss out on tax-advantaged savings opportunities and leave your future economic safety to chance.

Take advantage of plans available to you

Numerous retirement savings vehicles are available, with varying contribution limits, distribution rules and tax treatments. Whether you can contribute to a specific type of plan depends on a variety of factors, including your income, whether you are a business owner (or self-employed) or an employee, and what other retirement plans you contribute to or participate in.

If you are an owner, you have the most flexibility because you can choose the plan that will allow you to maximize your contributions. If you are an employee, you will have to make contributions based on the type of plan your employer offers, but you also can be eligible for other plans if you earn outside income in a self-employed capacity (such as consulting income). And whether you are an owner or an employee, you may be eligible to contribute to a traditional or Roth IRA.

Put away more with a Keogh plan

Typically, Keogh plans help small business owners save for retirement while reducing taxes through deductible contributions and tax-deferred growth. These plans usually take one of two forms:

1. Qualified defined-contribution plan. This plan can be a qualified profit-sharing plan, qualified money-purchase pension plan, or both. The

maximum 2004 Keogh plan contribution is the lesser of \$41,000 or 100% of your compensation. You need only the profit-sharing plan to contribute the

maximum. Because a money-purchase plan requires annual contributions in accordance with the plan's formula, if you still have this type of plan, you should probably eliminate it by termination or merger to avoid the mandatory contribution and the separate annual filing requirement.



2. Qualified defined-benefit plan. This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. Because it's actuarially driven, the annual contribution necessary to attain the projected future benefit may exceed \$41,000 based on your age and either your annual desired benefit or the maximum allowable benefit. The maximum annual benefit for 2004 is \$165,000 or 100% of earned income, if less, subject to a reduction if benefits will begin before age 62 and an increase if benefits will begin after age 65.

Whether you choose a defined-contribution or a defined-benefit plan, if you want to deduct contributions on your 2004 tax return, your Keogh plan must exist on Dec. 31, 2004. You then can make deductible profit-sharing plan contributions as late as the due date of your 2004 income tax return, including extensions — Oct. 17, 2005.



Money-purchase or defined-benefit plan contributions must be made by Sept. 15, 2005, regardless of the Oct. 17, 2005, extension.

Be careful: Loans or the use of plan assets as security can disqualify a Keogh plan if made to or used for the benefit of a sole proprietor or partner who is a more than 10% owner or an S corporation shareholder who is a more than 5% owner. But these restrictions will not apply if the nonowner participants are also offered the loans.

Set up a SEP even after year end

Under a Simplified Employee Pension (SEP) plan, you, as the employer, make contributions to an employee IRA. (New salary reduction arrangement SEPs — SARSEPs — for multiple employees can no longer be created.) The maximum allowable SEP contribution is \$41,000 annually, the same as a Keogh plan.

One advantage of a SEP is that you can establish it after Dec. 31, 2004, and deduct contributions on your 2004 tax returns even if made in 2005, as long as they are made by the due date of the 2004 tax return, including extensions. In addition, SEPs do not require the same documentation as Keogh plans, nor is Form 5500 required annually. Although SEP contributions cannot exceed 25% of your eligible compensation (net of the deduction for the contributions), you can contribute the maximum

Chart 8

Retirement plan contribution limit increases

Type of plan	Maximum annual contribution		
	2004	Amount	When fully effective ¹ Year
401(k), 403(b) and 457 plans	\$13,000	\$15,000	2006
Defined-contribution Keogh plans	\$41,000	\$40,000	2002
Defined-benefit Keogh plans	\$165,000 ²	\$160,000 ²	2002
Traditional and Roth IRAs	\$3,000	\$5,000	2008
Single-employee Simplified Employee Pension (SEP) plans	\$41,000	\$40,000	2002
Salary reduction SEP (SARSEP) plans	\$13,000	\$15,000	2006
Savings Incentive Match Plans for Employees (SIMPLEs)	\$9,000	\$10,000	2005
Catch-up contributions for individuals over 49 years of age			
▼ 401(k), 403(b), 457 and SARSEP plans	\$3,000	\$5,000	2006
▼ Traditional and Roth IRAs	\$500	\$1,000	2006
▼ SIMPLEs	\$1,500	\$2,500	2006

¹ Not including future adjustments for inflation. The maximum annual contributions started being adjusted for inflation in 2003 for defined-contribution Keoghs and single-employee SEPs and will start to be adjusted for inflation in 2006 for SIMPLEs; in 2007 for 401(k), 403(b), 457 and SARSEP plans; and in 2009 for traditional and Roth IRAs.

² This is the maximum annual benefit that the plan can provide for. To fund the benefit, the actual contribution may exceed the limits imposed on the defined-contribution Keogh plan.

Source: U.S. Internal Revenue Code

TAX PLANNING TIP 18 SEE HOW TAX-DEFERRED SAVING COMPARES

The benefit of contributing to a retirement plan can be seen when compared to investing in an after-tax income or equity account.

