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Personal Tax Plan

Prepared for:

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These give you the lowdown on reporting income and deductions: where to report them and further IRS resources.

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These highlight special opportunities to cut your tax. They may be clever ways to use tax laws to your advantages, or bright financial choices that also bring tax relief.

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These warn you of potential traps. They may be aggressive positions, IRS red flags, or financial mistakes that people make in the name of tax planning.

Internet Resources

These alert you to special Internet resources: articles, explanations, financial planning tools and calculators, and selected products and services to help you implement these strategies.

Sources

Here you'll find sources and citations to verify strategies discussed in the plan

IRC = Internal Revenue Code
Regs. = Treasury Regulations
Rev. Rul. = Revenue Ruling
Rev. Proc. = Revenue Procedure
PLR = Private Letter Ruling
IR = Internal Revenue Notice
TD = Treasury Decision

"The avoidance of taxes is the only intellectual pursuit that still carries any reward."

- John Maynard Keynes

Congratulations! You've just taken a giant step towards beating the IRS. This plan gives you a personalized road map for the maximum tax savings allowed by law. But before we start with specific recommendations, let's review how this plan is organized and how you can use it to squeeze the biggest savings out of your return. You'll find five main sections:

1. **How the Tax System Works:** This section outlines how the tax system works to lay a foundation for understanding specific strategies to come.
2. **Family, Home, & Job:** This section covers day-to-day strategies for your family, your home, and your job. This section outlines tax strategies for financing college and elder care, buying and owning your home, and making the most of popular employee benefits.
3. **Your Business:** Owning your own business—a bona fide business with a legitimate profit intent—is the best tax shelter left in America. This section outlines strategies for organizing your business, deducting day-to-day expenses, buying and owning real estate and equipment, and choosing retirement and employee benefit plans.
4. **Your Investments:** Making money is hard. *Keeping* it is easier. That's because you have more control over tax-efficiency than any other aspect of your portfolio. This section outlines how to use IRAs and retirement accounts, how to buy and sell stocks, bonds, and mutual funds, and how to manage real estate for maximum after-tax return.
5. **Cashing Out:** This final section outlines strategies to defer or eliminate taxes when you sell personal, business, and investment assets. Just one of these ideas can avoid six- and seven-figure tax bills and help assure your financial legacy for generations.

Supreme Court Justice Oliver Wendell Holmes called taxes "the price we pay for civilization." But he didn't say we had to pay retail. This plan is your guide to tax discounts throughout your return. Enjoy your savings. And don't spend it all in one place!

Filing Guide

IRS Publication 17:
Your Federal Income Tax

"The hardest thing in the world to understand is the income tax."

- Albert Einstein

The bad news is, the tax code is so complicated *Albert Einstein* can't understand it. The good news is you don't have to be Einstein to cut your taxes. You just have to know how the system works for you - your job or business, your investments, and your family. This plan offers you strategies to do just that. But before we start, let's make sure we have a common understanding of how the tax system works:

1. Add taxable income from all sources to figure total income.
2. Subtract "adjustments to income" to determine "adjusted gross income" (AGI).
3. Subtract standard or itemized deductions and personal exemptions to determine taxable income.
4. Consult table of tax brackets to figure your tax.
5. Subtract any available credits to figure your final bill.

That's really most of what you need to know. The real issue isn't the numbers. It's what you have to include in your income, what you get to deduct from that income, and where you invest to avoid reporting income at all. Having said that, there are three main strategies for cutting your tax:

1. **Earn as much nontaxable income as possible.** You have more control over business and investment income than any other income you earn. You can draw income from your business in the form of tax-deferred and tax-free benefits. And you can grow and draw income from your portfolio in all sorts of tax-advantaged ways. This system concentrates on these choices.
2. **Make the most of adjustments to income, deductions, and credits.** Adjustments to income and deductions save by cutting your taxable income. Tax credits save by cutting your actual tax. There's no magic to using them, other than knowing what you can deduct. This plan helps you exploit more of these opportunities.
3. **Shift income to other taxpayers and other tax years.** Shifting income from today to tomorrow cuts today's tax—plus it squeezes another day's use out of today's tax dollar. And shifting income from you to a lower-bracket taxpayer, such as a retired parent or child, saves even more. Many of this plan's strategies involve these sorts of moves.

Introduction: Taxable and Non-Taxable Income

Filing Guide

IRS Publication 525:
Taxable and Nontaxable Income

It all starts with taxable income. This includes most of what you'd expect the IRS to be interested in:

- Earned income from wages, salaries, commissions, and tips
- Profits from business and self-employment
- Interest and dividends
- Capital gains from the sale of property held for investment
- IRA and qualified plan withdrawals
- Annuity proceeds
- Rents and royalties
- Alimony
- Gambling winnings
- Barter proceeds
- Illegal income (remember who nailed Al Capone?)

But taxable income doesn't include every dime you take in. Don't pay tax on income you don't have to report!

- Gifts and inheritances
- Most employee benefits
- Most life insurance proceeds and dividends
- Municipal bond interest income
- IRA rollovers
- Property settlements at divorce
- Child-support payments
- Workers compensation proceeds
- Disability insurance proceeds (if you paid premiums yourself)
- Federal tax refunds
- State tax refunds (if you didn't previously itemize the tax)
- Most scholarships and fellowships

Introduction: Make the Most of Adjustments to Income

Filing Guide

IRS Publication 17:
Your Federal Income Tax

Deduction/Exemption Phaseouts (2008)		
Filing Status	Itemized Deductions	Personal Exemptions
Single	$159,950	$159,950
HoH	$159,950	$199,950
Joint	$159,950	$239,950
Separate	$79,975	$119,975

Adjustments to income are a group of specific deductions that cut your tax by cutting your taxable income. Depending on your income and certain other factors, they may include:

- Educator expenses
- Certain business expenses of reservists, performing artists, and fee-basis government officials
- IRA and Keogh plan contributions
- Job-related moving expenses
- One-half of your self-employment tax
- Self-employed health insurance
- Penalty on early withdrawal of savings
- Alimony you pay
- Student loan interest
- Tuition and fees
- Health Savings Account contributions

Total income minus adjustments to income equals adjusted gross income ("AGI"). This figure is important for two reasons:

1. Personal exemptions and itemized deductions phase out as AGI tops certain levels. Exemptions shrink by $1^1/_3$% for each $2,500 or fraction over the threshold. Deductions (except for medical expenses, investment interest, casualty and theft losses, and gambling losses) shrink by 2% for each dollar over the threshold, up to a maximum of 80% of your total. (These phaseouts are scheduled to disappear over five years ending in 2010.)
2. Many deductions are allowed only to the extent they exceed a certain percentage of AGI. Medical expenses are deductible only to the extent they exceed 7.5% of AGI; casualty and theft losses are deductible only to the extent they exceed $100 plus 10% of AGI; and most miscellaneous deductions are allowed only to the extent they exceed 2% of AGI.

   Example: Your AGI is $50,000 and you have $4,000 in medical expenses. 7.5% of your AGI is $3,750, so you deduct just $250 in medical expenses.

Introduction: Make the Most of Itemized Deductions

Filing Guide

Report itemized deductions on Schedule A.

IRS Publication 501:
Exemptions, Standard Deductions, and Filing Information

IRS Publication 529:
Miscellaneous Deductions

IRS Publication 600:
Optional State Sales Tax Tables

Deduction/Exemption Phaseouts (2008)		
Filing Status	Itemized Deductions	Personal Exemptions
Single	$159,950	$159,950
HoH	$159,950	$199,950
Joint	$159,950	$239,950
Separate	$79,975	$119,975

Tax Savers

If your itemized deductions are close to your standard deduction, try to "bunch" as many as you can in one year to maximize that year's savings then settle for the standard deduction the next. Candidates for bunching include:

- Medical and dental expenses
- Mortgage interest
- State and local taxes (prepay 4th quarter taxes due in January)
- Property taxes
- Charitable gifts
- Miscellaneous deductions

Tax Savers

You usually can't deduct expenses until you actually pay them. But if you charge deductible expenses to a third-party credit card (not a store card for purchases you make at that store), you can deduct the expense the year you incur the charge. This can accelerate deductions to capture tax savings now.

Itemized deductions are the classic write-offs most of us think of as "tax deductions." These include:

- Medical and dental expenses (over 7.5% of AGI)
- State and local income *or* sales taxes
- Foreign taxes
- Mortgage interest
- Casualty and theft losses (over $100 plus 10% of AGI)
- Charitable gifts
- Miscellaneous deductions over 2% of AGI (employee business expenses, safe-deposit & IRA custodial fees, investment interest and expenses, etc.)
- Miscellaneous deductions *not* subject to the 2% floor (gambling losses, unrecovered investment in pensions and annuities, estate tax paid on income in respect of a decedent)

You can claim the standard deduction or your itemized total, whichever is more. Standard deductions are high enough that just one in three taxpayers itemize: $5,450 for single filers; $8,000 for heads of households; $10,900 for joint filers; and $5,450 for married couples filing separately (2008). Add $1,050 if you're 65 or older or you're blind. Add $1,350 if you're 65 or older or blind, unmarried, and not a surviving spouse.

Itemized deductions (except for medical expenses, investment interest, casualty and theft losses, and gambling losses) phase out as AGI tops $159,950 ($79,975 for separate filers). You'll lose 2 cents of deductions for every dollar over the threshold, up to 80% of your total. Reporting expenses elsewhere (such as assigning part of your tax-prep fee to your business return) can sidestep these phaseouts.

Average Itemized Deductions (2004)				
AGI	Medical	Taxes	Interest	Charity
$0 - 15,000	$7,588	$2,581	$6,926	$1,421
$15,001 - 30,000	$6,229	$2,761	$6,664	$1,969
$30,001 - 50,000	$5,324	$3,592	$6,933	$2,132
$50,001 - 100,000	$6,125	$5,808	$8,310	$2,663
$100,001 - 200,000	$9,811	$10,528	$10,949	$4,130
$200,001 +	$31,332	$38,143	$19,721	$19,014

Don't take these figures as guidelines; you still have to substantiate your own. At the same time, don't be afraid to take higher-than-average amounts. By definition, half of all taxpayers claim above-average deductions — and itemized deductions rarely trigger audits.

