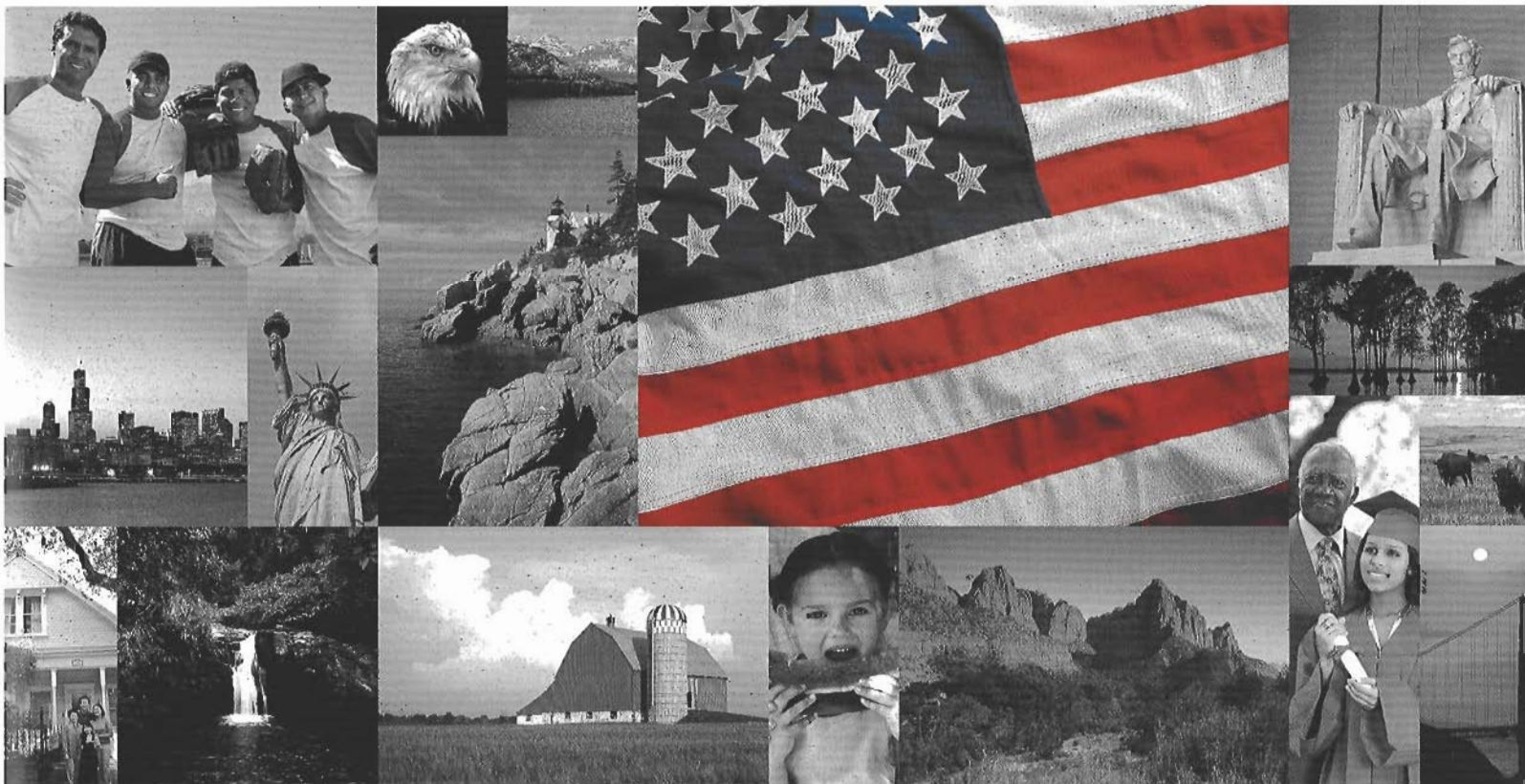


2006 Tax Planning Guide

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

Those who know, plan

With the passage of every new tax law, the tax code becomes more complex. So, while there are now more ways than ever to reduce your tax liability, taking full advantage of them is becoming increasingly difficult. Without planning, it's virtually impossible.

To help you save as much as possible, this tax planning guide highlights recent tax law changes, discusses various taxpayer scenarios, and points out new and proven ways to lighten your tax burden. It also shows how to tax-efficiently build up funds for education or retirement, and transfer your wealth to loved ones.

Given the complexity of tax laws and tax planning, this guide simply cannot cover all strategies that apply to you. So, as you read through it, note the sections that seem to pertain to your situation. Then, before implementing any of the ideas suggested here, contact a tax professional to learn whether these or other strategies may be best for minimizing your taxes and achieving your financial goals.

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And the beat goes on ... and the beat goes on

Congress has passed and the President has signed two major tax-related bills in 2006 thus far: the Pension Protection Act of 2006 (PPA), which was passed only after years of debate and months of negotiation between House and Senate lawmakers, and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). These new laws affect a wide variety of tax planning areas, such as investing, college funding, retirement planning, charitable giving and the alternative minimum tax (AMT). 2005 also had its share of new tax laws.

PPA

Besides strengthening traditional pension plans, the act includes provisions affecting retirement savings plans (such as IRAs and 401(k) plans), charitable deductions, charitable organizations, and other areas of tax law. Here's a closer look at the affected areas:

Traditional pension plans. To help ensure the security of employer-provided pension plans, PPA takes measures to ensure full funding, including even stricter requirements on plans deemed "at risk."

It also prohibits employers maintaining underfunded or terminated single-employer pension plans from funding nonqualified deferred compensation plans (which typically benefit top executives). This provision is effective for transfers or other reservations of assets that occur after Aug. 17, 2006, the date of enactment. (For more on nonqualified deferred compensation, see page 9.)

In addition, the act makes permanent the increases in the annual benefit limit that had been set to expire after 2010.

IRAs and defined contribution plans.

PPA includes provisions that enhance the retirement savings benefits of IRAs and defined contribution plans, such as 401(k)s, 403(b)s, 457s and SIMPLEs. For example, the act makes permanent the provisions from the 2001 tax act that were to "sunset" after 2010. These include the higher annual contribution limits for IRAs and defined contribution plans, catch-up contributions for those 50 and over, and Roth 401(k) and 403(b) plans. It also allows taxpayers to direct the IRS to deposit their income tax refunds into an IRA, effective for taxable years beginning after Dec. 31, 2006. (Read more about these plans on page 25.)

The new law also waives the early withdrawal penalty from IRAs or 401(k)s (and similar plans) for National Guard

members and reservists who are called up between Sept. 11, 2001, and Dec. 31, 2007, for a period exceeding 179 days. Plus it allows repayment within two years of the distribution without regard to the annual contribution limit. This provision comes on the heels of a smaller act that was passed in May 2006. The Heroes Earned Retirement Opportunities Act of 2006, retroactive to 2004, allows tax-exempt combat pay to be included when determining eligibility to contribute to an IRA.

Charitable giving. PPA allows taxpayers age 70½ and older to make tax-free distributions from their IRAs (up to \$100,000 annually) to tax-exempt charities through 2007, and it extends to Dec. 31, 2007, the enhanced food and book contribution rules that were enacted after Hurricane Katrina.

In an effort to curtail charitable deduction abuses, the act:

- ▶ Allows deductions for cash contributions *only* if the donor can produce a bank record or written communication from the charity as to the contribution amount, effective for contributions made in tax years beginning after Aug. 17, 2006,
- ▶ Allows deductions for donations of clothing and household goods *only* if they are at least in "good condition," effective after Aug. 17, 2006, and

- Lowers the threshold for imposing accuracy-related penalties on taxpayers who claim a deduction for donated property for which a qualified appraisal is required, effective for returns filed after Aug. 17, 2006.

In addition, the act clarifies the charitable deduction allowed with respect to easements for buildings and for land and structures located in a historic district. (Go to page 12 for more on charitable giving.)

Charitable organizations. PPA also tightens federal oversight of the organizations themselves. For example, the act doubles fines and penalties for certain activities by exempt organizations, and it extends present-law public disclosure requirements applicable to Form 990 to the Unrelated Business Income Tax (UBIT) returns of Section 501(c)(3) organizations, effective for returns filed after Aug. 17, 2006.

The new law also applies an excess benefit transaction tax on any loan, grant, compensation or other similar payment from a donor-advised fund to a donor, donor advisor or related party, and from a supporting organization to a substantial contributor or related person, effective for transactions after Aug. 17, 2006. (For more on donor-advised funds, see page 15.)

Other provisions. PPA also includes several miscellaneous provisions, the most notable of which is a permanent extension of the Section 529 provisions with respect to college savings and prepaid tuition plans. (For more on 529 plans, see page 22.)

TIPRA

Along with reconciling the 2005 federal budget, TIPRA extends several provisions that were set to expire within a

year or two. For example, the law extends the low 15% maximum tax rate on most long-term capital gains and on qualified dividends through 2010. (For more on capital gains and dividends, see page 18.)

The law provides a temporary fix for people who have fallen into the alternative minimum tax (AMT) trap by raising the AMT exemption amounts through the end of 2006. (For more information on the AMT, go to page 5.)

TIPRA also expands the “kiddie” tax by changing the age threshold from 14 to 18 years. Previously, only children under the age of 14 were taxed on unearned income at their parents’ tax rate. Affected children are still entitled to \$850 of tax-free unearned income in 2006, and the next \$850 will be taxed at the child’s rate before the kiddie tax applies. (For more on how to plan around the kiddie tax, see page 19.)

The law gives many small to midsize businesses a break by extending the increased Sec. 179 deduction. Originally scheduled to drop back to \$25,000 in 2006, the \$100,000 expensing election is now available through 2009. The deduction phases out when qualified property placed in service in any given year exceeds \$400,000. Because these amounts are indexed for inflation, for 2006 the Sec. 179 deduction limit is \$108,000, and the acquisition cap is \$430,000.

Finally, TIPRA makes a welcome change to the Roth IRA conversion process. It eliminates the \$100,000 of adjusted gross income (AGI) cap on individuals qualified to convert a traditional IRA to a Roth IRA. But you’ll have to wait awhile, because this provision isn’t effective until 2010. (For more on retirement planning, see page 25.)

Katrina Emergency Tax Relief Act of 2005 and GO Zone Act of 2005

These tax acts included relief provisions generally limited to people in the 2005 hurricane zones. Relief included expanded expensing allowances and 50% bonus depreciation for rebuilding, and five-year net operating loss carry-backs, among other provisions.

New IRS guidance

The IRS regularly issues guidance on how to comply with tax law. For individuals, one important area of recent guidance is related to the new nonqualified deferred compensation rules enacted as part of The American Jobs Creation Act of 2004. Starting with compensation deferred after 2004, the rules affect the timing of initial deferral elections and of distributions, funding of benefits, and making changes to elections. Distributions are allowed only upon specific events, and the payment of benefits generally cannot be accelerated.

These rules apply to a wide range of plans and arrangements but specifically exclude 401(k)s and other qualified employer plans, qualified governmental plans, and bona fide plans providing for vacation leave, sick leave, compensatory time or disability pay. Companies have until the end of 2006 to modify these compensation arrangements to comply. (For more on nonqualified deferred compensation, go to page 9.)

Are more changes in store for 2006?

The current tax law contains numerous provisions scheduled to expire, and, indeed, some that have already expired. So, additional tax law changes could be just around the corner.

The beat does, indeed, go on and on and on. Be sure to contact your tax advisor for more details so you don’t miss a single beat. ♣

Know the rules, pay only what you owe

It all started in 1913. That's when the 16th Amendment to the U.S. Constitution became effective, giving Congress the right to tax our income. And since then, calculating and paying taxes has become an annual ritual for most Americans.