Let's say you are deciding whether to annually contribute the maximum amount (\$13,000 in 2004, \$14,000 in 2005 and then \$15,000 in 2006 and after, without considering adjustments for inflation) to your employer-sponsored retirement plan or to make an equivalent investment of after-tax dollars to an account holding either income securities (and paying income tax) or equity securities. As the example below illustrates, after 20 years, the retirement plan will net you \$145,000 (42%) more than an account holding taxable income securities and \$68,000 (16%) more than an account holding only equities (and paying capital gains tax based on turning over the portfolio every five years). This holds true despite losing the benefit of the 15% capital gains tax rate on the long-term growth inside the retirement plan.

Net funds after 20 years

	Retirement plan	After-tax income account	After-tax equity account
Value at 8% (pre-tax)	\$757,000	—	—
Income tax on full distribution	(265,000)	—	—
Equivalent after-tax dollars	—	\$347,000	\$424,000
Net available funds	\$492,000	\$347,000	\$424,000

And the actual benefit of the retirement plan would probably be greater because:

- ▼ It is unlikely that you would fully withdraw the funds from the retirement plan in 20 years. Typically, you would withdraw only the minimum required distribution amounts after you reach age 70½, or an amount you needed to live on, with the remainder continuing to grow tax deferred,
- ▼ You may be subject to a lower income tax rate when you retire, and
- ▼ Many states exclude a portion of pension income from taxation.

Note: This example assumes an annual rate of return of 8% and a federal tax rate of 35%.

amount of \$41,000 if your compensation exceeds \$205,000. If self-employed with compensation in excess of \$205,000, setting up a SEP for your future retirement plan contributions can be a simpler alternative to a Keogh plan.

Defer salary with a 401(k), 403(b) or 457 plan

A 401(k) plan is a salary deferral plan that allows you, as an employee, to elect to have a portion of your compensation paid to a qualified trust under an employer-sponsored qualified deferred-compensation plan. The maximum employee elective contribution for 2004 is \$13,000 (increasing to \$14,000 in 2005 and \$15,000 in 2006) — \$16,000 for taxpayers 50 and over. This annual limit applies to the total contributions even if the employee has more than one salary deferral plan. But contributions to a self-employed SEP can be made in addition to this annual limit (subject to the aggregate limit of \$41,000).

Both 403(b) and 457 plans contain similar provisions to 401(k) plans. A 403(b) plan is for employees of public schools or tax-exempt educational, charitable and religious organizations. A 457 plan is set up for employees of state and local governments and any other tax-exempt organization other than a governmental unit or church organization.

Simplify with a SIMPLE

An employer with 100 or fewer employees who received at least \$5,000 of compensation in the preceding year can establish a Savings Incentive Match Plan for Employees (SIMPLE) as long as it generally doesn't maintain any other employer-sponsored retirement plan. A SIMPLE can take the form of an IRA or a 401(k) plan. Both plans allow employees to contribute up to \$9,000 (increasing to \$10,000 in 2005) — \$10,500 for taxpayers 50 and over — with the employer required to match that amount, up to a maximum of 3% of the employee's compensation, subject to limitation. A 1% match is permitted in two years out of every five years.

The benefit of a SIMPLE is that it is not subject to nondiscrimination and other qualification rules generally applicable to qualified plans, or to the top-heavy rules that apply to 401(k) plans. The

downside is that you cannot contribute to any other employer-sponsored retirement plan and the elective contribution limit is lower than for other types of plans. For the employee, the mandatory employer matching requirement can be attractive, though limited based on compensation. For the employer, it can be a disadvantage because the contributions are not discretionary.



Get a deduction with a traditional IRA
Perhaps the most widely known retirement plan, a traditional IRA allows deductible contributions and tax-deferred growth. As with the various qualified retirement plans, withdrawals (including your contribution amounts) are subject to ordinary income tax. The maximum deductible contribution for 2004 is \$3,000 (increasing to \$4,000 for 2005 and to \$5,000 for 2008) — \$3,500 for taxpayers 50 and over. But contributions for 2004 must be made by April 15, 2005, even if the date for filing your tax return is extended.

To be eligible to contribute to a traditional IRA, you must earn compensation equal to or greater than the IRA contribution amount. Also, you and your spouse (if married) cannot actively participate in an employer-maintained retirement plan (including a Keogh plan) for any part of the year. But you can avoid these requirements if you meet one of these exceptions:

- ▼ Only one of you actively participates in an employer-sponsored plan and your combined adjusted gross income (AGI) doesn't exceed \$155,000. Only the nonactive participant can make a deductible IRA contribution. A partial contribution can be made until the combined AGI reaches \$165,000.
- ▼ Both you and your spouse (filing jointly) participate in employer-sponsored plans but your AGI does not exceed \$65,000. You can make a partial IRA contribution until your AGI reaches \$75,000.