Introduction: Make the Most of Personal Exemptions

Filing Guide

Report itemized deductions on Schedule A.

IRS Publication 501:
Exemptions, Standard Deductions, and Filing Information

IRS Publication 504:
Divorced or Separated Parents

Deduction/Exemption Phaseouts (2008)		
Filing Status	Itemized Deductions	Personal Exemptions
Single	$159,950	$159,950
HoH	$159,950	$199,950
Joint	$159,950	$239,950
Separate	$79,975	$119,975

Tax Savers

Generally, the custodial parent gets to claim a child's personal exemption for a child following divorce. (This includes parents who never married.[6]) However, you can agree to trade the exemption back and forth or to release it entirely. To release your personal exemption for a child following divorce, complete Form 8332 and attach it to your return. The IRS requires this form (or a copy of the separation or divorce decree) even if the divorce decree specifies the non-custodial parent gets the exemption.

Tax Savers

You can generally claim an exemption for an unrelated person so long as they meet the income, support, and citizenship tests[7] - but *not* if they break local law by living with you.[8] (In some states, this includes heterosexual and same-sex partners).

Sources

[1]IRC §152.
[2]IRC §151(e).
[3]Rev. Rul. 73-156.
[4]Regs. §1.152-1(b).
[5]IRC §151(d)(3).
[6]*King v. Comm'r,* 121 TC 245 (2003).
[7]IRC §152(a)(9).
[8]IRC §152(b)(5).

Personal exemptions are deductions you get for yourself, your spouse, and each dependent. Each personal exemption cuts your taxable income by $3,500 (2008). Dependents include:

1. Your child, stepchild, grandchild, parent/stepparent, sibling/stepsibling, in-law, aunt/uncle, niece/nephew, foster child, or their blood relative,
2. Earning less than $3,500 in taxable income (not including Social Security, tax-exempt interest, etc.)(except for children under age 19 or full-time students under age 24),
3. Who gets more than half their support from you,
4. Who is a U.S. citizen, U.S. resident, or resident of Canada or Mexico, and
5. Who doesn't file a joint return with their spouse (except where each spouse's income is below the filing threshold and they file solely to claim a refund).[1]

You'll need to provide a Social Security number for each dependent you claim.[2] (In 1987, the first year the IRS required this information, hundreds of thousands of children mysteriously vanished overnight!)

Children born during the year[3] and taxpayers dying during the year qualify for full personal exemptions.[4]

Personal exemptions phase out by $1^{1}/_{3}$% for each $2,500 or fraction that your AGI exceeds certain thresholds.[5] There's really no way to beat this as there is for itemized deductions. You just have to swallow the "stealth" tax.

Introduction: Understand Tax Brackets

Filing Guide

IRS Publication 17:
[Your Federal Income Tax]

Adjusted gross income minus deductions and exemptions equals taxable income. Once you determine your taxable income, you can determine your actual tax. The tax system is designed to gather the most tax from those of us most able to pay. So the percentage of income you pay increases with your income. Tax brackets govern the amount of tax you pay on each dollar of income. Your “tax bracket” or “marginal rate” is the percentage you pay on your *last* dollar of income. The table at the bottom of the page lists tax bracket thresholds for various filers.

The Declaration of Independence says that all men are created equal. But not all income is created equal. Pay attention to these important exceptions to the general rates:

- Self-employment income from proprietorships, partnerships, and limited liability companies is taxed at 15.3% up to the Social Security wage base ($102,000 for 2008) and 2.9% on income above that base. This is on top of regular income tax and replaces Social Security for self-employed taxpayers.
- Long-term capital gains from the sale of property held more than 12 months are generally taxed at no more than 15%.
- “Qualified corporate dividends” are taxed at no more than 15%, regardless of your tax bracket.
- “Kiddie tax” is a special tax at your marginal rate on unearned income over $900 paid to children under age 19 (or full-time students under age 24).
- Alternative minimum tax is a parallel tax intended to stop “the rich” from escaping tax entirely.
- Don’t forget state and local taxes!

Tax Brackets (2008)

Tax Rate	Single	Head of Household	Married/ Joint	Married/ Separate
10%	$0	$0	$0	$0
15%	$8,026	$16,051	$16,051	$8,026
25%	$32,551	$43,651	$65,101	$32,551
28%	$78,851	$112,651	$131,451	$65,726
33%	$164,551	$182,401	$200,301	$100,151
35%	$357,701	$357,701	$357,701	$178,851

Filing Guide

IRS Publication 17:
Your Federal Income Tax

IRS Publication 514:
Foreign Tax Credit for Individuals

IRS Publication 524:
Credit for the Elderly or the Disabled

IRS Publication 596:
Earned Income Credit

IRS Publication 970:
Tax Benefits for Higher Education

Tax credits are like turbocharged tax deductions, only better. Deductions cut your taxable income. Every dollar of deduction cuts your total tax by a percentage of that deduction - and the percentage depends on your tax bracket. Credits cut your actual *tax*. Every dollar of credit cuts your *tax* by a full dollar.

Tax deductions become more valuable as your taxable income rises. If you're in the 15% bracket, every dollar you deduct cuts your tax by 15 cents. If you're in the 35% bracket, that same dollar deduction cuts your tax by 35 cents. But tax credits are more valuable for taxpayers in lower brackets. If you're in the 35% bracket, you need $2,857 in deductions to equal a $1,000 credit. In the 15% bracket, you'd need a whopping $6,667 in deductions to equal that $1,000 credit.

There's no shortage of tax credits you can use to cut that final bill. They key is simply to know what you can claim. Credits for families include:

- Adoption Tax Credit
- Child Tax Credit
- Dependent Care Tax Credit
- Earned Income Tax Credit
- Elderly and Disabled Tax Credit
- Hope Scholarship Tax Credit
- Lifetime Learning Tax Credit
- Savers Credit

Credits for investors include:

- Foreign Tax Credit
- Low-Income Housing Tax Credit
- Rehabilitation Credit

Finally, the General Business Credit includes credits for a variety of expenses, including:

- Alcohol fuels
- Disabled access
- Employer-provided child care
- Rehabilitation, energy, and reforestation investments
- Qualified research expenses
- Small employer pension plan startup costs
- Work opportunity and welfare-to-work expenses

Introduction: Avoid the Alternative Minimum Tax

Filing Guide

Figure AMT on Form 6251.

Market Segmentation Specialization Guide: *Alternative Minimum Tax for Individuals*

Tax Savers

If your regular tax is higher than the AMT rate, accelerate income into a year when you pay the AMT. You'll save up to 9% if you can shift income that would otherwise be taxed at the top bracket into an AMT year.

Sources

[1]New York Newsday, 03/10/2004.

Alternative minimum tax ("AMT") is a parallel tax designed to prevent "the rich" from using regular deductions to avoid tax entirely. In 2005, it hit 3 million taxpayers nationwide, primarily in states with high income and property taxes. (This includes IRS Commissioner Mark Everson, who announced in 2004 that he had been hit for the first time.[1]) But the tax is not indexed for inflation, and by 2010, it's expected to hit 30 million, including 94% of married filers with children making $75,000 to $100,000.

The AMT system starts with regular taxable income then adds "preference items." These include:

- Medical expenses between 7.5% and 10% of AGI
- State and local taxes deducted on Schedule A
- Home equity interest not used to buy, build, or improve your home
- Miscellaneous itemized deductions
- Investment interest figured according to special rules
- A portion of post-1986 accelerated depreciation
- Gains from incentive stock options ("ISOs")
- Interest from most "private activity" municipal bonds

Once you've determined AMT income, subtract an exemption of $66,250 (joint filers), $44,350 (single filers), or $33,125 (separate filers) (2008). These exemptions phase out by 25 cents for every dollar of AMTI above $150,000 (joint filers), $112,500 (singles), or $75,000 (separate filers). The tax itself is 26% of AMTI up to $175,000 plus 28% of AMTI above $175,000.

Here are eight ways to help avoid the AMT:

1. Don't prepay state income and property taxes in years you're subject to the AMT.
2. Avoid private activity municipal bonds.
3. Defer exercising ISOs where it makes investment sense.
4. Capitalize, rather than deduct, investment expenses
5. Schedule business equipment purchases when you can use your full depreciation deductions.
6. If your employer reimburses business expenses, make sure you have an "accountable" plan to keep them off your return.
7. Defer recognizing capital gains. These gains are taxed at the same 15% rate as for ordinary income; however, they increase taxable income subject to the AMT.
8. Consider emancipating college-age children. The AMT disallows personal exemptions, so there's no extra tax to pay by giving them up. Letting children claim those exemptions can save tax and qualify them for more generous financial aid.

Filing Guide

IRS Publication 552:
Recordkeeping for Individuals

IRS Publication 583:
Starting a Business and Keeping Records

Tax Savers

Julie Morgenstern, author of *Organizing From the Inside Out,* suggests archiving tax documents in a rotating six-year file: "Outfit a banker's box with six box-bottom file folders labeled Years 1 through 6 (rather than by the year itself to avoid having to relabel annually). Keep last year's tax records and related receipts in the Year 1 folder, the previous year's records in Year 2, and so on. At the end of each year, toss the contents of the bottom folder (Year 6), move each set of records back one folder, and put the records from the year just ended into Year 1."

Sources

[1]IRS Pub. 552, page 2 (1999).
[2]IRS Pub. 552, page 3 (1999).
[3]IRS Pub. 552, page 3 (1999).
[4]IRS Pub. 463, page 25 (2003).
[5]Reg. §1.274-5(b)(3).
[6]IRS Pub. 587, page 16 (2003).
[7]IRC §§274(d)(4); 280F.
[8]Regs. §1.274-5T(c)(1).
[9]IRS Pub. 552, page 6 (1999).

"Audit-proofing" your return means documenting deductions so that you can prove them if you're audited. Today's historically low audit rates make it pay to be aggressive. But you should file your return as if you expect to be audited. That way, if it happens, you can support your deductions and walk away a winner.