It's a ritual that hasn't gotten any easier over the years, however. Continually changing tax laws and disappearing deductions have created a nightmarish system compared to the relatively simple system of taxation first envisioned by our lawmakers.

Now, how much you owe depends on a number of factors, including your income and deductions, filing status, the applicable tax rates, credits, other taxes, and penalties. Moreover, different types of income are subject to different tax rates, various limitations apply to deductions and exemptions, and you have to worry

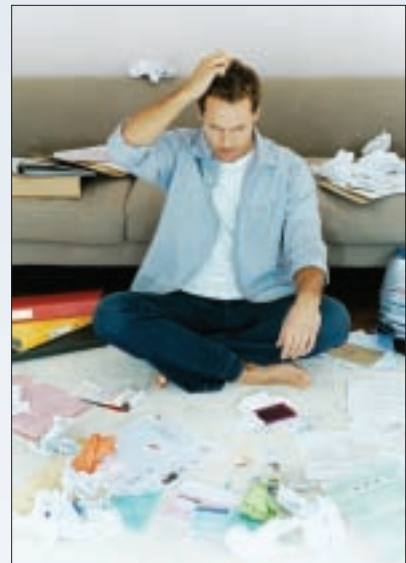


about not only the regular tax system but also the alternative minimum tax (AMT) system.

Tax rate schedules don't offer a clear picture

When most people hear the term "tax rates," they think about the tax rate schedules. These schedules reflect six graduated tax rates from 10% to 35%. The top rate that applies to you is your "marginal" rate. See Chart 1 on page 5 for the 2006 individual income tax rate schedules.

The tax rates are deceptive because your effective marginal tax rate (the rate you would pay on an additional dollar of income) may be higher due to hidden taxes. These include limits on deductions that cause you to pay



a higher effective tax rate — the \$3,000 annual limit on net capital losses, the overall 3% of adjusted gross income (AGI) limit on most itemized deductions, the nondeductibility of medical expenses that don't exceed 7.5% of AGI, the 30% and 50% limitations on most charitable contributions, and the 2% of AGI floor on miscellaneous itemized deductions.

Similarly, personal exemptions, certain rental real estate losses, and the ability to contribute to certain types of tax-advantaged retirement accounts phase out if your AGI exceeds applicable limits. Your ability to use most tax credits is also affected by your income, and even payments received from Social Security are taxed at different rates based on your overall income level.

Tax Action Strategy

Accelerate income to help zero out AMT

If you know you'll be affected by the AMT this year but not next year, accelerate income into the current year to the extent necessary to zero out the AMT. The effective tax rate on this income then becomes a maximum of 28% (the top AMT rate) vs. the maximum regular tax rate of 35%. But be careful to look at the overall tax impact, not just the AMT.

Chart 1
2006 individual income tax rate schedules

Single

If taxable income is over ...	But not over ...	The tax is:
\$ 0	\$ 7,550	10% of the amount over \$0
\$ 7,550	\$ 30,650	\$755 plus 15% of the amount over \$7,550
\$ 30,650	\$ 74,200	\$4,220 plus 25% of the amount over \$30,650
\$ 74,200	\$ 154,800	\$15,107.50 plus 28% of the amount over \$74,200
\$ 154,800	\$ 336,550	\$37,675.50 plus 33% of the amount over \$154,800
\$ 336,550	no limit	\$97,653 plus 35% of the amount over \$336,550

Married filing jointly

If taxable income is over ...	But not over ...	The tax is:
\$ 0	\$ 15,100	10% of the amount over \$0
\$ 15,100	\$ 61,300	\$1,510 plus 15% of the amount over \$15,100
\$ 61,300	\$ 123,700	\$8,440 plus 25% of the amount over \$61,300
\$ 123,700	\$ 188,450	\$24,040 plus 28% of the amount over \$123,700
\$ 188,450	\$ 336,550	\$42,170 plus 33% of the amount over \$188,450
\$ 336,550	no limit	\$91,043 plus 35% of the amount over \$336,550

Married filing separately

If taxable income is over ...	But not over ...	The tax is:
\$ 0	\$ 7,550	10% of the amount over \$0
\$ 7,550	\$ 30,650	\$755 plus 15% of the amount over \$7,550
\$ 30,650	\$ 61,850	\$4,220 plus 25% of the amount over \$30,650
\$ 61,850	\$ 94,225	\$12,020 plus 28% of the amount over \$61,850
\$ 94,225	\$ 168,275	\$21,085 plus 33% of the amount over \$94,225
\$ 168,275	no limit	\$45,521.50 plus 35% of the amount over \$168,275

Head of household

If taxable income is over ...	But not over ...	The tax is:
\$ 0	\$ 10,750	10% of the amount over \$0
\$ 10,750	\$ 41,050	\$1,075 plus 15% of the amount over \$10,750
\$ 41,050	\$ 106,000	\$5,620 plus 25% of the amount over \$41,050
\$ 106,000	\$ 171,650	\$21,857.50 plus 28% of the amount over \$106,000
\$ 171,650	\$ 336,550	\$40,239.50 plus 33% of the amount over \$171,650
\$ 336,550	no limit	\$94,656.50 plus 35% of the amount over \$336,550

Source: U.S. Internal Revenue Code

Congress has increased these “hidden” taxes over the last decade, with the result that sometimes, even when tax rates decrease, your tax still goes up because you have lost all, or part, of some deductions, exemptions and credits.

Don’t let the AMT take you by surprise

Probably the biggest unexpected impact comes from the AMT. While the AMT isn’t really a hidden tax, it catches many people by surprise.

The AMT was designed to keep the wealthiest corporate and individual taxpayers from paying less tax than their perceived fair share. The system, however, was created with several serious flaws. One is that the regular tax rate system is regularly adjusted for inflation,



Congress has given taxpayers two ways to limit their AMT exposure:

AMT exemptions. An AMT exemption is available at certain income levels. The recently enacted Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) temporarily protects some Americans from the AMT by increasing the AMT exemption amounts. For 2006, the exemption amount is \$62,550 if married filing a joint return, \$42,500 if single or head of household, and \$31,275 if married filing separately.

But many taxpayers' AMT exemptions will be reduced due to a phaseout based on income. The phaseout starts at \$150,000 of AMT income, and the exemption is eliminated altogether at \$400,200 on a joint return. For singles, the exemption is phased out starting at \$112,500 and eliminated at \$282,500. For married persons filing separate returns, the phaseout levels are one-half the amounts for joint filers.

AMT credits. An AMT credit may be available in limited situations. If you pay AMT in one year on deferral items, such as depreciation adjustments, you may be entitled to a credit that offsets regular tax in a subsequent year. In effect, this takes into account timing differences that reverse in later years — but the credit might provide only partial relief or take many years before it can be used in full.

It's often difficult to gauge the effects of the AMT. But you can mitigate them by being aware of its potential impact, and thinking twice before making large payments or entering into transactions

but the AMT system is not. So now, even taxpayers with annual earnings of \$100,000 or less can fall into the AMT trap if they aren't careful.

The AMT is a separate tax system, with its own set of rules. Certain deductions, credits, exclusions and other items that are allowed to reduce regular income tax aren't permitted for the AMT. These are called AMT adjustments or preference items. It's easy to fall into the AMT, and the impact is substantial because there are only two AMT rates — 26% on AMT income up to \$175,000 and 28% on AMT income above that amount. The brackets are compressed, and fewer write-offs are allowed.

How do you know if you'll be subject to the AMT? Each year you must calculate your tax liability under both methods and pay the higher amount. The AMT calculation starts with regular taxable income and then adds back those items not allowed for the AMT.

Common AMT triggers include:

- ▶ State and local income taxes,
- ▶ Real estate taxes,
- ▶ Certain miscellaneous itemized deductions,
- ▶ Tax-exempt interest on certain private activity bonds,
- ▶ Nontaxable exercise of incentive stock options,
- ▶ Accelerated depreciation adjustments and related gain or loss differences on disposition, and
- ▶ Life insurance proceeds received by C corporations.

Tax Action Strategy

Defer payments of certain expenses to minimize AMT bite

If you're subject to the AMT this year, postpone to next year, if possible, payment of deductible expenses that aren't allowed for AMT purposes, such as state and local income taxes, as well as real estate taxes.

Chart 2
Employment taxes

	Social Security	Medicare	Total tax
2006 income limit	\$ 94,200	no limit	NA
Employee rate	6.2%	1.45%	7.65%
Employer rate	6.2%	1.45%	7.65%
Self-employed rate	12.4%	2.90%	15.30%

Source: U.S. Internal Revenue Code

that may subject you to the AMT. Always seek professional help with AMT planning before year end.

AMT strategies

Here are some suggestions to help you avoid or reduce the AMT bite:

- ▶ If the spread between the fair market value and the exercise price of incentive stock options may trigger the AMT, evaluate whether to postpone exercising them or exercise and sell immediately. (See “Pay special attention to incentive stock options” on page 10.)
- ▶ If you’re not subject to the AMT this year but may be next year, consider whether to pay for certain items in 2006, when you’ll be able to benefit from the deduction.
- ▶ Always consider how significant transactions, such as selling assets or exercising incentive stock options, may affect AMT liability. Also consider it in your year-end planning. Knowing where you stand may enable you to adjust your income and deductions to minimize the AMT.

Employment taxes also take a bite

The Social Security system continues to spark debate over whether it needs to be reformed. Whatever the outcome, one thing is virtually certain — you must pay Social Security taxes on earned income.

The Social Security portion of the tax is capped, but you pay the Medicare tax on all your earned income regardless of how much you earn. Self-employment income may be generated from a sole proprietorship or miscellaneous services as an independent contractor and also includes certain income from partnerships and limited liability companies (LLCs) treated as partnerships. See Chart 2 (above) for the current rates and ceiling amount.

You don’t owe income tax only in April

A critical part of the tax system is the requirement to pay tax during the year — through either withholding or estimated tax payments. If appropriate payments aren’t made and taxes are underpaid, you will be penalized. To avoid this penalty, make sure your estimated payments equal at least 90% of your tax liability for the

current year or 100% of the prior year’s tax — 110% of the prior year’s tax in 2006 if your 2005 AGI was more than \$150,000.

If your income is irregular and skewed toward the latter part of the year, you may avoid the penalty by using the annualized income installment method. Rather than using a pro-rata approach for testing adequacy of quarterly estimated tax payments, annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period: March 31, May 31, Aug. 31 and year end. This method often benefits high-income taxpayers who have considerable variability in income due to bonuses, investment gains and losses, or seasonal income.

Wage earners with large year-end bonuses — or salary sufficient to cover substantial withholding — should consider having any tax shortfall withheld from wages before year end. Doing so can help you escape underpayment penalties. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters. ♣



All income is not created equal

All income will be taxed at some point unless it's specifically excluded by law. You may be wondering how any income could escape taxation. While it's rare, income that isn't taxed could be either tax-exempt (municipal bond interest) or excluded (certain scholarships). And even all taxable income isn't created equal when it comes to tax rate and tax treatment.

The tax impact of character and timing

The character of an item of income determines the tax rate and its treatment, and the timing determines the year in which it's taxed, though timing also can affect character. Typical tax planning goals are to have income favorably characterized and to defer taxation regardless of its character. This can change, or even reverse, however, depending on your situation in any given year.

Character of income is usually thought of as the distinction between ordinary income and capital gains. But it can be more complex than that. Even various types of capital gains are taxed at different rates, as indicated in Chart 3 on page 9. And a relatively new tax provision has reduced the maximum tax rate for qualifying dividends by more than half — to 15%, rather than an ordinary income rate as high as 35%.