If you are single, you can participate in an employer-sponsored plan and deduct IRA contributions if your AGI doesn't exceed \$45,000. And you can make a partial IRA contribution until your AGI reaches \$55,000.

Pay no taxes on Roth IRA distributions

The Roth IRA offers many advantages over a traditional IRA. For starters, though contributions are not deductible, qualified distributions are tax-free — so you never pay any tax on the earnings — as long as the IRA has been open five years and the distribution is made after age 59½ (with only a few exceptions). Pre-age 59½ and other nonqualified distributions are treated first as a nontaxable return of your contributions, so nonqualified distributions that do not exceed contributions are not taxed. But on amounts that exceed accumulated contributions, you're subject to regular income tax plus an additional 10% penalty on the nonqualified distributions.

The tax-free distributions alone make Roth IRAs more advantageous than traditional IRAs in most cases (see Tax Planning Tip 19 on page 41), but the benefits don't stop there. Another Roth IRA difference is that

original account owners are not required to take distributions beginning at age 70½ — or ever. Also unlike traditional IRAs, you can continue to contribute to a Roth IRA after you reach age 70½, as long as you have sufficient earned income.

And Roth IRA contributions (up to \$3,000 less contributions to any other IRAs — \$3,500 for taxpayers 50 and over) can be made even if your AGI is too high for a traditional IRA and you are covered by an employer-sponsored plan, as long as your AGI does not exceed:

- ▼ \$150,000 if you are married filing jointly, or
- ▼ \$95,000 if you are single or head of household.

You can make a partial Roth IRA contribution until your AGI reaches \$160,000 if married filing jointly and \$110,000 if single or head of household. The contribution deadline is the same as for traditional IRAs: April 15, 2005. If you cannot set up a Roth IRA under current law because of AGI limitations, you may be able to do so under a new provision: Starting this year, if your employer-sponsored retirement plan is amended to permit it, you can designate a portion of your contributions as going to a separate traditional IRA or Roth IRA. Because the Roth IRA generally is better, this will probably create a tremendous number of new Roth IRAs.



So what if you already have a traditional IRA in place? You may want to consider rolling it over into a Roth IRA. You can make such a rollover if your AGI (before the rollover) is less than \$100,000. (Married taxpayers filing separately are ineligible.) The advantage of this rollover is that you convert tax-deferred future growth into tax-free. The disadvantage is that the rolled over traditional IRA amount is taxable in the year of the rollover, as if you received the distribution. Before you roll over anything, evaluate the potential benefit of the tax-deferred growth compared to the lost earnings on the tax you pay because of the rollover.

Minimum distribution rules

As a result of sweeping changes made by the IRS in 2002, only one method and one table are used to determine minimum required annual distributions, with most taxpayers generally facing smaller required annual distributions — so more can grow tax-deferred. Plus, you no longer need to name your beneficiary for purposes of calculating your lifetime distributions, except if the beneficiary is a spouse more than 10 years younger than you. In that case, a joint and survivor life expectancy is used. The disincentive to leave retirement benefits to charity was also removed because you no longer will be subject to increased income taxes on accelerated distributions.

Consider these three items in light of the new rules:

1. Minimum distributions. These are the amounts that you must take from your plans (other than Roth IRAs) to avoid penalties beginning no later than April 1 of the year after you reach age 70½. Each year thereafter, the minimum distribution must be made by Dec. 31. But distributions are not required if you are still employed (regardless of your age). This exception does not apply to traditional IRA distributions or distributions to plan participants who own 5% or more of their companies. If you turned or will turn 70½ in 2004, you can either take a distribution in 2004 or defer the distribution until next year. If you elect to defer, you must take two distributions in 2005 (the first by April 1). Most distributions are taxable in the year received, except those coming from nondeductible

IRA and Roth IRA contributions. Thus, avoid taking the initial distribution in a year you are in a higher tax bracket.

2. Penalties. Early withdrawals can trigger penalties in addition to income taxes — as can failing to timely take required distributions. The most common is a penalty tax of 10% assessed on distributions taken before reaching age 59½, unless you:

- ▼ Take distributions in the form of substantially equal periodic or annuity payments for at least five years and the last payment is received in a year after you reach age 59½,
- ▼ Take distributions because of job separation (such as early retirement) and you are over 54 — this exception doesn't include IRA distributions (typically you would want to roll over retirement plan accounts anyway),
- ▼ Use the distributions from an employer-sponsored qualified plan for medical expenses,
- ▼ Face a qualifying disability and take distributions from your IRA, or
- ▼ Wish to make a first-time home purchase (up to \$10,000) or pay for qualified higher education expenses with IRA distributions. ("First-time home buyer" is defined liberally — as an individual and/or spouse who has not had an ownership interest in a home within two years of the purchase.)