The IRS generally doesn't require records in specific forms (except for travel, entertainment, automobiles, and gifts[1]). To verify expenses, you need to show what you paid and proof that you paid it.[2] Canceled checks (front and back) and credit card slips can verify payments. If you don't have a check or card slip, you can verify payment with "highly legible" bank statements.[2]

- **Checks** must show the check number, amount, payee, and date it was posted to the account.
- **Electronic funds transfers** must show the amount transferred, the payee's name, and the date the transfer was posted to the account
- **Credit cards** must show the amount charged, the payee's name, and the transaction date.

If you're self-employed or you own a business, your real challenge is proving the business purpose of your expense. The solution is to keep detailed written records, which you can do right in your regular appointment book. This verifies deductions for car and truck expenses[4], meals and entertainment[5], home office[6] and business property use[7], and more. Keep records as close to daily as possible.[8]

Recordkeeping Guidelines[9]

IF:	THEN:
1). If you owe additional tax, and situations (2), (3), and (4), below, do not apply	3 years
2). You do not report income that you should report, and it is more than 25% of the gross income shown on your return	6 years
3). You file a fraudulent income tax return	No limit
4). You do not file a return	No limit
5). You file to amend a previous return	Later of: 3 years, or 2 yrs after tax was paid
6). You amend your return due to bad debt deduction or loss from worthless securities	7 years
7). Employment tax records for your business	4 years
8). You sell assets used for your business	The period for the year in which you dispose of the property

Filing Guide

IRS Publication 2193:
Too Good to be True Trusts

IRS Publication 4035:
Home-Based Business Tax-Avoidance Schemes

Tax Savers

Just how aggressive can you get before risking penalties? You can avoid accuracy-related penalties if you have a "reasonable" basis for taking a position (generally, more than one chance in three of being accepted by the IRS). You can file Form 8275 or 8275-R to disclose positions you believe to be contrary to law or regulations. But some advisors recommend not filing them. Why volunteer information that can attract unwanted attention?

Internet Resources

The "market segmentation specialization program" publishes audit techniques guides for over 50 specific industries from Alaskan commercial fishermen to pizza restaurants and coin-operated laundries. You'll find them online at www.irs.gov. From the home page, click "Businesses," and scroll down to the link.

Information on frauds and scams:
www.ustreas.gov/irs/ci/tax_fraud/index.htm

Sources

[1]IRS Data Book, 2006, Table 10.
[2]Rev. Ruls. 2004-27 through 2004-32.

You might fear that aggressive deductions wave flags in front of IRS auditors. But in truth, today's historically low audit rates mean that your odds of attracting attention are slim. And if you've properly documented legitimate deductions, you have little to fear.

Audits peaked in 1972 at one out of every 44 returns. For 2006, the rate has dropped to one out of every 107.[1] Roughly half focused on a single issue: the Earned Income Tax Credit claimed by roughly one in seven filers. (This explains high audit rates for incomes under $25,000.) The IRS focuses the rest of its efforts on three main targets:

1. Small businesses, particularly sole proprietors operating cash businesses, who underreport income and skim receipts. (These make up the bulk of audit targets.)
2. Individual taxpayers who fail to report pass-through income from partnerships, limited liability companies, S corporations, trusts, and estates. (In 2002, the IRS launched a program matching income from those sources to recipients.)
3. Phony trusts, churches, home-based businesses, and similar frauds and protests.[2] (These account for most tax prosecutions — and while the IRS has lost a couple of high-profile criminal prosecutions, no court has upheld any of these theories.)

The table below, taken from the 2004-2006 IRS Data Books, summarizes audit data for those years:

Filer	FY 2004	FY 2005	FY 2006
Form 1040 (by Income)			
$0 - 24,999	1.26%	1.48%	1.49%
$25,000 - 49,999	0.43%	0.60%	0.62%
$50,000 - 99,999	0.44%	0.57%	0.62%
$100,000+	1.39%	1.19%	1.29%
Schedule C (by Gross Receipts)			
$0 - 24,999	3.15%	3.68%	3.78%
$25,000 - 99,999	1.47%	2.21%	2.09%
$100,000+	1.86%	3.65%	3.90%
"C" Corp. (Form 1120)	0.71%	1.24%	1.24%
"S" Corp. (Form 1120S)	0.19%	0.30%	0.38%
Partnerships (Form 1065)	0.26%	0.33%	0.35%

Introduction: Withholding and Estimated Taxes

Filing Guide

Use Form W-4 to tell your employer how much to withhold, and Form 1040-ES to calculate and pay quarterly estimates.

IRS Publication 505:
Tax Withholding and Estimated Tax

IRS Publication 919:
How Do I Adjust My Tax Withholding?

Tax Savers

Withheld taxes are treated as paid equally throughout the year, while estimated taxes are credited when paid. If you operate your business as a corporation, you can draw income through the year in the form of loans, then convert it into income (and withhold the resulting tax) in a single lump sum at the end of the year.

Tax Savers

Most states that collect income tax impose the same deadlines as the IRS. If you want to boost your current year's itemized deductions, prepay your fourth-quarter estimate this year to claim the deduction on next year's return. If you wait until next year to pay, you'll have to wait until the following year to claim the deduction.

Internet Resources

www.irs.gov/individuals/index.html
online withholding calculator

Withholding is the dirty little secret to making today's tax system work. That's because most of us don't actually write the checks for the tax we pay. Withholding saves time, eliminates paperwork, collects taxes regularly and timely, and verifies that we report all of the wages paid to us. Here's how it works:

1. Start with your salary (or your combined salary if you and your spouse both work).
2. Estimate your adjustments to income, itemized deductions, and personal exemptions.
3. Divide that number by $3,400 to calculate the number of "exemption equivalents" you need to subtract from your salary to reach your taxable income.

You need to deposit enough by the end of the year or you'll owe interest, calculated weekly, on what you should have paid:

- If your 2007 AGI was $150,000 or less, you'll need to withhold 100% of your 2007 tax or 90% of your 2008 tax.
- If your 2007 AGI was more than $150,000, you'll need to withhold 110% of your 2007 tax or 90% of your 2008 tax.

Estimated taxes are the alternative for those with no employer to withhold throughout the year. These require you to estimate your total bill, divide it by four, and send quarterly checks to the IRS. As with withholding, you owe specific percentages by specific dates or you'll owe interest on what you should have paid. For 2008, those requirements are:

- 22½% by April 15,
- 45% by June 16,
- 67½% by September 15, and
- 90% by January 15, 2009.

Review your withholding and estimates any time your tax picture changes. Employers have to make new W-4s effective by the start of the first payroll period ending on or after the 30th day after you submit your form. Do this as soon as possible if:

- You get married or divorced
- You have a baby (or adopt)
- You or your spouse takes a new job
- You or your spouse gets a raise
- You buy or sell a house
- You sell appreciated property

Introduction: Amended Returns To Claim Lost Savings

Filing Guide

Use Form 1040-X to amend your return.
Use Form 3115 for an "Automatic Application for Change in Accounting Method."

Deadlines

Form 3115 is due within the first 180 days of the year in which you take the deduction. File the form with IRS headquarters in Washington DC and attach a copy to that year's return.

Sources

[1]Rev. Proc. 96-31.

This plan may reveal dozens of breaks you never knew you could claim. Is it too late to claim them? Not necessarily! Filing an amended return lets you correct any mistakes you make the first time around. You'll report your original totals for income, adjustments to income, deductions, and credits, plus any changes.

- You can file an amended return within three years of the original filing date (including extensions), or two years after you pay the tax, whichever is later.
- For bad debts and worthless securities, you can file up to seven years after it becomes worthless.
- If you missed depreciation deductions for your business or investment real estate, you can use submit Form 3115 to "catch up" and deduct the entire amount in a single year.[1]
- If you've moved since you filed your original return, file the amended return with the IRS service center where you currently live.
- If you amend your federal return, don't forget to amend your state return too.
- If you're married and you originally filed separately, you can amend your return to file jointly—but not vice versa.
- If you filed a joint return, then divorce, you can amend your previous joint return with respect to your income only.
- Amended returns generally aren't considered "audit bait" so long as you can support your amendments as conclusively as if you had reported them with your original return. Your amended return should be complete and thorough. Attach any schedules you would have filed to document your claim with your original return.

Filing Guide

IRS Publication 526:
Charitable Gifts

IRS Publication 1771:
Charitable Contributions - Substantiation and Disclosure

Tax Savers

You can deduct the following volunteer expenses as charitable gifts on Schedule A:

- Travel, meals, and entertainment related to volunteer and charitable activities (actual expenses or 14 cents per mile, plus parking and tolls)
- Telephone calls and office supplies
- Convention expenses
- Part of organizational dues (the organization can tell you how much)
- Uniforms and work clothes, including laundry and dry-cleaning expenses, for clothing not usable as ordinary street clothing (Girl Scout uniforms, etc.)

Tax Savers

For 2006-2007 only, you could make charitable gifts up to $100,000 directly from your regular IRA. You must be at least 70½ years old, and gifts will count towards your minimum required distributions. Congress has not renewed this provision; however, it may be renewed in the future.

Tax Savers

You can deduct charitable gifts as a business expense *if* you can show they bear a direct relationship to your business *and* you make them with a reasonable expectation of financial return commensurate with the amount paid.[1] You can offer charitable gift coupons, pay part of your income or sales to charity, or link gifts to the business you generate through the charity.

Sources

[1]Rev. Rul. 77-124.