The timing of income affects its character when, for example, you hold an asset long enough that it becomes subject to

the lower long-term capital gains tax rate when sold. So deferring income may produce savings not only from the time value of money, but, in certain circumstances, also from real tax rate differentials due to changes in the law or your situation.

Changing the timing of income may produce surprising results. For example, suppose you sold stock for \$60,000 and your basis was \$20,000. If you held the stock for only 10 months and you were in the 35% tax bracket, your \$40,000 gain would result in tax of \$14,000. Your net after-tax proceeds would be \$46,000.

If, instead, you held the stock for 13 months but sold it for only \$55,000, your gain of \$35,000 would be taxed at a maximum 15% federal long-term capital gains rate. Thus, your tax liability would be only \$5,250. Your net after-tax amount would be \$49,750, leaving you with more cash in hand despite the lower sale price, due to the more favorable tax treatment. But beware: A larger decrease in stock value can also easily wipe out the savings and more.



Preparing for your investment income tax bill

Investments come in a variety of types and tax treatments. Understanding the tax cost can help you compare investment choices and be better prepared when your tax bill comes due. Investment income can include both the earnings while you own it and the gain upon its sale. (See page 18 for more information on gains.)

Qualifying dividends are taxed at the reduced rate of 15% (5% for those in the 5% or 10% bracket) currently scheduled

Chart 3
Income character determines tax rate

Character	Maximum rate
Ordinary income	35%
Qualified dividends	15% (through 2010)
Short-term capital gains	35%
Long-term capital gains	15% (through 2010)
Long-term real estate gains from unrecaptured depreciation	25%
Long-term gains on collectibles	28%

Source: U.S. Internal Revenue Code

to run through 2010. Therefore, dividend-paying stocks may initially seem more attractive from a tax perspective than other income investments, such as CDs and taxable bonds.

Interest income is taxed at ordinary income rates up to a maximum of 35%. But don't forget that some interest isn't subject to federal tax, such as tax-exempt interest from state and municipal bonds. You'll generally pay state income tax on the interest, with some exceptions. For example, some states exempt interest income on bonds issued within their own state.

Although municipal bonds usually pay a lower interest rate than other investments, their after-tax return may be higher, particularly if you can also avoid state tax, or in situations where the investment climate is changing and you can lock in a better interest rate.

AMT ALERT — Tax-exempt interest on certain private activity bonds can be subject to the alternative minimum tax (AMT).

Appreciating investments that don't generate current income aren't taxed until sold, perhaps allowing you to time the sale to your tax advantage — such as when you are in a lower tax bracket or a year in which you have capital losses to offset.

When choosing or disposing of investments, remember that tax goals are just one part of the equation. Also consider your risk tolerance, desired asset allocation and whether an investment makes sense for your economic and personal situation.

Investment strategies

Here are some time-proven strategies for keeping taxes on your investments in line:

- ▶ Take advantage of the reduced 15% rate for qualifying dividends and long-term capital gains. Consider buying stock that pays qualifying dividends and selling highly appreciated assets when they become long-term and before the lower rate expires.
- ▶ Also, with the tax rates for qualifying dividends and long-term capital gains now the same, it may be easier to focus on total return when investing in stock. Keep in mind, though, you

have only until 2010 to take advantage of the 15% rate (unless it's further extended by Congress).

- ▶ If you're paying for college expenses, consider giving an income-producing investment to your child. Rather than you paying education costs with your after-tax dollars, your child — who's most likely in a lower tax bracket and may be able to use tuition credits that you can't use — can pay them from the investment's income, netting an overall family savings.

Nonqualified deferred compensation still viable

Executives and other key employees are often compensated through a variety of methods, such as regular salary, bonuses and fringe benefits. In addition, there are more complicated methods with more complicated tax consequences, such as nonqualified deferred compensation.

This type of compensation arrangement pays employees some time in the future for services to be currently performed. These plans are often geared to the individual and based on their performance or on the company's performance. They are also subject to a variety of laws and regulations, which have been better defined by 2004 tax law changes.

Moreover, these rules may require amending plans you already have in place. Employment agreements that fall under the nonqualified deferred

Tax Action Strategy

Consider the best investments for retirement accounts

To maximize the benefits of today's low long-term capital gains and qualified dividend rates, as well as those of tax-deferred savings vehicles, consider arranging your portfolio accordingly. To the extent possible, hold ordinary income-earning investments in your retirement accounts (where they aren't currently taxed) and qualifying dividend and capital gain (15% rate) investments outside your retirement accounts.

compensation definition are still viable, but all parties must carefully follow the rules to avoid adverse tax effects.

Phantom stock and stock appreciation rights (SARs) are two specific forms of nonqualified deferred compensation that provide executives the benefit of sharing in increases in the company's value without the executive actually owning stock. With phantom stock, part of your compensation package includes contracted rights that mirror increases in the value of the company stock. After a deferral period, the amount of compensation paid is based on the increase in the stock's value. A SAR plan is similar: You are granted the right to receive payment equaling the appreciation in value of one or more shares of stock over a specific time period.

People are often surprised by one aspect of nonqualified deferred compensation — the timing of payroll tax payments. Employment taxes are generally due when services are



performed and amounts due are vested, even if the compensation isn't actually paid or recognized for income tax purposes until later years.

The question arises: Is it proper for the employer to pay the employee's portion of payroll taxes on the deferred amount if there is no cash compensation from which to withhold it? Be aware that your employer may solve this dilemma by withholding the required taxes out

of other cash wages to you or asking you to write a check. If your employer elects to pay your tax, you will have additional income.

Nonqualified deferred compensation strategies

Enlist the following strategies to ensure your plans meet your expectations:

- ▶ Make sure you understand any employment agreement or compensation arrangement and what tax results to anticipate.
- ▶ Compare the tax-adjusted amounts of salary, bonuses, fringe benefits and nonqualified deferred compensation when negotiating compensation.
- ▶ Don't forget about the Social Security tax and be aware that, in some instances, you will pay employment tax when services are performed and amounts are vested — not years later when the compensation is paid.

Pay special attention to incentive stock options

Incentive stock options (ISOs) are a form of executive compensation deserving special attention in your tax planning. Companies may offer stock options that serve double duty: They

Tax Action Strategy

Remember the AMT when exercising ISOs

The bargain element of incentive stock option (ISO) exercises produces an AMT adjustment item at the time of exercise, as shown in the following example:

In Year 1, Bill exercises 20,000 ISOs at \$10 a share when the stock is trading at \$15. The bargain element of \$5 per share creates an AMT preference of \$100,000. The AMT liability on this could be as high as \$28,000 ($\$100,000 \times$ the maximum AMT rate of 28%) or it could be zero — remember, the AMT applies only if it's higher than Bill's regular tax liability. Because he needs to hold the stock for more than one year to get long-term capital gains treatment, Bill should do some tax planning before he exercises so that he knows the AMT cost and has a plan for paying it.

If Bill sells his 20,000 shares of stock in Year 2 for \$20 per share, he gets long-term capital gains treatment on his \$200,000 ($\10 per share) gain and is probably happy with the result — even though he paid the AMT in Year 1. He hopes to get back the AMT tax paid through the AMT credit, and his AMT capital gain is \$100,000 less.

not only compensate the employee but also give him or her another reason to contribute to company growth. Plus, they aren't subject to the complex non-qualified deferred compensation rules, though they have special rules in order to receive tax-favored treatment.

Here's how an ISO works: The employer grants an employee a right to buy company stock at a fixed price in the future. This price must be at least equal to the stock's fair market value at the time of the grant. The employee can exercise the option and buy the stock after meeting a holding-period requirement. To be an ISO, an option must, by its terms, be exercised within 10 years after the date on which it's granted.

Assuming the stock appreciates in value, the purchase price under the option will be less than the current trading price when the employee exercises the option. This difference is called the "bargain" element. If all requirements are met, ISOs create no income tax either at grant or upon exercise. Exercise of the ISO may trigger the AMT, however. So be careful. (See the Tax Action Strategy at left.)

ISOs offer a favorable tax result by both deferring and changing the character of income. An employee who exercises an ISO doesn't recognize the bargain element as compensation income, but recognizes it as capital gain when the stock is sold in a later year. This is just about as good as it gets in the tax world — you postpone income to a later year and, potentially, reduce your tax rate from an ordinary income rate of 35% to the long-term capital gains rate of 15%.

But the option must be held for more than one year, and then the stock must be held for more than one year after exercise to receive long-term capital

gains treatment on the sale. If the stock doesn't meet that requirement, all gain on the sale is taxed as compensation income at ordinary income rates.

Although ISOs sound almost too good to be true, there are some disadvantages. You must put up the money to buy the stock and bear the market risk of holding it long enough to get the favorable tax treatment due to the one-year holding requirement.



AMT ALERT — One major drawback to ISOs is that they create an AMT tax adjustment when exercised. This is a particular problem because exercising the option doesn't generate any cash with which to pay the tax. The problem is magnified if the stock price drops after exercise. You can be left with a large AMT bill and the possibility of not recouping those dollars when the stock is sold. Note, however, that the recognition of AMT income increases your basis in the stock for AMT purposes. So, when you sell the shares, your AMT gain will be less than your regular tax gain (or the AMT loss will be greater). Also, don't overlook the impact of the credit for prior years' AMT. You may be entitled to a credit in a subsequent year if the AMT arose from certain items, including stock options, and if your regular tax is higher than the AMT in that subsequent year.

Incentive stock option strategies

Tax planning for ISOs is truly a numbers game and involves risk. With the help of your tax advisor, you'll need to calculate both regular tax and the AMT and crunch the numbers using various assumptions. Here are some strategies to consider:

- ▶ Find the "breakeven" point for the number of shares to exercise.
- ▶ Exercise early to narrow the spread and start the holding period running.
- ▶ Stagger annual exercise, which will spread out the impact of the AMT preference.
- ▶ Sell early and pay the higher short-term/ordinary income tax rate to avoid the AMT on potentially disappearing appreciation. This is called a "disqualifying disposition." But exercise care if you implement this strategy.

Nonqualified stock options taxed when exercised

In contrast to ISOs, nonqualified stock options generate compensation income (taxed at ordinary rates) on the bargain element in the year exercised. More companies are turning to nonqualified stock options as an economical compensation method.

Why? The company gets a compensation deduction at exercise when the employee pays tax on the bargain element. (With qualified ISOs, the employer gets no such deduction unless the employee makes a disqualifying disposition by selling the shares without holding them more than a year after exercise.) Because no additional tax applies, the employee can sell some of the newly acquired stock immediately to pay the tax. ♣

Deductions may now have greater impact on your taxes

Over the years, taxpayers have seen their itemized deductions have less and less of an impact on their overall tax bill. But, relief is in sight. Starting in 2006, the phaseout on exemptions and the limitation on itemized deductions will be gradually repealed. In 2006 and 2007, the phaseout amount is reduced by one-third.

If your 2006 adjusted gross income (AGI) exceeds a threshold amount of \$150,500 (\$75,250 if married filing separately), your itemized deductions are generally reduced by 3% of your income above the threshold.

Assume the phaseout amount of your itemized deductions using the general rule is \$3,000. For 2006 and 2007, however, the phaseout amount is reduced to \$2,000 (or one-third less).



Aside from the phaseout of itemized deductions, your expenses must exceed separate percentage thresholds before you can deduct medical expenses, casualty and theft losses, and miscellaneous itemized deductions.

Nevertheless, by planning now you can make the most of your possible deductions and significantly reduce your tax bill.

Double your pleasure with charitable giving

For many people, giving to charity is one of the best deduction planning opportunities around, because you can enjoy not only a sizable tax deduction, but also the satisfaction of doing good.