3. Lump-sum (or other eligible) distributions.

Amounts distributed from a qualified retirement plan can be transferred tax free into an IRA or another qualified plan as long as the transfer is done directly from trustee to trustee. If you personally receive the funds, the full amount of the distribution is subject to a 20% federal income tax withholding. You can elect not to have this withholding taken out of your

TAX PLANNING TIP 19 LOOK AT HOW YOU CAN BENEFIT FROM A ROTH IRA

As this example shows, the benefit of a Roth IRA is very significant if, despite your intentions, you do not invest the annual tax savings from a traditional IRA. Say you and your spouse make the maximum IRA annual contributions (\$3,000 each in 2004, eventually increasing to \$5,000 each in 2008). If you spend the tax savings rather than investing them, the Roth IRA accumulates \$164,000 more than the traditional IRA — over 50% more! Even if you do invest the tax dollars you save on the deductible IRA contributions, the Roth IRA will net you \$47,000 more, after taxes, in 20 years.

**Comparison of Roth IRA and traditional IRA
Net amount available in 20 years, after taxes**

	Traditional IRA if tax savings are		
	Roth IRA	Invested	Not invested
Value after 20 years	\$469,000	\$469,000	\$469,000
Federal taxes on withdrawal	0	(164,000)	(164,000)
After earnings on tax savings invested	—	117,000	—
Net amount available in 20 years	\$469,000	\$422,000	\$305,000

Note: This example assumes an annual rate of return of 8% and a federal tax rate of 35%. Withdrawals are not made until after the age of 59½.

distribution, but be careful of penalties if you underpay your tax for the year. (See the "Estimated Tax Requirements" chapter on page 10 for how to avoid these penalties.) If you fail to roll over the distribution within 60 days to another IRA or qualified retirement plan, you will be subject to income tax and possibly early withdrawal penalties on the distribution.

Should you take any distributions between ages 59½ and 70½? Even though you are not required to take distributions, you may need to take them to meet your expenses. But be careful not to exceed income thresholds requiring 85% of your Social Security payments to become taxable. Taking nonrequired distributions in any year that your tax bracket is low may be beneficial. But you must compare the benefit of the reduced tax rate against the tax-deferred growth if the funds are left in the retirement account. ▲

G I F T A N D E S T A T E P L A N N I N G

15

Waiting to see what happens with the repeal could cost your family

MORE THAN THREE years after it was passed, the repeal of the estate tax and the sunset provision reversing the repeal remain unchanged, offering no relief to the confusion that surrounds gift and estate planning. Congress continues to debate a permanent repeal, but the projected budget surpluses have turned into deficits. How will this get resolved? Only time can answer that, but ignoring gift and estate tax planning while Congress debates and decides future legislation could cost your family.

Tax relief has started ... Will it continue?

The maximum tax rate assessed on gifts, bequests and generation-skipping transfers (GSTs) drops to 48% for 2004. The gift tax exemption amount remains at \$1 million but the estate tax exemption has increased to \$1.5 million for 2004, as has the GST tax exemption. Further reductions are scheduled until 2010 (see Chart 9), when gift taxes are to be assessed based on a graduated rate table with rates ranging from 18% to 35% (equal to the top individual income tax rate at that time). Also at that time, the estate and GST taxes will disappear. But transfer taxes will return to 2001 rates in 2011 if no further legislation is passed.

If the estate tax is eventually repealed, the income taxes paid by your beneficiaries could increase and the estate planning process could be more complicated. One key provision of the repeal requires that the basis step-up on assets acquired from a decedent be treated as if the transfer were a gift. This means that your basis will carry over to your beneficiaries, requiring them to pay capital gains taxes when they sell any appreciated assets they inherited. A limited basis step-up will allow an aggregate basis of \$1.3 million — \$4.3 million if at least \$3 million is transferred to a surviving spouse.



And you can increase this allowable basis step-up by the amount of the decedent's capital loss carryover and net operating loss carryover.

But disqualifications abound. For instance, property acquired by the decedent by gift (other than from a spouse) within three years of death does not qualify for the basis step-up. Also, property that includes income in respect of a

decedent (such as IRAs to beneficiaries other than your spouse) does not qualify.

What should you do now?

Despite the estate tax's future uncertainty, you can still take advantage of the existing tax law as well as interim changes. By doing so, you can compound the benefits of removing future growth and income from your estate if the estate tax repeal does not happen, or you and your spouse don't outlive the remaining years before the repeal.

How do you get started? First, review your current gift and estate plan. Then implement any tax planning strategies to ensure that your family and other beneficiaries (including charities) will receive as much as possible from your estate. This review can also provide your executor and trustees with a blueprint to guide them when transferring assets and setting up distributions for your beneficiaries.