Charitable gifts let you do well for yourself while you do well for others. There are several ways to write off charitable gifts depending on what you give and any “strings” you keep attached. Here are the rules for cash gifts:

- You can deduct up to 50% of your AGI for cash gifts to “501(c)(3) organizations” or public charities. These include churches, symphonies and museums, schools and colleges, and traditional charities like the United Way. If your gifts exceed 50% of your AGI in a single year you can carry forward the excess for up to five years.
- You can deduct up to 30% of your AGI for cash gifts to *private* foundations. If gifts exceed 30% of AGI, you can carry forward the excess for up to five years.
- Gifts by check are deductible the year you present the check, even if it isn’t cashed until the next year. This makes charitable gifts good candidates for bunching deductions.
- If your gift of $75 or more entitles you to dinner or a banquet, the organization has to disclose the value of those benefits. You don’t need to reduce your deduction for token items such as calendars and tote bags or “intangible religious benefits.”
- If you give a single gift of more than $250, you’ll need a written receipt dated no later than the filing date of your return.
- If your donation to a college entitles you to buy athletic tickets, you can deduct 80% of your gift. The right to buy tickets is valued at 20% of the gift, regardless of the amount.

Charitable Gifts

Amount	Proof
Under $250	Dated bank record or receipt.
$250 - $500	Dated bank record & receipt. Receipt must show value received (dinner, etc.).
$500 - $5,000	Dated bank record & receipt. Receipt must show value received (dinner, etc.). Gifts of any single item of property over $500 require Form 8283.
Over $5,000	Dated bank record & receipt. Gifts of property worth more than $5,000 require a written appraisal (except for publicly-traded securities, or non-public stock up to $10,000).
Payroll Withdrawal	Pay stub, W2, or other document showing total withdrawal, plus pledge card showing name of charity.

Filing Guide

IRS Publication 526:
Charitable Gifts

IRS Publication 1771:
Charitable Contributions - Substantiation and Disclosure

IRS Publication 4303:
A Donor's Guide to Car Donations

Tax Savers

A conservation easement is a gift of a partial interest in real estate to a publicly-supported charity or government. You can give your entire interest in the property other than mineral rights, a remainder interest, or a restriction granted in perpetuity on the use of the property. You'll need an appraisal to support the value of your gift - the IRS is cracking down on inflated conservation easement deductions. If your gift exceeds 50% of that year's AGI, you can carry forward the excess for up to 15 years, rather than the usual fiver year limit for all other gifts.

Land Mines

Used cars and trucks have become popular charitable gifts. But Congress and the IRS have cracked down on abusive valuations.[1] You can deduct the vehicle's FMV only if the charity uses it for exempt purposes (such as a church using a van to drive parishioners). If the charity sells the vehicle, your deduction is limited to the charity's actual proceeds. If you claim more than $500, you'll generally have to attach a certification to your return that states the vehicle was sold in an arm's-length sale and includes the gross proceeds from the sale.

Internet Resources

www.edmunds.com
www.nadaguide.com
Used-car and truck valuations

Sources

[1]IR-2003-139.

Many donors claim rich deductions for charitable gifts without ever spending a dime of cash. Don't overlook gifts of property and appreciated assets for valuable deductions:

- Gifts of clothing, furniture, electronics, and household items in good condition are deductible at fair-market value ("FMV"), such as the price they would bring at a resale shop. New rules let the IRS deny deductions for items with minimal value, like used socks and underwear. But in general, these deductions can be far more valuable than you realize. Consider buying software, available at any office-supply store, for tracking gifts and their value. You might be surprised how much you save!
- Gifts of life insurance are valued at the policy's cash value, plus any ongoing premiums you give to the charity.
- Deductions for remainder interests in your home or other property are determined according to the property's value, your age, and the current "Section 7520" rate (published monthly by the IRS).
- If you're selling your home or other property that includes a structure to be demolished after the sale, consider donating the structure to your local fire department for "target practice." You'll get a charitable deduction equal to the structure's FMV!

As with gifts of cash, if your gifts of property exceed a certain percentage of your AGI in a single year, you can carry forward the excess for up to five years. For gifts to public charities, the limit is 50% of your AGI; for private foundations, 30% of AGI.

Appreciated assets such as securities, real estate, and artwork that you've held for more than a year make ideal charitable gifts. Special considerations apply:

- You deduct the FMV of the gift. (For securities, FMV is the average of the high and low sale prices on the date of the donation. For real estate, artwork, and personal property, FMV is the appraised value. Deduct appraisal fees as a miscellaneous itemized deduction.)
- You avoid tax on capital gains you would pay if you sold the property then gave cash.
- If you give art or tangible personal property (books, furniture, etc.) your deduction depends on how the charity plans to use it. If the charity plans to use it for "exempt" purposes, such displaying donated art for students to study, deduct the FMV. If the charity sells the gift, your deduction is limited to your basis or actual cost, whichever is less.

Filing Guide

IRS Publication 936:
Home Mortgage Interest Deduction

Tax Savers

A reverse mortgage is a loan against your home's equity that lets you draw income without making repayments until your death. Reverse mortgages are available if the youngest resident is age 62 or older. The lender advances cash in a lump sum, series of payments, or line of credit for a term of years or your lifetime. At your death, the lender sells the house, collects as much of the proceeds as necessary to repay the loan, and returns any excess to your heirs. If the equity at death isn't enough to repay the loan, the lender eats the loss. Since the money comes in the form of a loan, you pay no tax on what you receive from the arrangement.

Internet Resources

www.reverse.org
reverse mortgage resources

Potential Savings

Up to $330 in income tax for every $1,000 of personal interest converted to home equity interest.

You can deduct interest you pay on up to $100,000 of loans or lines of credit secured by your primary residence and one additional residence. Using home equity debt to pay off cars, colleges, and any similar creditors converts nondeductible personal interest into deductible home equity interest.

Home equity debt doesn't have to consist of an actual second mortgage. A single mortgage can include both acquisition indebtedness and home equity indebtedness. If you refinance an existing mortgage and take out equity (cash exceeding the original loan balance), you can deduct the interest on the original balance, plus whatever you use to substantially improve your residence, as "acquisition indebtedness," and interest on up to $100,000 more as home equity indebtedness.

- Make sure you compare after-tax rates before you refinance consumer debt with home equity debt. If you can buy a car with a special interest rate, your nondeductible personal interest may still cost less than deductible home equity interest. If you can transfer a credit card balance to a new card with a low introductory rate, you could save money and avoid the paperwork needed to refinance your home.
- You can use home equity interest to deduct otherwise nondeductible student loan interest. But avoid paying off loans while the student is still in college or qualifies for the student loan interest deduction. With many loan programs, the federal government pays or waives the interest while the student is still in school. It makes no sense to pay home equity interest when none is due to begin with.
- There's no deduction for home equity debt you use to buy life insurance or annuities.
- If you pay points on a home equity loan, deduct them over the term of the loan. If you sell the house or refinance the loan with a new lender, you can deduct any remaining balance when you sell or refinance.
- Home equity interest you don't use to buy or improve your home is an adjustment for the AMT.

You can still deduct the interest you pay on home equity balances over $100,000 if you use those loan proceeds for a deductible purpose. If you use home equity debt to buy stocks, you can deduct it as investment interest; if you use it to finance your business, deduct it as a business expense. Deducting home equity interest as a business expense is especially valuable because it avoids the phaseout of itemized deductions for incomes above $159,950, avoids AMT, and lowers business income subject to self-employment tax.

Filing Guide

IRS Publication 527:
Residential Rental Property (Including Rental of Vacation Homes)

Land Mines

Many vacation homeowners donate use of their property for raffle and auctions by schools, churches, and other charities. Unfortunately, those gifts aren't deductible. What's more, days of charitable use count as personal use for purposes of qualifying your vacation home as rental property. Don't let that stop you from giving - but be aware that it might not give you the tax break you expect.

Vacation homes offer similar tax breaks as your primary residence, plus the chance to earn tax-free rent. Here's how:

- You can deduct mortgage interest you pay on up to $1 million of "acquisition indebtedness" to buy your primary residence and one extra residence. If your mortgage debt tops $1 million, you can still deduct the interest you pay on the first $1 million of acquisition indebtedness. Write off the highest-rate mortgage first to maximize your break.
- You can deduct interest you pay on a loan secured by a timeshare, yacht, or motor home so long as it includes sleeping, cooking, and toilet facilities.
- If you rent your home for 14 days or less, income is tax-free.

If you rent your vacation home for more than 14 days, your rental income is taxable, but your mortgage interest, property taxes, maintenance, utilities, and other expenses to shelter that income. There are two ways to figure deductible expenses:

1. If you use the home personally for more than the greater of 14 days or 10% of the rental days, it qualifies as residential property. (Personal use includes days your family uses the house, days you rent it for below-market rates, days you trade its use for someplace else, and time you donate as a charitable gift, but not days you use to prepare it for rental.) You'll have to report your income—but your expenses may offset it enough to avoid paying tax. To calculate the rental portion of mortgage interest and property taxes, divide the days of rental use by 365. For maintenance and utilities, divide the days of rental use by the days of total use (including rental and personal use). You can deduct rental expenses such as advertising, commissions, and travel—but not depreciation. Any losses are nondeductible personal losses.
2. If you use it personally for less than the greater of 14 days or 10% of rental days, it qualifies as rental property. To calculate the rental portion of your mortgage interest, property taxes, maintenance, and utilities, divide the days of rental use by the days of total use. (There's no separate formula for "empty days" with mortgage interest and property taxes as there is when you treat the home as residential property.) You can deduct rental expenses such as advertising, commissions, and travel. And you can deduct depreciation. If the property generates a loss, you can deduct it against outside income if you qualify for the rental real estate loss allowance or you qualify as a real estate professional.

Filing Guide

Claim the hybrid vehicle credit on Form 8910.

Tax Savers

Business taxpayers can deduct up to $1.80 per square foot for investments in “energy efficient commercial building property,” placed in service between January 1, 2006 and December 31, 2007, and designed to save at least 50% of the building’s heating, cooling, and water heating costs, and interior lighting costs. (Deductions for energy-efficient lighting systems are limited to 60 cents per square foot.)

Business taxpayers can also claim credits for installing qualified fuel cell power plants, stationary microturbine power plants, and qualifying solar energy equipment placed in service between January 1, 2006 and December 31, 2007.

Internet Resources

The American Council for an Energy Efficient Economy offers a table of actual and estimated credits for specific hybrid vehicles: www.aceee.org/transportation/hybtaxcred.htm

As oil prices climb and emerging economies in China and India compete with the U.S. for scarce energy resources, lawmakers have acted to encourage conservation and efficiency. While tax credits for energy efficiency won’t make you rich, consumers can claim credits for qualified home energy and hybrid vehicle costs.