Charitable planning strategies can provide both tangible and intangible benefits to a broad range of people. A well-planned gift to charity can meet your charitable goals and give you a chance to be more personally involved with the charities close to your heart. It can also generate income and estate tax benefits while allowing you to take care of your heirs in the manner you choose.

Combine these benefits with the ability to maintain financial security while exercising control over assets both during your lifetime and after death, and you've got some powerful charitable giving tools at your disposal.

Deductions are subject to AGI limits based on the form of the donation and the type of charity. See Chart 4 for a list of the most common limitations. Contributions disallowed due to the AGI limit can be carried forward for up to five years. Deductions may be further limited by recent provisions enacted as part of the Pension Protection Act of 2006 (PPA).

In determining your charitable giving strategy, you need to consider what to give, as well as how to give it. Outright gifts of cash are the easiest, and probably the most common, gifts to charity. PPA now requires you to keep a canceled check, credit card receipt or other form of substantiation for every dollar you contribute. But the only other tax concerns with cash donations are whether you receive the desired deduction — and the amount and timing of the deduction.

Through 2007, PPA allows taxpayers 70½ and older to contribute to a charity up to \$100,000 annually directly from their IRA, avoiding the contribution limits shown in Chart 4. You won't get a tax

Chart 4

AGI limitations on charitable contribution deductions¹

Contribution type	Public charities	Private foundations ²	
		Operating	Nonoperating
Cash and unappreciated property	50%	50%	30%
Ordinary income property ³	50%	50%	30%
Long-term capital gains property ⁴	30%	30%	20%

¹ For this purpose, adjusted gross income (AGI) is computed without regard to the deduction for charitable contributions and any deduction for a net operating loss carryback.

² An operating foundation spends at least 85% of the lesser of its adjusted net income or its minimum investment return in carrying out its exempt activities and meets certain other tests. Others not meeting this definition are nonoperating foundations.

³ Deduction is generally limited to the property's adjusted basis.

⁴ Generally, the full fair market value of the property is deductible, subject to the percentage limitations.

Source: U.S. Internal Revenue Code

deduction, but you will avoid the tax that would have been owed had those funds been distributed to you or a beneficiary.

Gifts of property are a little more complicated:

Ordinary income property. If you contribute ordinary income property (such as stock held less than a year, inventory or property subject to depreciation recapture), you will receive a deduction equal to the lesser of fair market value or your tax basis.

Appreciated property. One of the best charitable giving strategies is to donate appreciated property that would otherwise be subject to income tax on long-term capital gain if sold. The property must be a capital asset, such as stocks, bonds or other securities, and meet the long-term holding period of more than 12 months.

By giving appreciated property to charity, you not only escape the capital gains tax but also receive an income tax deduction, usually at fair market value. Contributions of appreciated long-term capital gains property are limited to 30% of your AGI (or 20% depending on the type of charitable recipient), as

shown in Chart 4. This limitation can be increased to 50% if you elect to deduct the basis rather than the fair market value for most property. This may prove to be more favorable in limited circumstances, depending on your AGI and the likelihood of using the carryover within the next five years.

Not all contributions of property held longer than a year allow a deduction equal to fair market value. If you contribute tangible personal property that isn't related to the charity's tax-exempt function, you receive a deduction, but it's limited to your basis in the property. For example, if you donate a painting for a charity auction, you can deduct only your basis, but if you donate the

painting to an art museum for display, you can deduct its fair market value.

Property donations also have detailed reporting requirements. For example, those valued at more than \$5,000 (other than publicly traded securities) must be supported by a qualified appraisal, with an appraisal summary attached to the tax return.

Vehicles. Special rules apply to vehicle donations. The practice of donating vehicles to charity has come under fire recently. In response to allegedly excessive deductions being claimed for donated automobiles, the deduction is generally limited to the amount actually received by the charity,

Tax Action Strategy

Understand the rules when donating services or use of property

If you contribute your services to charity, you may deduct only your out-of-pocket expenses, not the fair market value of your services. If you donate use of property (such as one week's use of a ski condo for a charity auction), you receive no deduction because this is considered your personal use. One exception to this rule concerns your car, for which you may deduct 14 cents for each mile driven for charitable purposes. For 2006, a higher mileage rate (32 cents) applies to use of a vehicle solely to provide service to a charity related to Hurricane Katrina relief.

if and when it sells the vehicle. This is only one of many efforts to rein in excessive charitable deductions. And it serves as a reminder that, to obtain a valid deduction, you need to understand the rules and plan accordingly.

What you want to give may affect what is the best way to give it. In addition to making an outright gift, you can make donations via these tools:

Charitable remainder trust. A CRT may be appropriate if you wish to donate property to charity and would like to receive (or would like someone else to receive) an income stream for a period of years or for your expected lifetime. The property is contributed to a trust and you, or your beneficiary, receive income for the period you specify. The property is distributed to the charity at the end of the trust term.

So long as certain requirements are met, the property is removed from your estate and you receive a current income tax

Tax Action Strategy
Enjoy the added benefits of above-the-line deductions

“Above-the-line” deductions are those expenses you can subtract from your income in determining your adjusted gross income (AGI). Because AGI affects your ability to enjoy numerous tax breaks to their fullest, above-the-line deductions are especially beneficial. Examples include traditional IRA and Health Savings Account (HSA) contributions, moving expenses, self-employed health insurance costs, and alimony payments.

deduction for the present value of the remainder interest transferred to charity. You don't immediately pay capital gains tax if you contribute appreciated property. Distributions from the CRT generally carry taxable income to the noncharitable beneficiary. If someone other than you is the income beneficiary, there may be gift tax consequences.

A CRT can work particularly well in cases where you own non-income-producing property that would generate a large capital gain if sold. Because a CRT is a tax-exempt entity, it can sell the property without having to pay tax

on the gain. The trust can then invest the proceeds in income-producing property. This technique can also be used as a tax-advantaged way to diversify your investment portfolio.

To keep CRTs from being used primarily as tax avoidance tools, however, the value of the charity's remainder interest must be equal to at least 10% of the initial net fair market value of the property at the time it's contributed to the trust. There are other rules concerning distributions and the types of transactions that the trust may enter into.

Charitable lead trust. A CLT is basically the opposite of the CRT: The trust pays income to the charity for a term of years, and, at the end of the term, the property is distributed back to either you or a beneficiary. This technique works well if you don't need the current income but want to keep an asset in the family. Consider contributing income-producing stocks or bonds, or something more unusual, such as a painting that is transferred to a museum for the term of the trust. The charity receives income, or an asset they want, even if not permanently. This technique is used for income tax and estate planning purposes. (See page 29.)

Income tax treatment differs depending on whether the asset reverts to you or goes to a beneficiary. If you hold the remainder interest, you'll receive a current deduction for the present value of the annual income to be paid to the



charity. You'll also pay all income tax on the trust income, and the trust assets remain in your estate.

If a noncharitable beneficiary holds the remainder interest, you generally won't pay taxes on trust income. (The trust is treated like a complex trust. It pays the tax on such income, but is, subject to certain rules, generally entitled to a charitable contribution deduction each year for the amount paid to the charitable beneficiary.) You are deemed to have made a gift of the remainder interest, possibly subject to gift tax, and the trust assets are removed from your estate, but you won't receive an income tax deduction.

Private foundations. If you or your family wishes to make large donations but also wants a degree of control over how that money will be used, consider forming a private foundation. A foundation is particularly useful if you haven't determined what specific charities you want to benefit.

Be aware, though, that increased donor control comes at a price: You must follow a number of rules designed to ensure that the private foundation serves charitable interests and not private interests. For example, there are requirements on the percentage of annual payouts to charity and restrictions on most transactions between the foundation and its donors or



Tax Action Strategy
Contribute appreciated stock to charity

Contributions of appreciated stock can be especially effective. Along with receiving an income tax deduction and avoiding the capital gains tax, you also remove that asset from your estate, thereby reducing your potential estate tax burden. The following example illustrates how this strategy works:

Robert wants to contribute \$100,000 to his alma mater's sports program before year end. His tax advisor, also an alumnus, suggests Robert donate stock rather than cash. Robert has stock worth \$100,000 that he purchased seven years ago for \$60,000. If Robert were to sell the stock, he'd have a \$40,000 long-term capital gain. Assuming the maximum tax rate, here is a comparison of contributing the stock vs. selling the stock and contributing the cash:

	Stock	Cash
Tax savings on contribution deduction (\$100,000 x 35%)	\$ 35,000	\$ 35,000
Capital gains tax on sold stock (\$40,000 x 15%)	0	(6,000)
Net tax savings	\$ 35,000	\$ 29,000

The example shows that contributing capital gains property instead of cash can save you a significant amount of tax, including additional tax savings for applicable state income taxes not reflected here.

managers. Private foundations are also generally prohibited from benefiting any private individual. If these requirements aren't met, substantial penalties will be imposed.

Private foundations are also restricted as to the types of investments made, and investment income is subject to a yearly excise tax of 1% to 2%. Finally, a private foundation is responsible for ensuring that funds distributed to a nonpublic charity are properly expended.

As shown in Chart 4 on page 13, the AGI limitations for deductibility of contributions to private nonoperating foundations are lower. Depending on whether cash or property is donated, deductions to private nonoperating foundations are limited to 30% or 20% of your AGI.

Donor-advised funds. Many larger public charities, particularly those that support a variety of charitable activities and organizations, offer donor-advised funds. Such a fund is simply an agreement between the donor and the charity: The charity agrees to consider the donor's wishes regarding use of the donor's funds. This agreement is non-binding, and the charity must exercise final control over the disposition of the funds, consistent with the charitable purposes of the organization. If this isn't the case, no income tax deduction will be allowed. In some situations, the donor can name someone in the family to give direction after the donor is gone.

Because of abuses with donor-advised funds, PPA provides that, if the fund "advisor" (typically the contributor) or

family members receive an incidental benefit from a fund distribution, a 125% tax can be imposed. This provision potentially subjects these funds to even stricter rules than private foundations.

Before deciding which charitable giving vehicle is right for you, consider the administrative and legal costs of creating and managing it. And, if you choose to proceed, consult with both your tax and legal advisors to determine its feasibility. Just remember that satisfying your desire for control comes at a price — proper planning is essential.

Charitable contribution strategies

Take the time to analyze which giving strategies will help you best meet both your charitable giving and your tax planning goals. Consider the following:

- Keep in mind the new rules under PPA.
- Only donations to qualified charitable organizations may be deducted. If you have doubts about a charity, check the IRS listing online to see if it qualifies.
- Before you donate property to a charity auction, think about whether you'll receive a deduction and, if you can, change the donation to maximize your deduction.



Tax Action Strategy

Treat dividends and capital gains as ordinary income for lower tax bill

Because qualified dividends and net long-term capital gains (from the sale of investment property held for more than one year) are taxed at the beneficial 15% rate, they aren't considered investment income for purposes of deducting investment interest expense. But you can elect to treat dividends and capital gains as investment income by subjecting them to ordinary income rates. Though, in some cases, this will reduce your current tax, you must weigh this benefit against its impact on future years.

- If you want to benefit charity while diversifying assets and retaining income during your lifetime, consider setting up a CRT.
- If you have long-range charitable goals, consider setting up a private foundation or exploring other sophisticated giving strategies.
- Although charitable contribution deductions aren't disallowed in figuring your alternative minimum tax (AMT) liability, if you are subject to the AMT, the tax savings from your charitable contributions may be reduced.

Your investment expenses may be deductible

Under U.S. tax law you may deduct expenses used to generate taxable investment income. Expenses related to tax-exempt income, however, aren't deductible. If you have investments at the same investment firm generating both tax-exempt income and taxable income and the firm's statement reflects one fee amount, the investment fees must be allocated. Investment expenses also include research costs and security for your investments, such as a safe deposit box. These expenses are considered miscellaneous itemized deductions, deductible only to the extent that they exceed 2% of your AGI.