Chart 9

Scheduled transfer tax rate, exemption and credit changes

Year	Top tax rates		Exemptions			Credits
	Gift	Estate and GST	Gift	Estate	GST	Allowable state death tax credit
2001	55% ²	55% ²	\$675,000	\$675,000	\$1,060,000	100%
2002	50%	50%	\$1,000,000	\$1,000,000	\$1,100,000	75%
2003	49%	49%	\$1,000,000	\$1,000,000	\$1,120,000	50%
2004	48%	48%	\$1,000,000	\$1,500,000	\$1,500,000	25%
2005	47%	47%	\$1,000,000	\$1,500,000	\$1,500,000	None
2006	46%	46%	\$1,000,000	\$2,000,000	\$2,000,000	None
2007	45%	45%	\$1,000,000	\$2,000,000	\$2,000,000	None
2008	45%	45%	\$1,000,000	\$2,000,000	\$2,000,000	None
2009	45%	45%	\$1,000,000	\$3,500,000	\$3,500,000	None
2010	35%	Repealed	\$1,000,000	Repealed	Repealed	None
2011 ¹	55% ²	55% ²	\$1,000,000	\$1,000,000	Indexed	100%

¹ If the repeal is not extended.

² Excluding 5% surtax.

Note: Federal gift and estate taxes are unified so that any gift tax exemption you've used reduces your available estate tax exemption and a single progressive tax rate schedule, starting at 41%, applies to your cumulative lifetime taxable gifts and transfers at death. (The minimum tax rate will increase as the exemption amount increases.) Lifetime taxable gifts are included even if you did not pay a gift tax because of your lifetime exemption.

Source: U.S. Internal Revenue Code

And you'll be improving future management and investment decisions by using trusts and other vehicles that will carry out your desires and protect your wealth. Generally, use only strategies that won't cause you to pay gift taxes, because they'll reduce the value of transferred assets if the estate tax repeal is extended (or made permanent). Here are some other potentially effective strategies:

Make annual exclusion gifts. The annual exclusion allows you to make tax-free gifts up to \$11,000 per year, per individual (\$22,000 if you are married and use a gift-splitting election), in 2004. You can apply this exclusion to gifts to an unlimited number of people. Also look to your lifetime exemption of \$1 million if you have not already done so. (See Tax Planning Tip 20.)

Mitigate medical and education costs. You can directly pay unlimited tuition and medical

expenses free of gift taxes to any person. This exclusion is in addition to the annual \$11,000 gift exclusion and includes health insurance premiums and tuition payments for nursery school through graduate school. You must make these payments directly to the qualifying educational organization or medical provider.

Take advantage of trust strategies. Transfer future appreciation out of your estate at an immaterial, if any, gift tax cost by creating a trust, such as a grantor retained annuity trust (GRAT). (See "Grant yourself the benefits of a GRAT" on page 46.) Also determine whether you can remove life insurance proceeds from your estate by using an irrevocable life insurance trust (ILIT). (See "Live better with a life insurance trust" on page 46.) Or diversify your portfolio with a charitable trust to combine estate planning with your charitable desires. (See the "Charitable Giving" chapter starting on page 30.)

Form a family vehicle. You can transfer a portion of your asset ownership to your beneficiaries by creating a family limited partnership (FLP) or family limited liability company (FLLC). This will allow you to take advantage of your gift tax exclusion amounts yet control when funds are actually distributed to your beneficiaries. Either entity allows you to transfer indirect ownership of your assets by gifting limited partnership or member interests rather than the actual assets, typically to your children, at a significant discount (based on several valuation principles). And you can still maintain management control of the investments. But be careful of control issues in partnership documents. The IRS recently

has been successful in reducing discounts. (See Tax Planning Tip 22.)

The benefits of making lifetime gifts today

At first glance, it may seem easy to do nothing and take your chances that you will avoid the estate tax by simply passing your assets to your beneficiaries at your or your spouse's death, assuming either occurs after the estate tax is repealed. But as we have already discussed, this may be costly tax-wise because of the uncertainty surrounding the estate tax repeal. And it may also restrict your ability to assist your family during your lifetime.

TAX PLANNING TIP 20 EXHAUST YOUR \$1 MILLION GIFT TAX EXEMPTION

From a tax perspective, you're typically best off using your lifetime gift tax exemption immediately. If the transferred assets remain in your estate instead, all future growth and income will be subject to tax at your surviving spouse's death, and possibly at a higher tax because of progressive tax rates. In addition, you may completely lose the exemption's benefit. If you and your spouse have not yet used your exemptions, you can make gifts up to \$2 million in addition to annual exclusion gifts.

Let's compare the difference of transferring these assets to your beneficiaries now rather than through your estate (using a 6% after-tax growth rate):

If you transfer \$2 million in 2004. Giving the maximum amount of \$2 million to your beneficiaries means, in 20 years, it will grow to about \$6,645,000. And that's gift and estate tax free.

If the appreciated assets pass through your and your spouse's estates. With proper planning you each receive a single lifetime exemption of \$1 million. The estate tax will be \$2,090,000 on net taxable value of \$4,645,000 (\$6,645,000 less the \$2 million exemption at the 45% rate). Your beneficiaries will receive the \$4,555,000 balance.

It is also possible that the estate tax repeal will not be extended but that the tax rates will be reduced or the exemption amount increased. Even so, your beneficiaries would still benefit from the reduced estate taxes at whatever rate might then apply on both the utilized exemption amount and the future appreciation from the assets.