Home Energy Efficiency

You can claim a 10% credit, up to $500, for the cost of buying qualified energy efficiency improvements you install in your main home in the United States. The credit is available for expenses you make between January 1, 2006 and December 31, 2007. However, don’t be surprised if Congress extends this break in 2008.

- Qualified expenses include insulation systems to reduce gain and loss, exterior windows and skylights, exterior doors, and metal roofs. ($200 maximum for window expenses.)
- You can claim credits for the cost of “qualified” residential energy property expenses (meeting IRS requirements). These include up to $50 for each advanced main air circulating fan, $150 for each qualified natural gas, propane, or oil furnace or hot water heater, and $300 for additional items of qualified energy efficient property.
- You can claim one credit equal to 30 percent of the qualified investment in a solar panel up to a maximum credit of $2,000, and another equivalent credit for investing in a solar water heating system. But no part of either system can be used to heat your pool or hot tub.

Hybrid Vehicles

The law offers a separate credit for new vehicles you buy (not lease) for delivery on or after January 1, 2006. Credits range from $250 to $3,400 according to a vehicle’s fuel economy and weight. Examples include $2,200 for the Lexus RX400h, $2,600 for the Toyota Highlander 2-wheel drive, and $3,150 for the Toyota Prius.

Credits for energy efficiency are dollar-for-dollar reductions in your regular tax. These are generally more valuable than a deduction from taxable income. However, the credits won’t reduce your alternative minimum tax. You can’t use them to reduce your tax below zero, and you can’t carry forward any excess to future years. And credits for hybrid vehicles, like hot-selling models on the showroom floor, are limited, phasing out for each manufacturer beginning the second calendar quarter after that manufacturer sells 60,000 vehicles qualifying for the credit.

Your Investments: Make the Most of Tax Deferral

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Sources

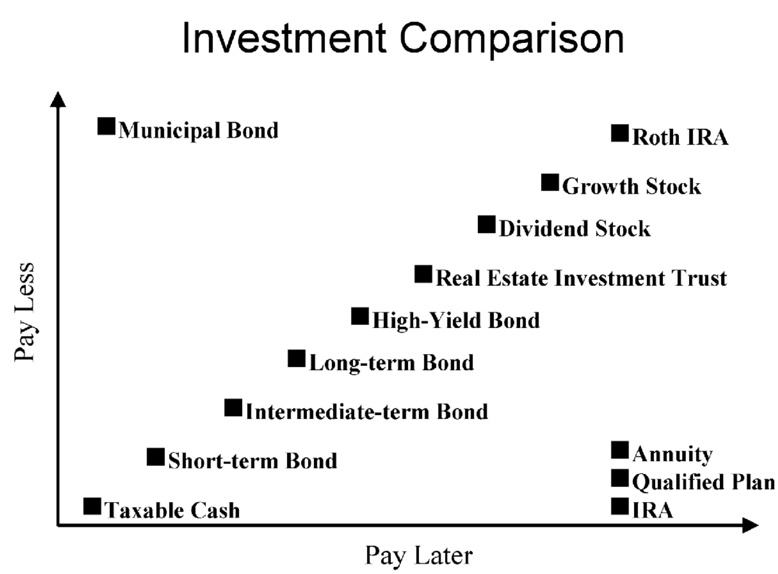
[1]Dammon, Spatt, & Zhang, "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," *The Journal of Finance,* June, 2004 (pp. 999-1037).

There are two main strategies for saving tax on investments. Tax-advantaged investments such as tax-free municipal bond interest, qualified corporate stock, and long-term capital gains, let you pay less, in the form of tax-exempt interest, qualified corporate dividends, and long-term capital gains. And tax-deferred accounts such as qualified plans, IRAs, life insurance, and annuities, let you pay later. Together, paying less and paying later are keys to tax efficiency.

Albert Einstein supposedly called tax-deferred compounding the eighth wonder of the world. And it's a cornerstone of most investors' plans. But tax-deferred accounts pose three problems:

1. All income is taxed at ordinary rates. This keeps you from profiting from lower rates on long-term capital gains.
2. There's no chance to profit from stepped-up basis at death.
3. Most withdrawals before age 59½ are subject to penalty tax.

These rules mean that tax deferral can actually backfire—especially if it converts long-term capital gains (taxed at 15% and eligible for stepped-up basis) into ordinary income. The best solution is generally to use tax-deferred accounts for your least tax-efficient holdings.[1] If you're in the 15% bracket, this generally means taxable cash and bonds in tax-deferred accounts and growth stocks in taxable accounts. If you're in the 25% bracket or above, it means stocks in tax-deferred accounts and tax-free money markets and bonds in taxable accounts.



Filing Guide

IRA custodians report withdrawals on Form 1099-R. Carry your total to Form 1040, Line 15a.

IRS Publication 590:
Individual Retirement Arrangements

Deadlines

Make your IRA contribution by the filing deadline of the return for the year for which you wish to contribute.

Tax Savers

A spousal IRA is an IRA for a nonworking spouse. Your combined income, minus your own IRA contribution, has to be enough to cover your spouse's contribution. If your spouse doesn't actively participate in a qualified plan, they can contribute $5,000 regardless of your income. If they do, they can contribute so long as your AGI is $159,000 or less. Otherwise, rules are the same as for ordinary IRAs.

Tax Savers

Nondeductible IRAs are ordinary IRAs for taxpayers who don't qualify to deduct their annual contributions. (File Form 8606 to report nondeductible contributions and withdrawals.) When you withdraw funds from the account, each withdrawal includes tax-free "basis" and taxable earnings. To figure the tax-free portion, divide the sum of all your nondeductible contributions by the sum of all your IRA account balances. Repeat the process for future years' withdrawals. This makes recordkeeping crucial to avoid paying tax on previously taxed contributions!

Land Mines

Some employers let you establish "deemed IRAs" by making deductible contributions into their qualified plan. But you're limited to the plan's investments, and you might wind up paying loads and fees on those choices you wouldn't otherwise pay yourself.

Individual retirement accounts ("IRAs") are savings accounts that let you deduct contributions (subject to certain limits) and compound earnings tax-deferred for retirement:

- You can contribute all of your earned income up to $5,000.
- If you're 50 or older, you can make "catch-up" contributions of up to $1,000 more.
- If you don't actively participate in an employer's qualified plan, you can deduct contributions regardless of your income. If you participate in a qualified plan, deductions phase out for incomes between $53,000 and $63,000 (single filers) or $75,000 and $85,000 (married filers).
- You don't have to contribute actual income. You can contribute outside savings or even borrowed money so long as your earned income qualifies you to contribute.
- You have to deposit cash. You can't transfer securities from another account, except for rollover contributions.
- You can hold almost any investment in an IRA: cash, stocks, bonds, and mutual funds; LLC and partnership interests; residential and commercial real estate; mortgages and promissory notes; tax lien certificates; and more. About the only investments you can't hold are collectibles, gold coins, and certain options and futures.
- Withdrawals before age 59½ are generally taxed as ordinary income plus a 10% penalty for premature withdrawals.
- Once you reach age 59½ you can withdraw funds as ordinary income. Withdrawals are fully taxable unless your account includes after-tax contributions.
- You have to start withdrawals by April 1 of the year *after* the year you reach age 70½.
- When you die, your IRA passes directly to your designated beneficiaries (bypassing probate). If your spouse is your beneficiary, they can take over the account as their own.
- IRA account fees are deductible as investment expenses if you pay separately by check, rather than from plan assets.
- For 2006-2007 only, you could make charitable gifts up to $100,000 directly from your regular IRA. You had to be at least 70½ years old, and gifts counted towards your minimum required distributions. This rule may be extended in the future.

Filing Guide

Account custodians report withdrawals on Form 1099-R

IRS Publication 590:
Individual Retirement Arrangements

Tax Savers

Waiting until the last minute and taking two distributions in a single year raises your AGI for figuring deductions and credits, and may push you into a higher tax bracket. If this is the case, consider taking your required minimum distribution in the year in which you reach age 70½, rather than waiting until next April's required beginning date.

Tax Savers

For 2006-2007 only, you could make charitable gifts up to $100,000 directly from your regular IRA. You had to be at least 70½ years old, and gifts counted towards your minimum required distributions. Don't be surprised to see this rule extended through 2008 or beyond.

Tax Savers

If you're actively employed, participating in your employer's qualified plan, and you own no more than 5% of the employer's stock, you can defer minimum distributions until after you've retired.

Land Mines

If you miss a required distribution, you'll owe a special tax equal to 50% of the amount you should have taken. The IRS may waive this tax only if you show the shortfall was due to reasonable error and you've taken reasonable steps to remedy the shortfall.

Since IRAs and qualified plans are intended for retirement, you have to start withdrawals from regular, nondeductible, or spousal (but not Roth) IRA and qualified plans by a specified required beginning date. Here's how it works:

- Your first distribution is due by April 1 of the year *after* the year in which you reach age 70½. That distribution counts for the year you turn 70½. Your next distribution is due by December 31 of that year and is based on the same December 31 account balance, minus your first distribution.
- To calculate distributions, divide the previous year's December 31 account balance by the distribution period for your age. If you have more than one account, calculate distributions for each. However, you can take your required total from a single account.
- If your beneficiary is your spouse *and* is more than 10 years younger than you, you can withdraw funds over your true joint life expectancy as found in the table below:

Uniform Life Expectancy (Owners)

Age	Period	Age	Period	Age	Period
70	27.4	86	14.1	102	5.5
71	26.5	87	13.4	103	5.2
72	25.6	88	12.7	104	4.9
73	24.7	89	12.0	105	4.5
74	23.8	90	11.4	106	4.2
75	22.9	91	10.8	107	3.9
76	22.0	92	10.2	108	3.7
77	21.2	93	9.6	109	3.4
78	20.3	94	9.1	110	3.1
79	19.5	95	8.6	111	2.9
80	18.7	96	8.1	112	2.6
81	17.9	97	7.6	113	2.4
82	17.1	98	7.1	114	2.1
83	16.3	99	6.7	115+	1.9
84	15.5	100	6.3		
85	14.8	101	5.9		

Example: You reach age 70½ on August 1, 2006 and finish the year with $100,000 in your IRA. Your distribution period is 27.4 years. Your first withdrawal, which is due by April 1, 2007, is $3,650 (1/27.4 of your December 31, 2005 balance). Your next withdrawal, due December 31, 2007, is $3,635 (1/26.5 of $96,324). Your next withdrawal, due by December 31, 2008, is 1/25.6 of your December 31, 2007 balance.