Investment interest expense is deductible only to the extent of net investment income. For this calculation, the investment interest expense is compared to all net investment income on your return, not just the income specifically traceable to the interest expense. But remember that, unless you elect otherwise, long-term capital gains and dividends that are taxed at the preferential rate aren't included in net investment income.

Unused investment interest expense can be carried forward indefinitely and may be usable in later years. It may be beneficial to carry the unused investment interest until after 2010, when the preferential 15% rate on long-term capital gains and certain dividends is scheduled to end.

Deducting home-related interest

Most people are familiar with the deductibility of interest expense, so we'll only remind you of rules for a few situations:

- You can deduct mortgage interest on your principal residence and a second home so long as the total of all mortgages doesn't exceed \$1 million. A "residence" can include a motor home, boat or airplane as long as it's self-contained, such as having a kitchen, toilet and sleeping spaces.

- ▶ Interest is deductible on home equity loan balances up to \$100,000 in addition to the \$1 million.
- ▶ Consumer interest, such as on credit cards and personal loans, isn't deductible.

Investment interest expense is discussed in the previous section. See Chart 5 below for deductibility of various categories of interest expense.

AMT ALERT — Only mortgage interest is deductible for AMT purposes. Home equity loan interest can subject you to the AMT in certain circumstances.

You may be entitled to deduct professional fees

Professional fees are deductible in limited circumstances. Fees for investment and tax advice are deductible as miscellaneous itemized deductions subject to the 2% of AGI floor, as are tax return preparation fees.

But legal fees are subject to more complex tax rules. There are three categories that apply to legal bills: deductible, nondeductible and capitalized. Legal fees incurred in connection with a business transaction, preserving business reputation and goodwill, or protecting or managing income are generally deductible.

Nondeductible legal fees include personal actions, such as property settlement and child custody in a divorce, drafting wills, and criminal defense.

Capitalized legal fees include amounts paid or incurred to defend or protect title to property, acquisition and disposition of property, and development or improvement of property. Property transactions needing capitalization include tangible property (such as real estate) and intangible property (such as patents).

Legal fees and court costs in cases involving unlawful discrimination and certain other federal laws are fully deductible above the line in computing AGI.

Deduction strategies

Try to structure the timing of payments to maximize your itemized deductions. Consider the following actions:

- ▶ Accelerate deductions by paying before year end any items you'd normally pay in the following year. This is particularly advantageous if you're apt to be in a lower tax bracket next year.
- ▶ Bunch deductions in one year to exceed the percentage limitations. For example, miscellaneous itemized deductions subject to the 2% floor (such as unreimbursed employee business expenses or investment and tax advisory fees) should be accelerated or deferred where possible to maximize the amount paid in a single year.



AMT ALERT — These strategies can backfire if you are subject to the AMT. If you're accelerating payments — for example to prepay your fourth quarter state estimated tax payment — plan before you pay. You may not benefit from the deduction at all if you are subject to the AMT. Generally, the only way to determine this is to do your tax planning and calculate your tax under various scenarios before year end and before you make payment. ♣

Chart 5
Interest expense deduction

Nature of debt	Not deductible	Itemized deduction	Business or above-the-line deduction
Consumer or personal	•		
Qualified residence ¹		•	
Taxable investment ²		•	
Tax-exempt investment	•		
Trading activities			•
Business activities			•
Passive activities ³			•
Education loans			•

¹ Including a second home.

² Limited to net investment income.

³ Generally limited to passive income.

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

Source: U.S. Internal Revenue Code

Whether you win or lose, it's how you play the gain

Being a successful investor doesn't mean just anxiously checking the ticker at the end of the day. In fact, if you do it right, you won't even care about the daily ups and downs of the stock market. Successful investing requires active, long-term planning and keeping a vigilant eye on your gains and losses throughout the year.

How net gains are taxed

Capital gain is the profit you make when selling a capital asset. Capital assets held for more than 12 months are considered long term, subjecting them to a maximum tax rate of only 15% (5% for individuals in the 15% and 10% tax brackets). Higher rates apply to certain types of assets. See Chart 3 on page 9.

Property held for 12 months or less produces short-term gain, which is taxed at the same rates as ordinary income — at a maximum rate of 35%.

The 15% tax rate is the lowest capital gains tax rate in more than 70 years. And it's now good through 2010 thanks

to a two-year extension under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

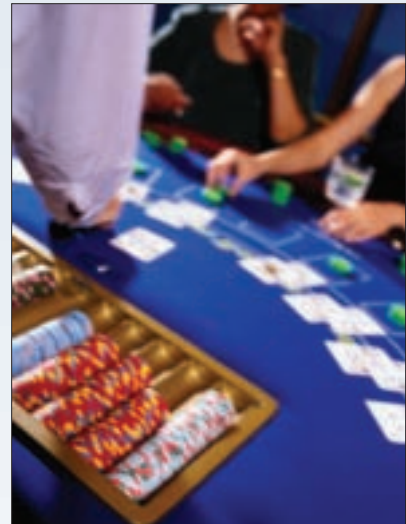
On your tax return, capital losses are netted with capital gains. If the result is a gain, tax is computed at regular rates or the 15% capital gains rate, depending on whether the net gain is long-term or short-term. If the net result is a loss, you can deduct up to \$3,000 against other income in the current year and carry over any remaining losses to next year.

Time gains and losses

By determining your year-to-date gains and losses now, you can time sales of other investments before year end to maximize your tax savings.

Tax Action Strategy Swap your bonds

Bond swaps are another way to maintain your investment position while recognizing a loss. With a bond swap, you sell a bond, take a capital loss and then immediately buy another bond of similar quality from a different issuer. The wash sale rule doesn't apply because the bonds aren't considered substantially identical. Thus, you achieve a tax loss with virtually no change in your economic position.



If you have a net capital gain, consider selling off investments with unrealized losses to offset the gain. But first evaluate whether it pays to do so, due to differences in rates. For example, it may be wiser to pay 15% tax on a net long-term capital gain and to defer realizing the loss until it can offset gains that would be subject to higher rates.

If you decide to offset the gain, keep in mind that, under the netting rule, you can offset short-term gains with long-term losses and long-term gains with short-term losses. Your tax savings will be based on the type of gain you reduced or eliminated, not the type of loss you used. So, for example, if you're in the 35% bracket and have a net short-term gain of \$50,000, you can recognize a \$50,000 long-term loss to

offset it. This saves taxes at the 35% rate (\$17,500) because you eliminated the short-term gain.

If you have a net capital loss, consider generating gains to use the loss. But again, evaluate whether it may be more beneficial to carry forward the loss. For instance, if you can offset the loss next year against short-term gains, rather than offsetting with a long-term gain this year, the deferral may be worthwhile. Or, if you are hesitant to give up a gain position on investments and can offset the loss (up to \$3,000) against ordinary income next year, failing to currently use the loss may not seem so bad.

As a reminder: If you sell shares that were purchased at different times, you'll normally want to identify high-basis shares as having been sold to reduce the gain on sale. If you don't specify which shares you're selling, they'll usually be considered sold on a first-in, first-out (FIFO) basis.

Remember to consider market conditions and expectations, as well as your tax strategies, when dealing with gains and losses. Finally, remember that for tax purposes the trade date, not the settlement date, of publicly traded securities determines the year in which you recognize the gain or loss.

Watch out for the wash sale rule

In your effort to recognize losses to offset capital gains, don't forget about the wash sale rule. It prevents you from using a loss on a stock or security if you buy the same — or substantially identical — stock or security within 30 days. The time limit is both 30 days before and 30 days after you sell the stock or security.

You can avoid the wash sale rule by buying stock of a company in the same industry or shares in a mutual

Tax Action Strategy

Take into account the special considerations for mutual funds

Earnings on these funds are typically reinvested. Unless you (or your broker or investment advisor) keep track of these additions to your basis, you may report more gain than required.

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'll 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'll 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.

fund that holds securities much like the one you sold. Or, consider doubling up on your investment for a 31-day period before selling the original shares or selling and then waiting 31 days to repurchase.

There is no wash sale rule for recognized gains. If, for tax purposes, you'd like to generate a gain, but still want to keep your stock position, you can sell the stock at a gain and immediately repurchase it. You would pay tax on the gain (or use it to offset a loss), but then you'd have a new, and increased, basis in the repurchased stock. Furthermore, your holding period would restart.



Give your children appreciating investments

Children who are 18 and older can sell capital gains property and pay tax at rates as low as 5% (zero in years 2008 through 2010), depending on their income. (TIPRA raised the age from 14 to 18 for years after 2005.) In 2006, you and your spouse, together, can give up to \$24,000 of assets to each of your children (or grandchildren) — free of federal gift tax — without using any of your \$1 million lifetime gift tax exemptions. (For more on gift tax planning, see page 29.)

Keep in mind, however, that this strategy might not work for gifts to younger children because the “kiddie” tax applies. Unearned income beyond \$1,700 is taxed at their parents' marginal rate unless the appreciating assets are sold after the children are 18 or older.

Defer gain with an installment sale

If you are contemplating or negotiating an asset sale, you may be able to defer some of the tax burden by structuring it as an installment sale. This gain deferral could work with sales of real estate, business assets, closely held stock or



partnership interests. The installment sale method allows you to recognize the gain and pay tax over time, as you receive the payments. The character and holding period of the asset determines the character of the installment sale gain.

The installment sale method can't be used for sales of publicly traded stock or inventory. And because it also doesn't work with depreciation recapture, you should discuss how to allocate sales proceeds with your tax advisor to minimize this result.

Here are some other tax traps to watch out for when using installment sales:

- Depreciable property is potentially subject to gain acceleration. Depreciation recapture must be recognized in the year of the sale regardless of the amount of payments received during the year. This can be an unpleasant surprise if you have gain on depreciation recapture and no cash with which to pay the tax.
- An installment sale to a related party, followed by a subsequent sale by that party within two years, accelerates your installment gain. You could pay tax on the entire remaining gain in the year in which the related party sells the asset.

Also keep in mind that dealers may not use the installment sale method, and certain property isn't qualified for installment sales.

Defer gain longer with a like-kind exchange

If the concept of gain deferral appeals to you, you can go one better than an installment sale. With a qualifying exchange of like-kind property, you may be able to defer your gain until the replacement property is sold.

Here's how it works: You exchange business or investment property for qualifying property that's of the same kind or class — for example, real property for real property. You'll have a taxable gain only to the extent that you receive cash or nonqualifying property, or obtain a net reduction in your liabilities. Any gain you don't recognize currently reduces the basis

of the replacement property, so any depreciation on the new property is less than if the property had been purchased. The deferred gain is recognized whenever the replacement property is sold.

There is a downside to like-kind exchanges. Because the gain is postponed — not eliminated — you'll eventually recognize the gain when the property is sold. This raises a significant potential drawback to deferred exchanges, given the fact that the 15% rate on long-term capital gains is due to expire after 2010. Deferred gain on the sale of replacement property after 2010 may be taxed at a higher rate. Finally, don't exchange property that has declined in value; the loss would be deferred under a like-kind exchange.

Opportunities to do a simple, straightforward exchange are limited. You may be able to facilitate an exchange, however, by having an intermediary hold your property and acquire the desired replacement property. Structuring any like-kind exchange requires careful planning, so take time to consult your tax advisor.

Passive loss rules complicate tax planning

Losses from passive activities generally can offset only income from other passive activities. Unused or suspended passive losses are carried forward until

Tax Action Strategy

Beware of phantom income that could come back to haunt you

Keep in mind that disposing of a passive activity may trigger phantom income. This typically occurs when you sell your interest in a real estate partnership, or the partnership sells the underlying property. In these cases, you may have to "recapture" prior year losses. Assess the tax implications and engage in tax planning, if possible, before disposing of passive activities, particularly those with real estate holdings.