Note: For comparative purposes, the example assumes the estate tax exemption will also be \$1 million. It also assumes the estate tax rate will be a flat 45% — the lowest maximum rate scheduled other than in the year of repeal.

Consider that you may want to help your beneficiaries start a business or build a house, and the amount you want to gift may exceed the gift tax exemption. You would be subject to a substantial gift tax on the excess amount, even after the repeal of the estate tax. But if you give up to the gift tax exemption now or in a subsequent year, you will avoid the gift tax while your beneficiaries enjoy the use of the funds and gain from any future appreciation on the gift free of gift and estate taxes.

Also remember that one reason to avoid making lifetime gifts of highly appreciated assets will be gone when the estate tax is repealed: Your beneficiaries will have to use your adjusted basis (or fair market value, if lower) on assets they inherit that exceed the potential \$4.3 million limited basis step-up. (See the earlier section, "Tax relief has started.") So it no longer will make sense to hold on to assets that have appreciated significantly for the purpose of gaining the basis step-up. This is a hidden cost of the estate tax repeal, because it will increase taxable income — most likely long-term capital gains — when your beneficiaries sell the assets.

Double the tax savings by making generation-skipping gifts

A 48% tax is currently imposed on transfers to your grandchildren (or for their eventual benefit) or other “skip persons” (individuals two or more generations lower than you). This GST tax is in addition to federal gift and estate taxes. But you do have a tool to avoid this double tax: a GST tax exemption that allows you to transfer an aggregate amount up to \$1.5 million free of the GST tax.

So consider making immediate gifts to your grandchildren up to the remainder of your lifetime gift tax exemption. Why? Because you will avoid one level of tax that would be assessed on your children when their assets pass to your grandchildren. If you transfer your assets only to your children, an estate tax will be assessed on your estate and then again when the assets pass through your children’s estates to your grandchildren. Even though you can use the GST tax exemption up to \$1.5 million, you would be subject to a gift tax on the transfer because the gift tax exemption is only \$1 million. Considering the uncertainty of gift and estate tax rules, it may be prudent to avoid paying a gift tax at this time.



Consider a credit shelter trust for your better half

You’ll incur no federal gift or estate taxes on amounts you transfer to your spouse during your life or at your death (as long as he or she is a U.S. citizen).

The tax will be due either when your spouse gifts the assets or when they pass through his or her estate. Even though this marital deduction can allow you to initially avoid gift and estate taxes, it is typically more beneficial to divide your assets properly so that you can take advantage of both your and your spouse’s gift and estate tax exemptions and reduce the combined taxes paid by your estates.

A zero-out grantor retained annuity trust (GRAT) can enable you to remove significant appreciation from your estate. Typically a short-term GRAT is used with a term not greater than several years and with an annuity high enough to zero out the current gift amount of the remainder interest.

Let’s say you transfer securities in a company with great potential to a three-year GRAT. The securities are currently valued at \$250,000 based on 25,000 shares at \$10 per share. Based on the current IRS actuarial assumptions and your age (say, 55), let’s say you would have to set the annual annuity payment at 39% (rounded) to zero out the remainder interest and pay no gift tax on the transfer. You would receive an annual annuity payment of \$97,500 per year, totaling \$292,500 for the three years.

How does it work? Assume the stock pays no dividends and its value appreciates to \$12 per share at the end of the first year, \$15 at the end of the second year and \$20 at the end of the third year. You would have to make the following annuity payments at the end of each year: Year 1: 8,125 shares (\$97,500 divided by \$12 per share). Year 2: 6,500 shares. Year 3: 4,875 shares. This would leave 5,500 shares, valued at \$110,000, for your beneficiaries free of gift taxes.

Alternatively, the GRAT may borrow against the stock to pay the annuity. If so, it would still own the 25,000 shares at the end of the trust’s term along with an obligation to pay \$292,500 (plus interest on the loans) to the grantor. The trust can then use 14,625 shares at \$20 per share to pay the \$292,500 it owes (plus let’s say another 800 shares to pay the accrued interest), leaving the beneficiaries with 9,575 shares valued at \$191,500 free of gift and estate taxes.

But what if you are concerned about transferring assets during your lifetime? You may prefer to wait until either your or your spouse’s death to use your lifetime exemption. Fortunately, your executor can use the exemption to fund a credit shelter trust that will pay income, or even principal, to your surviving spouse. On his or her death, the remainder goes to your beneficiaries free of estate tax because the assets have already been covered by your estate tax exemption. Make sure each spouse has individual ownership of sufficient assets to fund the trust.