Your Investments: Minimize Tax on Social Security Benefits

Filing Guide

IRS Publication 915:
Social Security and Equivalent Railroad Retirement Benefits

Land Mines

Loans, rents, and dividends can hold down earned income to pass the "earnings test." But the Social Security administration may request a Self-Employment/Corporate Officer Questionnaire to verify that you're actually retired. Careful!

$ Potential Savings

Up to $6,732 in income tax per year.

Social Security benefits are generally nontaxable income. However, there's a special retirement earnings test that may cut your benefits if you keep working while you receive Social Security. And benefits are taxable if your "provisional income" exceeds certain limits.

Earnings Test

If you're between age 62 and 65 and you work while you collect Social Security, you'll lose $1 of Social Security for every $2 of earned income above $13,560 (2008). In the year you reach full retirement age, you'll lose $1 for every $3 of earned income above $36,120 until the month you reach full retirement age (2008). (The penalty ends at "normal retirement age.") This applies to earned income from wages, salaries, commissions, and self-employment. If your earned income tops these thresholds, consider waiting to collect benefits.

If you own your own business, you can use several strategies to hold down earned income between ages 62 and full retirement age. You can pay yourself with loans, rents, or S corporation dividends, rather than earned income. You can create a special class of stock or LLC interest, or sell shares back to the business.

Taxable Benefits

Social Security is intended as backup retirement income along with pension plans and personal savings. Benefits are nontaxable *unless* your "provisional income" exceeds certain limits. (Provisional income includes regular taxable income, tax-exempt interest income, and 50% of Social Security benefits.) You owe tax on 50% of your benefits if your provisional income exceeds $25,000 ($32,000 for joint filers). You owe tax on 85% of your benefits if your provisional income exceeds $34,000 ($44,000 for joint filers).

This rule can be a real blow to your income and artificially spike your tax bracket. One dollar of Social Security can add $1.85 to your taxable income. Consider investments that don't increase provisional income:

- Permanent life insurance lets you draw tax-free income from loans and withdrawals.
- Immediate annuities to offer partially tax-free income equal to your "exclusion ratio."
- Fixed and variable annuities accumulate income without generating taxable interest, dividends, or capital gains.

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Cash and cash equivalents such as CDs, savings accounts, and money-market funds, are core parts of most asset allocations, as anchors to limit portfolio volatility and safe harbors from choppy markets. But cash is the least tax-efficient investment. Bank interest and money market dividends are taxable as ordinary income immediately as earned, and there's scant opportunity to profit from lower capital-gain rates. Fortunately, there are tax-advantaged alternatives to traditional banks and money markets. Your choices turn mostly on what you're doing with your interest income—spending it or saving it.

If you're spending your interest income as you earn it:

- Treasury money market funds invest solely in Treasury securities. These are free from state income tax.
- T-bills (Treasury bills issued at a discount and maturing in less than 12 months) aren't taxable until maturity.
- Tax-free money market funds buy short-term municipal bonds. These are free from federal income tax. They may also be fully or partially free from state income tax, depending on whether you buy a national fund or a single state fund.
- Immediate annuities pay partly in the form of tax-free return of principal.

If you're accumulating interest as part of a growth portfolio:

- Fixed annuities and variable annuity fixed accounts work like a tax-deferred CD.
- A variable annuity money market fund is a money market fund in a tax-deferred wrapper. High contract charges may erase the advantage of tax deferral. But low-load or no-load contracts offer tax deferral with lower charges.
- IRAs and qualified plans offer money market options.

It may seem like a waste of tax deferral to hold cash in tax-deferred accounts. But the key is to shelter your *least* efficient investments. If taxable money market funds make more sense than tax-free funds, then a retirement account may be the place to hold your cash. There's no problem exiting cash investments because there's no capital gain when you sell. Just find a tax-deferred alternative and transfer your assets.

Filing Guide

IRS Publication 550:
[Investment Income and Expenses]

Tax Savers

If you pay a "premium" above a bond's face value or call value to buy a municipal bond, include it in your basis for figuring gain or loss on sale or redemption.

Tax Savers

Capital gains and losses on municipal bond sales are taxable. This makes bonds and bond funds suitable for tax swaps. If your bond's value falls, you can swap it for another to realize a capital loss. You can increase your income, improve your credit quality, and change your bond's maturity, all at the same time. To claim a loss, you'll need to change at least two out of three features: maturity, issuer, and coupon.

Municipal bonds are issued by cities, counties, and agencies, including universities, water and sewer districts, and municipally-backed private activities such as stadiums and aquariums. The 2003 tax act makes municipals less attractive relative to taxable bonds or corporate stock. But municipals are still the cornerstone of most high-income investors' bond portfolios:

- Municipal bond interest is free from federal income tax.
- Most municipals are free from state tax in their home state.
- Puerto Rico municipal bonds and bond funds are free from state tax in any state. These may be appropriate if your home state taxes in-state bonds.
- Municipal bond interest income isn't included in AGI. This makes them even more valuable if your high AGI phases out exemptions, deductions, and credits.
- Interest income from "private activity" bonds sold after August 1, 1987 to finance stadiums and similar projects is subject to Alternative Minimum Tax.
- Municipal bond interest is included in "provisional income" for purposes of calculating tax on Social Security benefits.

Since municipal bond interest is tax-free, issuers can pay lower rates. The key rate is "taxable equivalent yield" - the pre-tax rate you'd have to earn with a taxable bond to equal the municipal's tax-free yield. The table below illustrates taxable equivalent yields for selected interest rates. However, state and local taxes also affect your taxable equivalent yield:

Taxable Equivalent Yields

Tax Rate	4%	5%	6%	7%	8%
15%	4.71%	5.88%	7.06%	8.24%	9.41%
25%	5.33%	6.66%	8.00%	9.23%	10.66%
28%	5.55%	6.94%	8.33%	9.72%	11.11%
33%	5.97%	7.46%	8.95%	10.45%	11.94%
35%	6.15%	7.69%	9.23%	10.77%	12.31%

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Tax Savers

If you hold stocks in a separate account or fee-based account with a single fee for an unlimited number of trades, there's no specific commission to assign to each transaction. Deduct fees as investment expenses, up to net investment earnings, subject to the 2% floor on miscellaneous itemized deductions. Alternatively, you can capitalize the fee and add it to your basis in the portfolio.

Land Mines

If you hold stock in a margin account and your broker lends your stock for short sales, you'll receive "payments in lieu of dividends" rather than true dividends. These payments don't qualify for the new lower rates, so you may want to avoid holding dividend-paying stock in margin accounts.

Preferred and common stocks generate two kinds of income: dividends, taxed at potentially preferable rates when paid; and capital gains, taxed at potentially preferential rates when you sell. Together, dividends and capital gains make up total return. Common stock generally returns more in capital gains than in dividends, so stocks are considered tax-advantaged investments. Here are the basic rules:

- Profit or loss is taxed as short-term or long-term capital gains or losses when you sell.
- Commissions you pay to buy and sell are added to your cost or deducted from your proceeds to figure adjusted cost basis and adjusted sale proceeds.

Stock dividends have traditionally been taxed as ordinary income when paid. The 2003 tax act makes dividends more valuable by capping rates on most dividends at no more than 15%. Here's how it works:

- "Qualified corporate dividends" are those paid by domestic "C" corporations and "qualified" foreign corporations out of previously-taxed earnings. (This definition excludes most dividends from real estate investment trusts ("REITs"), which pay no tax on funds from operations. It also excludes most preferred stock dividends, which issuers generally deduct as interest. Consider holding REITs and preferreds in tax-deferred accounts to shelter dividends from immediate tax.)
- Qualified corporate dividends paid from January 1, 2003 through December 31, 2009 are taxed at 5% (for dividends that would otherwise be taxed at 10% or 15%) or 15% (for dividends that would otherwise be taxed at 25% or above.) Dividends paid in 2010 will be taxed at 0% (for dividends that would otherwise be taxed up to 15%) or 15% (for dividends that would otherwise be taxed at 25% or above).
- To qualify for the lower rate, you have to hold the stock for more than 60 days out of the 120-day period starting 60 days before the "ex-dividend" date. You can hedge part of your exposure by selling covered calls, but you can't own puts on the stock.
- The new law doesn't apply to dividends you earn in tax-deferred IRAs, qualified plans, and variable life insurance and annuity subaccounts. Those dividends are taxed as ordinary income when you withdraw them from the account. This means that holding dividend-paying stocks in tax-deferred accounts converts tax-advantaged dividends into ordinary income.

Your Investments: Understand Mutual Fund Distributions

Filing Guide

Funds report dividends on Form 1099-DIV. If taxable dividends exceed $1,600, report them on Schedule B; otherwise, report them directly on Form 1040, Line 8a.

Funds report gains and losses from sales on Form 1099-B. Report sales on Schedule D, then carry the total to Form 1040, Line 13.

Some funds retain capital gains and pay tax themselves, rather than distributing them to you to pay yourself. You can claim a credit for the tax the fund pays. Funds report your share of the tax on Form 2439. Carry the amount to Form 1040, Line 54, check the box for Form 2439, and attach the form to your return.