Tax Action Strategy

Watch out if you have significant installment receivables

A problem that affects fewer sales, but one that can surprise you, is the restriction on tax deferral for large installment sales. If you have outstanding installment receivables of more than \$5 million that arose in the same tax year, you are, in effect, “denied” installment treatment and must pay an “interest charge” on the amount of tax deferred.

you have passive income, or until you dispose of your interest in the activity in a taxable transaction (a sale, not a gift). You may have a passive activity if you invest in a business in which you don't materially participate. Moreover, rental activities are specifically defined as passive, though there are exceptions for real estate professionals and certain rental real estate activities.

A number of rules and different tests define material participation in an activity. Under two of these tests, you must participate in the activity more than 500 hours each year, or your involvement must be substantially all of the participation in the activity. If you can increase your involvement in passive loss activities, or decrease your involvement in an income-producing passive activity, you may be able to change your categorization and escape the passive loss limitations.

If you qualify as a real estate professional, you may be able to treat your rental real estate activities as nonpassive. To qualify, you must spend at least 750 hours per year in real property trades or businesses, and more than half of your annual personal services must be performed in real property trades or businesses in which you materially participate.

If you have rental real estate activities in which you actively participate (a lower standard than material participation), you may be able to deduct up to

\$25,000 of rental real estate losses.

This special allowance begins to phase out when modified adjusted gross income (AGI) reaches \$100,000 and is completely phased out at modified AGI of \$150,000.

Strategies for gains and losses

Consider some or all of these ideas to keep your taxes at bay:

- ▶ Review investments before year end to determine if you have any worthless stock or bad debts that should be written off.
- ▶ Avoid capital gains by donating appreciated property to charity. See page 12 for more information on charitable contributions.

- ▶ Make sure you've met the requirements and don't have any problems with accelerated tax recognition before finalizing an installment sale.
- ▶ Consider the post-2010 change to the capital gains rate if you are negotiating an installment sale. Payments received in later years may be taxed at a higher tax rate unless Congress acts again in the interim.
- ▶ If you're considering a like-kind exchange, bear in mind the effect of the scheduled increase in the long-term capital gains rate after 2010. It may be better to recognize the gain now, while the rates are the lowest they've been in more than 70 years.

AMT ALERT — The maximum federal tax rate of 15% on long-term capital gains applies to both the regular tax and the alternative minimum tax (AMT). However, because substantial net long-term capital gains can increase your deductible state (and local) income taxes — which aren't deductible for AMT purposes — paying these taxes in the same year may trigger the AMT. ♣



The ABCs of tax-effective education funding

If you have young children, you may think you have years to plan for their college education. But the sooner you start formulating strategies for dealing with educational expenses in your wealth management plan, the more likely it is that you won't miss out on any of the educational benefits offered through our tax law. And if you have children who are in college now — or you're currently paying for your own higher education — you may have additional opportunities for saving taxes.

Be tax-wise when funding future expenses

Education planning encompasses all levels of education — whether public or private — including elementary, secondary, college and graduate education. The best plan will coordinate tax saving, investment and financial aid considerations.

Tax-favored education funding is now a potpourri of options. The most prominent may be 529 plans and Coverdell Education Savings Accounts (ESAs).

Each offers different tax benefits, along with its own rules and concerns:

529 plans. Qualified tuition programs are often referred to as 529 plans, based on the Internal Revenue Code section for which they are named. They come in two forms:

1. Prepaid tuition plans. Both states and private education institutions can provide these plans that allow you to “buy” tuition at current levels on behalf of a designated child. If

your contract is for four years of tuition, tuition is guaranteed regardless of its cost at the time your child actually attends the school.

2. College savings plans. Only states can offer these plans that are established to pay a student's qualifying expenses at any eligible educational institution. If your child (or grandchild) doesn't use all of his or her account funds, the excess can be rolled over to a college savings plan for another family member.

Although both plans are flexible and — unlike most other education tax incentives — aren't subject to adjusted gross income (AGI) limitations, the college savings plan may be better because it allows more flexibility in choosing schools, with more certainty in how benefits will be applied based on school selection.

Another advantage of investing in a 529 savings plan is that funds can be used to pay for equipment, supplies, books, fees, tuition, and room and board. This broader list of qualified expenses generally outshines other education incentives.

Contribution limits are imposed by the plan and vary. Contributions aren't tax deductible for federal purposes (though they may be for state purposes if you participate in your own state's plan),



Chart 6
2006 education tax break AGI phaseouts

Tax break	Single filers	Joint filers
ESA contribution	\$ 95,000 – \$ 110,000	\$ 190,000 – \$ 220,000
Hope credit	\$ 45,000 – \$ 55,000	\$ 90,000 – \$ 110,000
Lifetime Learning credit	\$ 45,000 – \$ 55,000	\$ 90,000 – \$ 110,000
Student loan interest deduction	\$ 50,000 – \$ 65,000	\$ 105,000 – \$ 135,000

Source: U.S. Internal Revenue Code

but withdrawals are tax free as long as they are used to pay qualified college education expenses.

The result? Earnings on the account escape taxation and can amount to a significant sum over a period of time. The Pension Protection Act of 2006 made this popular plan's tax-free provisions permanent. They had been set to expire after 2010.

You are allowed to make a tax-free rollover of funds to a different qualified tuition program for the same child every 12 months. Rollovers to another child may happen at any time. There may be associated gift tax consequences, however.

For many people, 529 savings plans may offer the best education tax break. You maintain control of the account and can change beneficiaries or withdraw funds — even after the child is of legal age. Moreover, age restrictions and income limitations don't apply as they do with many other education tax breaks.

There are, however, some disadvantages: The investments may not earn as high a return as you could earn elsewhere, and you don't have direct control over investment decisions. Plus, you might not benefit from additional state tax breaks unless you set up a plan in your resident state.

ESAs. While 529 plans help you save for college only, tax-free withdrawals from an ESA can help pay for your child's elementary and secondary school expenses — as well as college expenses. For this purpose, higher education expenses include tuition, fees, room and board, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. Besides tuition, elementary and secondary school expenses are defined to include tutoring, room and board, computer costs, Internet access and certain other costs.

You can make nondeductible annual contributions of up to \$2,000 to an ESA

generally until a child reaches age 18. However, your ability to make contributions phases out as your AGI level increases. (See Chart 6.) If your AGI prevents you from contributing to your child's ESA, others (such as grandparents) whose AGIs fall within the limits may make contributions on his or her behalf.

If you think an ESA is too limited, think again. Remember that, although 529 plans allow you to contribute more, ESAs can pay for elementary and secondary education expenses. Also, you have more investment options and control with an ESA. Finally, you have until April 15 of the following year to make the contribution, so you have plenty of time to make up your mind.

Tax credits help allay today's costs

Two tax credits are available for current college education expenses:

- 1. The Hope credit.** For 2006, up to 100% of the first \$1,100 of tuition expenses and 50% of the next \$1,100 are allowable. Thus, the maximum credit is \$1,650 per student per year. The credit is available only

Tax Action Strategy Jump start a 529 plan

It's the power of compounding that makes 529 plans such a valuable education funding tool. So the sooner you contribute, the greater the benefit. But 529 plan contributions are generally considered gifts subject to the gift tax rules. This means that, to avoid gift taxes, you need to either limit your contributions to annual exclusion gifts or use up part of your \$1 million lifetime gift tax exemption.

Fortunately, a special break for 529 plans allows you to jump start a plan without negative gift tax consequences: You can make five years of annual exclusion gifts in one year. This means that, in 2006, accounts can be funded with as much as \$60,000 (\$120,000 for a couple) without incurring gift tax if you elect to use up to five years of the \$12,000 annual exclusion per beneficiary. Grandparents may find this a great way to both benefit their grandchildren and garner estate planning benefits for themselves.



for the first two years of college education, and it covers only tuition (not room, board or books) and certain fees at colleges, universities or vocational or technical schools. In the case of an individual who attends an eligible educational institution in the Gulf Opportunity Zone, an increased credit is available (double the \$1,100 amounts above), and the definition of qualified expenses is expanded to include books, supplies and qualified room and board expenses.

2. The Lifetime Learning credit. This is also available for qualified college tuition and fees, with a maximum credit of 20% of qualified expenses up to \$10,000 — a \$2,000 credit — per year per taxpayer. The credit can be used anytime during college years as well as for graduate education. This credit is also expanded for students attending qualified educational institutions in the Gulf Opportunity Zone by increasing the 20% figure to 40%. Likewise, the definition of qualified expenses is expanded for such students.

Bear in mind that you cannot use both credits in the same year for the same student.

Unfortunately, both credits are phased out at relatively low levels of AGI. (See Chart 6 on page 23.) If you can't claim either credit because your income is too high, consider letting your child take the

credit. You won't be able to claim an exemption for the child, and the child also cannot claim an exemption for him- or herself. But, based on your income, the exemption may have been phased out anyway.

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extends through 2006 a provision that allows you to take nonrefundable personal credits, such as the Hope and Lifetime Learning credits, against the AMT as well as the regular tax.

Education planning strategies

Figuring out which education benefit to use can be tricky. Keep in mind the following:

- ▶ In most cases, 529 plan withdrawals can be used in the same year as the Hope or Lifetime Learning credit, but they may not be used to pay for the same expenses that qualify for the credit.

- ▶ You may put money into an ESA for the same beneficiary in the same year you contribute to a 529 plan.
- ▶ If you paid student loan interest this year and your AGI doesn't exceed the limits, you may qualify for a deduction for some or all of your expense. (See Chart 6 on page 23 for AGI phaseouts.)
- ▶ Consider giving appreciated stock to your kids. They can sell the stock to pay college costs — and pay tax at their lower tax rate. Once a child reaches age 18, he or she can have taxable income of slightly over \$30,000 but still pay taxes on investment income at a rate not greater than 15% — at 5% on long-term capital gains. Before a child reaches age 18, investment income over \$1,700 (in 2006) is taxed at the parent's rate. (TIPRA increased the age from 14 to 18, effective in 2006.)
- ▶ For grandparents who already have grandchildren in college, consider making direct payments of tuition to the educational institution. Your payments will be gift-tax free, and they won't count against the annual exclusion amount of \$12,000 or your \$1 million lifetime gift tax exemption. ♣

Tax Action Strategy

Use dual strategies when financing your child's education

If your child attends school in an area with increasing real property values, consider combining investing and paying for education. Purchasing a residential property for housing your student may make sense. You'll likely enjoy some appreciation on the property and, if the property has more than one unit or your child has roommates, you may receive rental income, which may be sheltered from tax due to property expenses and depreciation. On your child's portion, you may receive a tax deduction for real estate taxes and mortgage interest.

Turn your retirement dreams into reality

Dreaming of retirement? Don't let those dreams turn into nightmares. To make sure you have enough money to last through your golden years, you need to stop dreaming and start planning. The good news is that you have a variety of retirement plans to choose from. And the Pension Protection Act of 2006 (PPA) may help your dreams come true. Here's a closer look at some of your options.

Take advantage of employer-sponsored qualified plans

Qualified plans, such as 401(k)s, governmental and tax-exempt organization plans under Internal Revenue Code Sections 457 and 403(b), Savings Incentive Match Plans for Employees (SIMPLEs) and Simplified Employee Pensions (SEPs), must meet certain statutory requirements.

Each covered worker's account, with contributions and earnings, is held by the plan until the employee retires or leaves the company. Income taxes are deferred until the worker receives his or her money. With a qualified plan, the employer receives a deduction when it makes contributions to the employees' accounts.