TAX PLANNING TIP 22 GIVE MORE FOR LESS WITH AN FLP OR FLLC

You can increase the amount that goes to your beneficiaries if you use your gift tax exemption to transfer assets to a family limited partnership (FLP) or family limited liability company (FLLC) rather than gifting assets outright to them. Plus, you get to decide when they should receive distributions, and you retain control of the assets. For example, let's assume you and your spouse have not yet used any of your lifetime exemption of \$2 million. You can transfer assets valued at \$2,857,000 to an FLP or FLLC, free of gift taxes, instead of only \$2 million if gifted outright (based on the assumption you can sustain a 30% minority and marketability discount on the value of the limited interests).

How much more will your beneficiaries receive? The \$2,857,000 represented by the limited interests will grow to \$9,492,000 in 20 years, using a 6% after-tax growth rate, free of gift and estate taxes. If the assets were left to accumulate in your estate, the estate tax could be as high as \$3,371,000 (\$9,492,000 less the \$2 million exemption at the 45% rate).

Caution: The IRS has had some success in reducing the valuation discounts claimed by taxpayers. In addition, the IRS has gone to the Tax Court in an attempt to include the assets of FLPs in a decedent's estate if the decedent retained control over the assets after the transfer to the FLP. An initial opinion that was favorable to the IRS has recently been offset by another opinion from the same circuit appeals court. Although the facts of these cases differ somewhat from the above example and suggestions, this area of law is evolving, and you need to be careful when setting up these partnerships.

Note: For comparative purposes, the example assumes the estate tax exemption will also be \$1 million. It also assumes the estate tax rate will be a flat 45% — the lowest maximum rate scheduled other than in the year of repeal.

Grant yourself the benefits of a GRAT

Already popular estate planning tools, GRATs have become even more common in light of the 2001 tax act. Why? Because with this trust, you pay minimal, if any, gift tax yet you can potentially transfer substantial property to your beneficiaries. You can also exclude future asset appreciation from your estate.

GRATs give you an annuity, and the assets remaining at the end of the trust's term, if any, pass to your beneficiaries free of additional gift and estate taxes.

When you create a GRAT, you (as grantor) are deemed to have made a gift equal to the fair market value of the assets transferred to the trust less the present value of the annuity you will receive.

The success of a GRAT depends on the appreciation of the trust's assets. If GRAT assets appreciate faster than the rate used in the IRS actuarial assumptions, you will end up transferring the excess growth to your beneficiaries tax-free. As grantor, you pay the tax on any income from the assets during the trust's term. Thus, it's common for GRAT terms to be short, with high annuity payouts. By repeating this process, frequently referred to as cascading GRATs, you can eventually transfer significant amounts to your beneficiaries while limiting your expense to relatively small gift tax and administrative costs. A zero-out GRAT can be especially beneficial — see Tax Planning Tip 21.

Another GRAT form, a qualified personal residence trust (QPRT), allows you to transfer your personal residence to a trust (typically for your children's benefit) even though you continue to retain the right to live in the home during the trust's term. You hold an income interest in the home based on the present value of the right to live there. Gift tax applies to the net of the property's fair market value reduced by the retained income interest.

The same GRAT concept already discussed applies to QPRTs. Appreciation in excess of IRS rate assumptions will go to your beneficiaries free of additional gift or estate taxes. When the term expires, the trust (through your children) can charge you a fair-market-value rent to allow you to continue using the residence. And the rent you pay is not included in your estate.

Live better with a life insurance trust

Life insurance can serve an important function in your estate plan, because it can provide you with liquidity to pay estate taxes, especially if the value of your business (or other nonliquid assets) represents a significant portion of your estate. Life insurance can also provide immediate funds to help your family in the event of a sudden death.

But if the proceeds are left in your taxable estate, the estate tax could reduce them by as much as 48% without even considering state death taxes. To avoid this, you need to remove the proceeds from both your and your spouse's taxable estates. This can be accomplished if you ensure the proceeds are not payable to either estate and neither of you possess any incident of ownership in the policy at death. An irrevocable life insurance trust (ILIT), structured properly, can accomplish these goals because the trust is both the policy's owner and beneficiary. It can also provide income to your surviving spouse and principal to your children or other beneficiaries on that spouse's death. Plus, you can use it to properly manage and invest the insurance proceeds through a designated trustee.

To prevent you from having any incident of policy ownership, you can use one of three options:

1. You can gift sufficient funds to the trust so it can buy the insurance policy and pay all current and future premiums.
2. You can assign a current policy to the trust and gift future premiums, as long as the transfer is completed at least three years before your death. (Otherwise it will be included in your estate.)
3. You can gift the premiums on a policy owned by the trust by paying for them, generally on an annual basis.

But be careful of gift tax issues to the extent you gift funds to purchase the policy, pay premiums or transfer an existing policy that has value. You will incur a gift tax only if the amount exceeds the annual exclusion and any remaining gift tax lifetime exemption. The annual exclusion is available only if the trust document includes a withdrawal (Crummey) power and the beneficiaries are notified of the right of withdrawal of the premiums.