IRS Publication 564:
Mutual Fund Distributions

Internet Resources

www.morningstar.com
mutual fund ratings and commentary

Mutual funds pay several types of distributions taxed in several different ways. Be sure you understand these differences for funds you hold in non-retirement accounts:

- "Income" dividends consist of income earned by the fund's portfolio—bond interest, stock dividends, etc. These are taxed as ordinary income whether you take them in cash or reinvest them in new shares.
  - Income from "qualified corporate dividends" are taxed at new low rates
  - Treasury income is free from state income tax
  - Municipal bond income is free from federal tax.
- "Capital gain" dividends are profits from sales of fund assets. These are generally taxed as long-term capital gains, regardless of how long you own the shares. Some qualify for even lower "five-year" rates. Like income dividends, they're taxed when distributed whether you take them in cash or reinvest them.
- "Return of capital" distributions consist of your own capital. These reduce your basis in your shares when you finally sell. If your basis reaches zero, report further distributions as capital gains.
- Some funds pay foreign tax on foreign income. You can claim a deduction or credit for foreign taxes paid on your behalf.

Keep good records to minimize tax when you sell! Funds pay dividends as often as every month to be reinvested at changing prices. A fund you hold for five years might include shares with 60 different prices. There are three methods to account for share costs, or "basis." The one you choose can make a huge difference when you sell—*and* save you from paying tax twice on reinvested dividends:

- **Average cost:** Divide the number of shares you own into your total basis in the fund (including reinvested dividends) to calculate your basis for each share you sell. You can also divide your shares into two groups (those held up to a year and those held longer than a year), to calculate separate averages for short-term and long-term gains.
- **First-in, first-out:** You're treated as selling your oldest shares first. In rising markets, these will generally be your lowest-priced shares, generating higher taxable gains.
- **Specific shares:** Designate specific shares to sell. If you've bought shares over a period of months or years at different prices, this method lets you choose which shares to sell to report the lowest gain. Reviewing your purchase records and selling the shares which carry the highest cost basis saves tax by minimizing taxable gains.

Your Investments: Tax-Efficient Funds for Taxable Portfolios

Filing Guide

IRS Publication 564:
[Mutual Fund Distributions]

Tax Savers

If you trade indexes and hold them for less than a year, rather than buying and holding for the long term, consider buying broad-based index options instead to qualify for preferential "Section 1256" treatment. Gains and losses from these contracts are taxed 60% as short-term and 40% as long-term, regardless of how long you hold them. This cuts your effective rate to no more than 23% for gains that would otherwise be taxed at 35%.

Land Mines

Some index funds, including smaller funds and "enhanced" and "leveraged" funds, don't actually buy the securities that make up their underlying index. Instead, they use options or futures to track the index or beat it by specific percentages. These generate high short-term gains, costing you much of the tax advantages of true index funds. So watch out when you index. Hold true index funds in taxable accounts. Buy proxy index funds, enhanced index funds, and leveraged funds in tax-advantaged accounts.

Internet Resources

www.indexfundsonline.com
www.exchangetradedfunds.com
www.morningstar.com
mutual fund ratings and commentary

Mutual funds you hold in taxable accounts distribute all sorts of taxable dividends—and taxes drag down total returns. Here are eight ways to choose tax-efficient funds in taxable accounts:

1. Consider index funds to passively track indexes such as the S&P 500 or Russell 2000. These funds avoid the frequent sales that rack up taxes with actively managed funds. That's because they sell only when they need to redeem shares or the underlying index itself changes.
2. Consider exchange-traded funds ("ETFs"), closed-end index funds that trade on an established exchange. They offer similar advantages as open-ended index funds. And they trade just like stocks, which lets you buy and sell throughout the day, use stop orders and limit orders, and short sales. (Downside: you'll pay commissions to trade ETFs, and you can't automatically reinvest shares like with open-end funds.)
3. Consider tax-managed funds, which focus on after-tax returns by avoiding turnover, harvesting tax losses, and selling specific shares to minimize taxable gains. Some also impose early-redemption fees to discourage withdrawals that might force managers to sell shares and realize gains.
4. Consider "basket portfolios" of up to 50 stocks, packaged in "baskets" of shares you own individually, rather than as a piece of a fund. Baskets let you manage taxes by timing sales, harvesting losses, and offsetting gains.
5. Look for funds with high "return after taxes." This figure, calculated by *Morningstar Mutual Funds*, reports each fund's annualized after-tax return. Morningstar calculates this figure twice, once for "return after taxes on distributions" and again for "return after taxes on distributions and sales."
6. Look for funds with low "tax cost ratios." This *Morningstar* figure represents the percentage-point reduction in an annualized return that you lose to income taxes.
7. Look for funds with low "Potential Capital Gains Exposure." This *Morningstar* figure reports what percentage of a fund's total assets represents undistributed capital appreciation. If the fund were liquidated today, this embedded capital gain would be taxable to shareholders. Embedded capital gains can be real ticking tax time bombs. In fact, some funds have deliberately distributed capital gains to existing shareholders in order to cut embedded gains to attract new shareholders!
8. Avoid funds with high turnover. This isn't a perfect measure of tax efficiency, but it's a useful indicator once you've narrowed your fund choices down to a few finalists.

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Tax Savers

Separate account fees are deductible as an investment expense, subject to the 2% floor on miscellaneous itemized deductions. (Report these fees on Schedule A.) Alternatively, you can capitalize fees and add them to your basis in your holdings to avoid the 2% floor.

Separately managed accounts ("SMAs") are mutual fund alternatives that give you the tax advantages of holding individual securities rather than a piece of a fund. Mutual funds let you choose a manager then pay cash for a piece of the fund itself. Your manager directs the fund, which owns the underlying investments. SMAs let you choose a manager, then give them cash or securities to open a separate account of your own. Your manager directs your portfolio, and you own the underlying securities yourself. This subtle difference offers important tax and investment advantages:

- SMAs let your manager invest specifically for taxable accounts. You can choose accounts that avoid turnover, match gains and losses, and sell high-basis stock first. You can direct your manager to realize gains or losses to manage your tax liability. Most mutual funds, in contrast, accept both taxable and tax-deferred money and manage solely for pre-tax returns.
- SMAs can serve as "completion funds" to round out large holdings in a single company or industry. If you've retired from P&G with a big block of their stock, the last thing you need is more P&G. SMAs let you avoid P&G or the entire consumer goods sector, while exposing you to technology, finance, utilities, and other sectors.
- SMAs don't carry embedded capital gains like funds. SMAs establish separate cost bases and holding periods for each security you buy, insulating you from other shareholders.
- SMAs let you give specific securities to family or charity.
- Many SMAs will open an account with securities you already own. This saves you from liquidating holdings and paying immediate tax in order to participate.
- If your manager stinks, you can move your account to another without liquidating holdings and recognizing gains. With mutual funds, in contrast, you have to sell your shares and pay your taxes in order to move to a new fund.

There are three ways to hire SMA managers. You can find and hire them yourself; engage an independent consultant to find and monitor them; or open a "wrap account" for a bundle of services including asset allocation, investment management, performance reporting, commissions, and fees. Wrap programs can include dozens of styles and managers, and open doors you might not otherwise be able to afford. But fees generally run higher than for mutual funds. So be sure you'll realize value from your SMA before you pay those higher costs.

Your Investments: Buy and Sell Funds Efficiently

Filing Guide

IRS Publication 564:
Mutual Fund Distributions

Internet Resources

www.morningstar.com
mutual fund ratings and commentary

Here are six strategies for buying and selling funds in taxable accounts. Several are the same as for individually traded stocks. Others take advantage of funds' particular operating structure:

1. **Limit turnover.** Frequent turnover whacks your profits with each sale. And frequent trading subjects more of your gains to high ordinary-income rates, rather than favorable long-term gain rates. But don't be afraid to walk away from a loser. And consider tax swaps to convert paper losses into tax savings.
2. **Avoid "buying the dividend."** Funds accumulate capital gains throughout the year then pay them out on a designated date near the end of the year. If you buy shares just before that date, you owe tax on those gains whether you actually profit from them or not.
3. **Convert income dividends into capital gains.** This is the reverse of avoiding purchases near year-end. When a fund distributes a dividend, the price of each share falls by the dividend distribution. That dividend is taxed as ordinary income, "qualified corporate dividend," or capital gain. If you want to sell shares that generate interest income that you've held for more than a year, doing so when the shares are "fat" before that dividend effectively converts that income, taxed at ordinary rates, into capital gains, taxed at preferential rates.
4. **Beware checkwriting with short-term bond funds.** Your fund may let you redeem shares by simply writing a check. The fund then covers the check directly. It's convenient. But each time you write a check you sell shares with different holding periods and cost bases. And you can't specify which shares to sell. (The fund prospectus tells which shares will be liquidated.) Don't throw away the checkbook. Just understand the recordkeeping hassles it creates.
5. **Beware systematic withdrawals.** These plans pay specific dollar amounts monthly or quarterly. Fund managers pays accumulated income first then liquidates shares if income isn't enough to pay the entire distribution. Like checkwriting, this forces you to sell shares at different times and different prices. Confining systematic withdrawals to tax-deferred accounts avoids a lot of paperwork.
6. **Beware portfolio rebalancing.** Portfolio rebalancing plans periodically buy and sell to maintain your target asset allocation. The problem here is that rebalancing forces you to sell winners, thus recognizing gains, to generate cash to replenish laggards. Consider replenishing the lagging funds with new money, rather than from selling your winners. And consider rebalancing within tax-deferred accounts.

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Tax Savers

If you like index or exchange-traded funds, you can still use swaps for components of the index. For example, international investors can buy diversified funds tracking several countries, leaving no opportunity to harvest single-nation losses. Or they can buy a basket of single-country funds and harvest losses within that basket to boost overall after-tax returns.

Sources

[1]IRC §1091
[2]IRS Publication 550, Page 47 (2003).

Harvesting tax losses ("tax swaps") involves selling one asset at a loss then buying a similar but not "substantially identical" replacement. The swap leaves your portfolio looking the same—but lets you claim a deduction for the loss on your original asset. You can use swaps with individual stocks, bonds, and mutual funds. For example, you can swap one municipal bond for another, one computer manufacturer for another, or one growth fund for another. You can use short- and long-term losses to offset unlimited gains, and you can deduct up to $3,000 in capital losses against ordinary income ($1,500 for married couples filing separately.)