Most plans are defined contribution plans, which specify the maximum annual contribution amount based on income limitations. Defined contribution plans tell you how much can be put into a plan each year, but not what you'll have at retirement. That depends

on the contributions that have been made and what the earnings are before your retirement.

Make the most of your employer-sponsored plan by, at minimum, taking advantage of any employer matching funds and, if possible, contributing the maximum amount allowed.

PPA increases the retirement savings opportunities of defined contribution plans. For example, it has permanently extended provisions from the 2001 tax act that were to "sunset" after 2010. These include the higher annual contribution limits and "catch-up" provisions for those 50 and over. (See Chart 7 on page 26.)

The following are some of the most common defined contribution plans:

401(k) plans. 401(k)s are undoubtedly the most popular of the qualified plans. Employees elect to defer a portion of their salary by contributing it to the plan. The annual contribution limit is the lesser of a certain percentage of

salary, as defined by the plan, or the contribution dollar limit as specified by law. The maximum employee deferral for 2006 is \$15,000. After 2006, the limit will be adjusted each year for inflation. An additional \$5,000 catch-up amount can be contributed by people 50 and older in 2006 if the plan permits it. (See Chart 7 on page 26.)

401(k) contributions reduce your taxable salary amount, and the earnings grow tax-deferred — you don't pay taxes until you receive money from the plan. Contributing the maximum amount allowed each year will help you reap the greatest benefit. And if your employer matches 401(k) contributions — usually up to a certain percentage of annual pay — you'll be throwing away money if you don't take advantage of it.

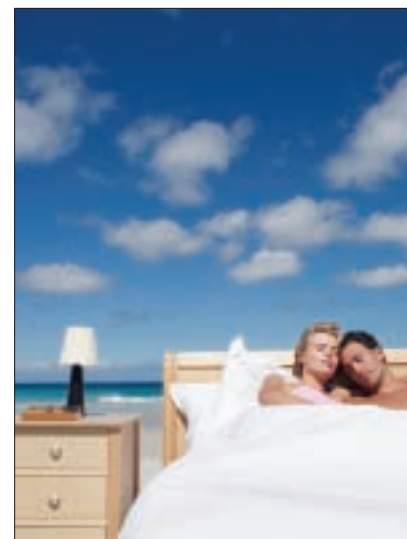


Chart 7
2006 retirement plan contribution limits

401(k)s, 403(b)s, 457s and SARSEPs ¹	401(k)s, 403(b)s, 457s and SARSEPs for taxpayers 50 and over ¹	Traditional and Roth IRAs	Traditional and Roth IRAs for taxpayers 50 and over	SIMPLEs	SIMPLEs for taxpayers 50 and over	SEPs ²
\$ 15,000	\$ 20,000	\$ 4,000	\$ 5,000	\$ 10,000	\$ 12,500	\$ 44,000

¹ Includes Roth versions where applicable.

² Not subject to "catch up" provisions.

Source: U.S. Internal Revenue Code

An exception to this is the newly minted Roth 401(k) plan. Similar to a Roth IRA, contributions to a Roth 401(k) don't reduce your taxable income, and withdrawals — so long as they are properly structured — are tax free. The income limitations that apply to Roth IRAs, however, don't apply to a Roth 401(k). Some good news: PPA makes permanent both Roth 401(k)s and 403(b)s. They had been set to expire after 2010.

SIMPLEs. These plans are designed for companies with no more than 100 workers who earned at least \$5,000 in the prior calendar year. (Note that this doesn't mean an employer isn't allowed to have more than 100 employees. It's just not allowed to have more than 100 employees that earn at least \$5,000.)

SIMPLEs can be designed as either an IRA plan or as a simplified 401(k) plan. Because they generally can't be mixed with other plans, you must live with the lower SIMPLE contribution limits — \$10,000 in 2006. The catch-up provisions allow an additional \$2,500 in 2006. (See Chart 7.)

However, SIMPLEs aren't subject to nondiscrimination rules, so they may work best in some situations. Unlike with a 401(k) plan, where matching is optional, the employer is generally required to match the employee's contributions up to 3% of compensation.

SEPs. These are good retirement plan choices for self-employed individuals or companies looking for simplicity. In the latter case, the company makes contributions to employee accounts, and there are minimal documentation and filing requirements. Furthermore, the SEP can be set up after Dec. 31 and still qualify for the previous year. The company can deduct the contribution amount on its tax return so long as plan contributions are made before the due date of the tax return (including extensions).

Defined benefit plans — what are commonly thought of as pension plans — have been declining in popularity over the years. They specify what the end result should be based upon the plan's criteria. Actuarial calculations are needed to determine how much to contribute each year to reach the specified amount in the specified time frame. Defined benefit plans usually define retirement benefits based on wages and length of service. Employers can make significant contributions — with corresponding deductions — using these plans.

The primary focus of PPA was to ensure the security of defined benefit plans. The law takes measures to ensure full funding, and it includes even stricter requirements on plans deemed "at risk." PPA also makes permanent

the increases in the annual benefit limit that had been set to expire after 2010.

Business owners may want to consider all types of plans as well as combinations of plans to increase their own retirement benefits. There are limits, however, to what can be designed because most qualified plans can't discriminate in favor of highly paid employees.

Save on your own with an IRA

An IRA is a retirement account you can set up yourself with a financial services provider. With a traditional IRA, you may be able to receive an above-the-line deduction for your contributions, and funds grow tax-deferred until distributed.

However, many taxpayers, especially two-income couples, don't qualify to deduct traditional IRA contributions. If both you and your spouse participate in an employer-sponsored plan and your adjusted gross income (AGI) exceeds \$85,000 for joint filers (\$60,000 for singles), you cannot make deductible IRA contributions. If you're married, only you or your spouse is covered by an employer plan, and your combined AGI is less than \$160,000 (phaseout begins at \$150,000), the spouse who isn't covered may make a deductible IRA contribution. Although these income levels have been on the rise — and are scheduled to increase even more — they still exclude many people from IRA deductibility.

Roth IRAs can be a great way to save money for retirement or even for your heirs, but, again, income limitations can reduce or eliminate your ability to contribute. Unlike traditional IRA contributions, Roth IRA contributions aren't deductible. However, distributions are tax free. This gives you a tax-free — rather than tax-deferred — potential buildup of earnings. Another Roth IRA advantage over a traditional IRA is that there are no required distributions, and you can continue to make contributions after age 70½.

In fact, you can make at least partial Roth IRA contributions as long as you have earned income and your AGI is below \$160,000 if you are married filing jointly (\$110,000 for singles). A phase-out range nets you a partial contribution if your income falls between \$150,000 and \$160,000 for joint filers (\$95,000 and \$110,000 for singles).

In 2006, provided you have sufficient earned income and your AGI is within the limits, you may contribute up to \$4,000 to an IRA (Roth or traditional); and, if you're 50 or older by the end of the year, you can make an additional "catch-up" contribution of \$1,000. (See Chart 7 on page 26.)



Tax Action Strategy

Get your kids started building their nest eggs

You may be ineligible or unable to participate, but traditional or Roth IRAs can still be great strategies for your kids. If your child has earned income, consider sheltering it with an IRA. Through the power of compounding, you could give your child a tremendous financial boost.

This effect is magnified if your child takes advantage of the tax-free treatment for Roth IRAs. For example, let's say your son makes Roth IRA contributions of \$4,000 each year for 10 years starting at age 16. Assuming an 8% rate of return and that he lets the account build up until he is 67, he will have nearly \$1.5 million, which can be distributed tax free. Think how much more this could be if he made contributions the entire time.

Your children must have earned income to begin IRA contributions. If you're a business owner, you can pay your children a "fair value" wage as soon as they can perform legitimate services. Money earned (and reported) from baby-sitting, raking leaves or other odd jobs also counts. (Chores at home don't.) If your children don't want to invest their hard-earned money, consider a way to make it up to them: Have them deposit their earnings and then reimburse them as a gift. It's simply too good a deal to pass up.

You can convert an existing IRA to a Roth IRA if your AGI (excluding the amount converted) doesn't exceed \$100,000 in the year of conversion. The conversion is treated as a distribution — so you'll be taxed on the full amount. This can still be advantageous because the rollover converts future tax-deferred growth into tax-free growth under certain circumstances.

Note that the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) waives the \$100,000 income requirement starting in 2010. Thus, regardless of your income, you'll be eligible to convert to a Roth IRA.

Following the minimum distribution rules

Even if you're years away from retirement, it doesn't hurt to plan ahead for taking distributions from your retirement plan. Distributions can be tricky: You

can be penalized for not taking out enough money, taking it out too soon or taking it too late.

The tax-deferred benefits of retirement plans are so great that the IRS requires you to take distributions after you reach age 70½. The IRS has prescribed a method and table for determining annual required minimum distributions. To avoid penalties, you must take a distribution each year by Dec. 31 once you reach age 70½. The initial distribution can be deferred until April 1 of the following year, but you will then have a double distribution that year.

If you're turning 70½ in 2006, you can either take a distribution in 2006 or defer the distribution until 2007. If you defer, you must then take two distributions in 2007 — one for 2006 (by April 1) and one for 2007, which must be made by the end of the year.

Regardless of age, if you are still employed, distributions from 401(k) plans may not be required in certain circumstances. And there are no required distributions from a Roth IRA, unless you are a nonspouse beneficiary or a spouse beneficiary that hasn't rolled over the account into your own.

Curiously, the Roth 401(k) has required distributions even for the plan participant. You may be able to avoid such distributions by rolling the funds into a Roth IRA.

Beware of early distribution penalties

Most distributions from tax-deferred retirement plans and annuities before age 59½ will be taxed and penalized. Withdrawals are taxed at your regular income tax rate — as high as 35% — and then a 10% penalty is added onto that. An early withdrawal may not be worth it when you look at what you net in after-tax proceeds.

You can escape the early withdrawal penalty for the following reasons:

- ▶ You become disabled, or the distributions are a result of your inheriting the plan.
- ▶ You receive a series of substantially equal periodic payments, based on your (or your beneficiary's) life expectancy, that then remain unchanged and are made for at least a five-year period or, if longer, until you reach age 59½.
- ▶ Distributions are made after age 54 due to early retirement or other job separation.
- ▶ The distribution is used for deductible medical expenses.
- ▶ You get divorced and the distributions are made pursuant to a qualified domestic relations order (QDRO).

Tax Action Strategy

Include a Roth IRA in your estate plan

A Roth IRA is a great estate planning vehicle — not only because it has no required distributions during your life, but also because you can bequeath the Roth IRA to your heirs and they can draw the money out tax free over their lifetimes. Note that the Roth 401(k) has many of the same benefits, though it's subject to required minimum distribution rules. You'll need to consider the effect of estate taxes, however, because the value of the Roth IRA will be included in your taxable estate upon your death.

401(k) plans have their own "hardship" distribution rules based on "immediate and heavy financial need." But those rules merely allow a participant to get funds out, not to escape either the income tax or the 10% penalty unless one of the general exceptions to the penalty applies.

IRAs offer a little more flexibility, because they also allow you to withdraw funds early without penalty for:

- ▶ A first-time home purchase (up to \$10,000),
- ▶ Qualified higher education expenses for yourself, your spouse or descendants, or
- ▶ Health insurance premium payments if you have been receiving federal or state unemployment compensation for 12 consecutive weeks.

You can make withdrawals from a Roth IRA up to your total contributions at any time without tax or penalty. While the tax treatment is the same for Roth 401(k)s, the amount you are allowed to withdraw may be limited.