There are some disadvantages to life insurance trusts in addition to gift tax issues, but you can minimize them with proper planning. There will be some additional costs: You'll incur legal fees because a carefully drafted trust instrument is

needed to satisfy specific rules, and there may be trustee fees. Also, income tax returns may be required if the trust has assets generating taxable income. However, if the trust holds only life insurance and you pay the annual premiums through gifts, income tax returns are not typically required. To the extent the trust has taxable income, you can elect to report the income on your personal tax return instead, thereby avoiding trust tax returns.

Keep it in the family: Forming an effective FLP or FLLC

FLPs and FLLCs continue to be among the most effective gift and estate tax planning entities because they allow you to transfer assets to your beneficiaries at a discounted value yet retain control of investment decisions as well as the timing and amount of distributions to the partners or members (typically family members). This control applies even if your family members own a majority of the economic interest of the partnership. Plus, you can establish a gift planning program to make additional gifts of partnership units without creating a new entity each time.



To form an FLP or FLLC, you contribute assets to it in exchange for both a general partnership and a limited partnership interest, or for a member interest. You (and your spouse, if you desire) keep the general interest, commonly 1%. This general interest allows you to retain management control of the investment and distribution decisions. You gift only the limited interest, usually to your children or a trust for their benefit. The goal is to gift only an amount equal to your available annual and lifetime exclusions, so you can avoid gift tax. If married, you can double this amount by electing to split the gift. Because the limited interests are minority interests subject to a lack of marketability, the gift's value can be discounted and the corresponding tax-free amount of the gift can be increased. See Tax Planning Tip 22 for a look at just how valuable a tool an FLP or FLLC can be. ▲

2005 TAX CALENDAR

Date	Deadline for
Dec. 31, 2004	<p>Prepaying expenses to deduct on 2004 return, including state and local taxes not due until Jan. 17 or even April 15, if appropriate, and taking capital losses to offset gains.</p> <p>Accelerating income into 2004 if you are in a lower tax bracket this year than you expect to be in next year.</p> <p>Establishing a Keogh plan for 2004.</p>
Jan. 18, 2005	Paying final installment of 2004 estimated taxes.
April 15, 2005	<p>Filing individual income tax return (or extension request) and payment of balance of 2004 taxes.</p> <p>Filing gift tax return (or extension request) and payment of gift tax for 2004 gifts.</p> <p>Making 2004 traditional and Roth IRA contributions.</p> <p>Making first quarterly estimated tax payment for 2005.</p>
June 15, 2005	Making second quarterly estimated tax payment for 2005.
July 1, 2005	Filing foreign bank accounts report.
Aug. 1, 2005	Filing Keogh plan report (Form 5500) or extension request.
Aug. 15, 2005	Filing extended 2004 individual income tax return (or filing second extension request).
Sept. 15, 2005	<p>Making third quarterly estimated tax payment for 2005.</p> <p>Making 2004 money-purchase and defined-benefit Keogh plan contributions.</p>
Oct. 17, 2005	<p>Filing 2004 individual income tax return, if on second extension.</p> <p>Making 2004 profit-sharing Keogh plan contributions and SEP plan contributions if your tax return is on second extension.</p>
Jan. 3, 2006	<p>Prepaying expenses to deduct on 2005 return, including state and local taxes not due until Jan. 16 or even April 17, if appropriate, and taking capital losses to offset gains.</p> <p>Accelerating income into 2005 if you are in a lower tax bracket in 2005 than you expect to be in 2006.</p> <p>Establishing a Keogh plan for 2005.</p>
Jan. 17, 2006	Paying final installment of 2005 estimated taxes.

Source: U.S. Internal Revenue Code



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We've always been believers that looking back shows us how to move forward. Thanks to our accomplishments and our clients' successes over the past half-century, we've established a solid reputation for client service second to none. Being able to serve our clients from a professional perspective grounded in long-term relationships gives both parties an added confidence that we are "doing the right thing" to assure their continued success.

Approach — Relationships grow out of listening to one another.

Many of our clients have been with us as long as some of our partners. We think that says a lot about how we feel about getting to know our clients — and their children, and their grandchildren. We treat our clients' families like our family. A tradition has been established here: that we always be that right hand for our client.

When our clients make business decisions, they can count on us as one of their resources. In order to be an effective resource, we must first know what our client wants to accomplish — and that comes from listening. Our job is about a lot more than numbers. It's about listening first, then servicing our clients' needs.

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Our Services — It's not just staying in touch. It's about total understanding.

The way we see it, our effectiveness in working for any of our clients depends on just how good a rapport we've established and just how open we can keep the lines of communication. We are always there as consultants. That means listening, really hearing their needs, and recognizing that their needs change. We try to be insightful; we ask probing questions; we become immersed in our clients' businesses, and we develop concepts to help them grow their businesses.

We understand that each client has its own special needs, and our extensive knowledge of specific industries allows us to provide comprehensive, personalized solutions to all of our clients.

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CERTIFIED PUBLIC ACCOUNTANTS

Brickell Bay Office Tower
1001 Brickell Bay Drive, Suite 1400
Miami, Florida 33131-4938