Retirement planning strategies

Here are additional strategies to consider:

- ▶ If your income is too high for a deductible IRA or a Roth IRA, consider a nondeductible IRA

contribution. The earnings can build up on a tax-deferred basis, giving some shelter on investment income recognition while you put away money for retirement. The nondeductible contribution amount is still limited to the lesser of your earned income or the IRA contribution limit (\$4,000 for 2006, \$5,000 with the catch-up provision).

- ▶ Watch out for the mandatory 20% federal income tax withholding on eligible rollover distributions from employer retirement plans. If you change jobs, make sure you don't personally receive the funds. Instead, use a trustee to facilitate a rollover directly into an IRA or a qualified retirement plan sponsored by your new employer.
- ▶ After you reach age 59½, consider taking nonrequired distributions in any year your tax bracket is low. But make sure you compare the benefit of the reduced tax rate to the potential tax-deferred growth if the funds are left in the retirement account.
- ▶ Start planning now for the possibility of converting your traditional IRA to a Roth IRA once the income restriction is waived in 2010. ♣

Making the most important move for your family

You've made plans for limiting your income tax liability, planned for your children's education and even planned out your eventual retirement. But don't stop there. Planning for the eventual distribution of your estate is perhaps the most important move you'll make for your family.

As you shift gears to consider tax-motivated estate planning, you'll need to focus on the implications of the gift, estate and generation-skipping transfer (GST) taxes, along with using trusts to ensure your wishes are carried out as planned. Here are some key estate planning issues to consider.

Understanding transfer taxes is essential

There are three main transfer taxes — each with differing rules — that will affect your planning strategies:

1. Gift tax. This year gifts can be taxed at a rate as high as 46%. Fortunately, under the gift tax exemption, you can make \$1 million of taxable gifts over your lifetime without having to actually pay gift tax. But that's not the only way to avoid gift taxes.

The annual exclusion allows you to make tax-free gifts of up to \$12,000 per person, per year, to an unlimited number of recipients (\$24,000 per year if you and your spouse choose to split gifts) without using any of your \$1 million lifetime exemption.

The exclusion amount is indexed for inflation, but only in \$1,000 increments. Because this year it increased from the \$11,000 2005 amount, it probably won't increase again for a few years.

Gift-giving remains one of the best estate planning strategies. Giving away an asset not only removes it from your estate, but it also removes future appreciation and/or any annual earnings, resulting in a lower future estate tax.

In addition, when post-gift income is generated, it will be taxed at a lower rate if the recipient is in a lower income tax bracket — netting an

overall family tax reduction when the asset is transferred to children in lower tax brackets. Starting a gifting program early means you can gradually transfer much of your estate free from gift and estate taxes.

2. Estate tax. Like gifts, assets includable in your estate at your death are taxed at a rate as high as 46% in 2006. As there is for gifts, there is an estate tax exemption. But, as shown in Chart 8 on page 31, the exemption amounts differ for gift and estate taxes, with the lifetime gift tax exemption never going beyond \$1 million while the estate tax exemption is currently \$2 million and is scheduled to go as high as \$3.5 million before the 2010 estate tax repeal. The gift tax, however, isn't scheduled for repeal.

Because of these differences, it's critical to coordinate gifting with your overall estate plan. Any amount of your gift tax exemption you use

Tax Action Strategy

Remember state death taxes in your estate plan

Many states impose estate tax at a lower threshold than does the federal government. Just because the value of your estate doesn't exceed the current federal exemption amount doesn't mean a state estate tax will not be imposed upon your death. Check the laws of the states where you reside or own property and make sure your estate plan takes state taxes into account.



during your lifetime reduces the estate tax exemption available at your death dollar-for-dollar.

3. Generation-skipping transfer (GST)

tax. Transfers of assets to your grandchildren, or other transfers that skip a generation, are subject to the GST tax in addition to any applicable gift or estate tax. Like the estate tax, you can avoid or at least minimize the GST tax by making annual exclusion gifts directly to your grandchildren or others more than one generation removed from you.

For a few years after the 2001 tax act changed estate taxes, the GST tax exemption differed from the estate tax exemption. Now the two are the same, with the GST tax exemption to become indexed again in 2011.

Until then, the GST tax exemption and the estate tax exemption amount increase together over the years, as shown in Chart 8 on page 31. The GST tax is also scheduled to be temporarily repealed in 2010.

Trusts offer control and tax benefits

Trusts are often part of an estate plan because they're versatile and binding. Here's a closer look at some of the more common types of trusts:

Marital trust. This trust is created to benefit the surviving spouse and is funded with just enough assets to ensure that no estate tax will be due upon the death of the first spouse. The remainder of the estate, which would equal the estate tax exemption amount, is used to fund a credit shelter or bypass trust.

Bypass trust. The bypass trust is created at death to primarily benefit the children. Funds can be made available, either from income or principal, for the spouse's use during his or her lifetime if so elected. This two-trust arrangement takes advantage of the full estate tax exemption amount of the first spouse to die. A bypass trust estate plan that is more than three years old should be reviewed to make sure it's still accomplishing your goals. Because the estate tax exemption has been increasing, an allocation between trusts that made sense a number of years ago may now be missing the target.

Qualified terminable interest property (QTIP) trust.

The QTIP trust is a type of marital trust — typically drafted to be created at death — that passes trust income to your spouse for life, with the remainder passing to your children. A QTIP trust gives you (not your surviving spouse) control over the final disposition of your property and is often used in second marriages to protect the interests of children from a previous marriage.

Irrevocable life insurance trust (ILIT).

The ILIT owns insurance policies on your life, and it manages and distributes policy proceeds according to your wishes. Using an ILIT keeps insurance proceeds, which would otherwise be subject to estate tax, out of your estate. You aren't allowed to retain any powers over the policy, such as the right to change the beneficiary or to make the proceeds payable to your estate. For these and other reasons, you can't serve as the trustee of your own ILIT. Upon your death, the trust can make a loan to your estate for liquidity needs, such as paying estate tax.

Other trusts, such as the charitable remainder and charitable lead trusts, described on page 14, as well as grantor retained annuity trusts and

Tax Action Strategy

Use a trust to manage your affairs when you can't

The revocable living trust protects and manages your assets in the event you become incapacitated during your lifetime. The trust becomes irrevocable at death, at which time it helps avoid probate, protects your privacy and distributes your assets. Revocable living trust agreements typically provide that assets will be distributed at death to your marital trust and bypass trust.

qualified personal residence trusts, are sophisticated tools for removing future asset appreciation from your estate. They are often used when the techniques listed above are insufficient to minimize the estate tax burden.

FLPs still a good choice for some

Family limited partnerships (FLPs) are another vehicle to consider for your gifting strategy. This is how they work: You transfer property, such as a business, rental property or investments, to the FLP. Interests in the FLP can then be given to family members either all at once or over time. Although these gifts are subject to gift tax, a valuation discount may be allowed when the gifts are made. This discount, combined with careful timing of the gifts, may enable you to transfer substantial interests free from gift tax. The FLP works especially well for transfers of rapidly appreciating property, real estate and other investments.

A caveat: The IRS has attacked FLPs in a number of cases and has had some success based upon two theories: First, if the donor retains the actual or implied right to enjoy the FLP assets, such as by transferring a personal residence to the FLP and continuing to live there rent free, or by transferring most of his or her assets, thus leaving the donor dependent upon distributions from the FLP to meet living expenses, the FLP's assets must be included in the donor's taxable estate.

Therefore, you should not transfer personal-use assets to an FLP, you should not transfer so much of your assets as to leave insufficient means to pay for living expenses, and you should not have unfettered access to FLP assets for your own use.

A second, more controversial, avenue of attack is including all FLP assets in the donor's estate even if the only

Tax Action Strategy
Ensure your goals are achieved with a business succession plan

If you own your own business, you've undoubtedly considered how you'll dispose of it upon your retirement or death. A business succession plan can help you transfer control according to your wishes and help carry out an orderly transition. A well-thought-out plan will also minimize the tax liability for you and your heirs while meeting your financial needs.

As such, a succession plan should be part of your overall financial and tax strategy, shaped by factors such as the type of business and whether you have an heir apparent. The best succession strategies may include gifts or transfers of ownership interests to family members as well as methods to allow key employees to acquire ownership interests.

interest retained by the donor is the right to manage the FLP. For many donors, giving up the right to manage the FLP, at least indirectly, is unacceptable. If you wish to create an FLP while retaining some control, you should discuss the risks with your professional advisor and determine the best way to proceed.

Estate planning strategies

Consider these strategies, too:

- Making direct tuition or medical expense payments to providers on behalf of grandchildren or others allows you to increase how much

you give as tax-free gifts. These payments can be in addition to the annual gift tax exclusion amount of \$12,000 (\$24,000 if married and splitting gifts) and still not use up your lifetime exemption.

- Rethink gifts of appreciated property that might not be sold by heirs before your death. If the property stays in your estate, it gets an automatic step-up in basis to fair market value at the time of death. This could result in a significant income tax saving for your heirs upon later sale. ♣

Chart 8
Transfer tax exemptions and rates

Year	Estate and GST tax exemptions ¹	Gift tax exemption	Highest estate, GST and gift tax rate
2006	\$ 2 million	\$ 1 million	46%
2007	\$ 2 million	\$ 1 million	45%
2008	\$ 2 million	\$ 1 million	45%
2009	\$ 3.5 million	\$ 1 million	45%
2010	(repealed)	\$ 1 million	35% ³
2011	\$ 1 million ²	\$ 1 million	55% ⁴

¹ Less any gift tax and GST tax exemptions used during life.
² The GST tax exemption is adjusted for inflation.
³ Gift tax only. Equal to highest marginal income tax rate, which is currently 35%.
⁴ Reverts to 2001 rules. The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates and gifts over \$10 million.
Source: U.S. Internal Revenue Code

Talk to your advisor about appropriate strategies

We hope the preceding pages have given you a better understanding of the importance of proactive tax planning and helpful ideas about ways to reduce your tax liability. Now it's time to identify the strategies that apply to your situation and put together a plan for implementing them.

See where you stand

Start by profiling your situation. Your advisor can help you look at the different types of income you have and how they are taxed, and estimate your tax liability in light of recent tax law changes. He or she can also point out credits, deductions and other tax-reduction strategies, and show how to take advantage of them for 2006 and subsequent years.

Don't forget to consider your AMT liability. Reducing it involves different strategies

than minimizing your regular tax liability. So have your advisor estimate your exposure to this tax as soon as possible to see which steps may be best for you.

Clarify your needs and goals

Next, consider your family's educational needs and your goals for retirement and wealth transfer. Determine if changes in your personal situation will necessitate additional planning in the near future. Use the checklist below to identify areas where you need more information or assistance.

Tax Action Strategy Tax planning checklist

Here are some common taxpayer challenges you may want to discuss with your advisor:

- Calculating your AMT liability
- Minimizing capital gains tax
- Maximizing deductions
- Accelerating, deferring or shifting income
- Deciding to file joint or separate returns
- Saving for education expenses
- Determining retirement plan contributions
- Making the most of charitable gifts
- Reducing estate tax liability



Sketch out your plan

With your advisor's help, you can identify the strategies that seem most likely to help you save tax, the actions required to implement them, and the dates by which you need to take the steps involved. Be sure you are comfortable with your plan and understand how different strategies may affect your ability to achieve various financial goals.

In developing your plan, you and your advisor should review your tax return for the last year or two to identify areas in which you seemed to pay more tax than necessary. Ask him or her about steps you might take to reduce your liability in these areas, and look for additional ways to increase deductions and credits or otherwise lower your taxable income.

Act now

It's never too soon to think about steps you can take to minimize your taxes for this and following years. In fact, there's no better time than now. So call your advisor today to start planning — and start saving, too. ♣