> **Example:** On January 3, you buy 100 shares of Starsky Growth Fund at $100 each. On June 30, those shares are worth $80 each. You sell to realize $2,000 in taxable loss, then reinvest the $8,000 proceeds in the Hutch Growth Fund.

Tax loss harvesting can be emotionally hard. Investors are reluctant to sell their losers because it means admitting a mistake. But recent research suggests that tax loss harvesting boosts after-tax returns significantly. This suggests that regular tax-loss harvesting should be a part of every taxable investor's plan.

If you, your spouse, or a corporation you control replaces the original investment with a substantially identical security (or a contract or option to acquire a substantially identical security) within 30 days before or after your sale, your loss is disallowed as a wash sale.[1]

- To keep your investment but still realize a loss, consider "doubling up," or buying an identical lot *more* than 31 days before selling your old lot.[2]
- It's not clear how similar two mutual funds can appear before becoming "substantially identical." It would be aggressive to swap one S&P 500 index fund for another—but not to swap an S&P 500 fund for a Russell 1000 fund.
- The IRS doesn't explicitly prohibit you from using an IRA, qualified plan, or trust to avoid the wash sale rule by selling a holding from a taxable account, replacing it in the IRA, qualified plan, or trust, then claiming the loss in the taxable account. However, the "related party" rules suggest that this would be an aggressive strategy.
- If you use separate accounts to manage your money, make sure your managers communicate. Otherwise, one manager's buys could jeopardize tax losses from another manager' sales.

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Tax Savers

If you want oil and gas investments without passive loss restrictions, you can buy a "working interest" in a well to offset losses against ordinary income.

If you're looking for tax-advantaged current income beyond municipal bonds, consider oil & gas, equipment leasing, and master limited partnership programs. These investments use partnership tax treatment and depreciation deductions to pay generous tax-advantaged incomes. As limited partnerships, they're subject to passive loss and at-risk rules intended to stamp out 1980s-style abuses. But the new breed of limited partnerships offer solid tax benefits for investors willing to dig a little deeper for income opportunities:

- **Oil and gas programs** take advantage of four specific tax breaks to profit from oil and gas resources:
  - You can deduct intangible drilling and development costs like labor, fuel, supplies, and other expenses of drilling a well. These are deductible currently even if there's no income to offset. Some programs offer enough of these to deduct your entire investment in the first year.
  - You can depreciate equipment used to extract resources.
  - You can deduct interest you pay to finance the program.
  - You can deduct a percentage of your income as a depletion allowance to reflect the economic reality that someday the well will run dry.

- **Equipment leasing programs** buy equipment such as computers, machine tools, airplanes, railroad cars, and ships, to lease to users. They then pass along the income to you, the investor, along with healthy depreciation deductions that shelter the income from tax. Accelerated depreciation rules let equipment buyers "front-load" their deductions for bigger savings their first few years of ownership. This depreciation, along with up-front costs and interest on any borrowed capital, shelters your income the first years of the lease.
- **Master limited partnerships** ("MLPs") are limited partnerships that trade on a public exchange. MLPs don't pay tax themselves. Instead, like other partnerships, they pass through income and deductions directly to investors. This lets them pay higher yields than companies subject to corporate tax. Higher yields would ordinarily mean higher personal tax. But most MLPs operate in energy industries such as pipelines and distributors that require heavy capital investment. Depreciation from that investment offsets much of that current income and reduces your basis (but not below zero) by the amount of tax-deferred distribution. This effectively converts today's income into tomorrow's capital gain.

Your Investments: Consider Low-Income Housing Tax Credits

Filing Guide

Program sponsors report tax credits on Form K-1. You'll report those figures on Form 8586.

Tax Savers

You can buy low-income housing credits from your broker or financial planner. You might also find units available for resale on a secondary exchange.

Potential Savings

Up to $8,250 in income tax per year.

Congress enacted the low-income housing tax-credit program in 1986 to stimulate private development of low-income housing, such as senior living facilities in suburbs and small towns. These programs reward you with tax credits rather than taxable income. Private developers form limited partnerships to buy or build units to operate as low-income housing for 15 years under strict federal rules. The Treasury Department pre-allocates and pre-funds 10 years of tax credits equal to nine cents for each dollar invested. Once the 15-year period expires, the manager sells the underlying real estate and returns investors' capital. Here are the rules:

- You can use low-income housing tax credits to offset tax on up to $25,000 in taxable income. If you're in the 15% bracket, you can claim up to $3,750 in credits; if you're in the 35% bracket, you can claim up to $8,750. (Multiply $25,000 by your marginal federal rate to figure your maximum credit). Excess credits are wasted; don't buy more than you need.

  Example: You're in the 25% tax bracket, so you can shelter $6,250 (25% of $25,000), and you can buy partnership interests generating a 12% credit. The most that you should invest is $52,083 (12% of $52,083 yields a $6,250 credit).

- You can't use low-income housing tax credits to reduce your tax below your alternative minimum tax.
- Tax credits partnerships interests are limited to "qualified investors." Depending on state law, you may need a net worth of $150,000, excluding your home and personal property, or a net worth and annual income of $45,000.
- Tax credits cut your rental real estate loss allowance dollar-for-dollar. For example, claiming $2,000 in low-income housing tax credits cuts your $25,000 rental real estate loss allowance to $23,000.
- Married couples filing separately can't claim the credit.
- Credits don't affect "provisional income" for taxing Social Security benefits.
- Tax credit partnerships are passive activities. Partnership distributions may generate passive income and losses to offset other passive investments—usually when the manager uses leverage to boost the tax credit for each dollar invested. (This makes low-income housing credits even more valuable if your portfolio generates passive income. Partnership losses can shelter that passive income, while the tax credits shelter ordinary income.)

Filing Guide

IRS Publication 575:
Pension and Annuity Income

Immediate annuities let you exchange a lump sum today for a specified income. Payouts can range from a period of years to a joint lifetime, with optional "period-certain" guarantees to protect your heirs if you drop dead after your first payment. When you buy an immediate annuity, the insurer uses their current credited interest rate and your life expectancy or payout term to determine your income. Annuities are sometimes underappreciated choices for income investors. As life expectancies rise and retirements lengthen, more and more investors are choosing to annuitize at least a part of their assets.

- Income from an immediate annuity is partially tax-free (except for distributions from IRAs or qualified retirement plans). That's because part of each payment consists of your own principal. To determine your "exclusion ratio," divide your investment in the contract (your cost, minus the value of any "period certain" refund) by the total payout you expect from the contract (determined according to your life expectancy). Once your original investment is paid out, your remaining payments are fully taxable.
- If you die before you recover your cost, you can deduct your unrecovered cost on your final tax return as a miscellaneous itemized deduction *not* subject to the 2% floor.
- Immediate annuities may help protect your assets if you or your spouse accepts Medicaid for nursing home costs. This generally forces you to "spend down" your assets before the state steps in to pick up the tab. Annuities may convert part of your assets into an income stream they can't take. This is a tricky area, so consult an expert before you make a move.

"Plain vanilla" annuities offer fixed payments for life. These grow less valuable over time as inflation eats away at your purchasing power. But inflation-adjusted contracts offer rising income over time. And variable immediate annuities expand options even further. These contracts pay out a fixed number of "accumulation units" whose value fluctuates with the value of the underlying investment. Some contracts let you choose multiple settlement options, such as putting 50% into a fixed payout and 50% into a variable payout. Others let you borrow from your contract or withdraw any remaining unpaid principal.

Immediate annuities have traditionally been based on published life expectancies. This made them a poor choice if you don't expect to live long enough to justify surrendering your principal. "Impaired-risk" annuities may be appropriate if your health is poor. These annuities involve underwriting to more accurately determine your true life expectancy. Shorter life expectancies, in turn, yield larger payments.

Filing Guide

Annuity providers report withdrawals on Form 1099-R. Report those amounts as "Pensions and Annuities" on Form 1040.

A fixed annuity is an insurance contract that resembles a bank CD in a tax-deferred wrapper. The insurance company guarantees a fixed interest rate for a specified time. At the end of that period, the company renews the contract for a new period at a new rate. Fixed annuities are popular choices for conservative investors who don't need current income.

Fixed annuities carry no up-front sales loads or commissions. Instead, the insurer levies a contingent deferred sales charge on withdrawals within a specified period, much like the familiar "penalty for early withdrawal" with bank CDs. Most insurers will let you withdraw 10% of the contract value or 100% of the annual earnings without penalty.

Because annuities qualify as "insurance," they offer several attractive tax benefits:

- There are no limits on contributions as there are with IRAs and qualified plans.
- Your earnings grow tax-deferred until you withdraw them from the contract.
- You can "annuitize" your account for a guaranteed income you can't outlive. This involves converting part or all of your lump sum account value into a fixed or variable payment stream, much like buying a pension benefit.
- Death benefits pass directly to your beneficiaries, avoiding probate delays and expense.

Equity index annuities ("EIAs") are a new type of contract tied to an equity index such as the S&P 500 that offer a fixed annuity's guaranteed return, plus the chance to profit from increases in the index value. The insurer might offer something like "90% of the price appreciation of the S&P 500" or "3% per year of 90% of the initial investment." While EIAs offer potentially greater gains over time, they're taxed identically to traditional fixed annuities.

Your Investments: Make the Most of Investment Expenses

Filing Guide

Report itemized deductions on Schedule A.
Report investment income on Form 4952.

IRS Publication 550:
Investment Income and Expenses

Tax Savers

Commissions you pay to buy and sell investments are included in the cost of the investment for figuring gains and losses when you sell. However, if you pay your broker or investment manager an asset management fee that includes commissions on investment trades, you can deduct the fee the year you pay. If your asset management fees, along with your other investment expenses, don't top the 2% floor on miscellaneous itemized deductions, you can capitalize those expenses and add them to your basis in your portfolio.

Land Mines

You can't deduct interest or expenses you pay to manage tax-exempt securities, simply because there's no taxable income to offset. You can't deduct costs you pay for investment seminars or the travel costs for shareholder meetings.

Sources

[1]IRC §212.
[2]Regs. §1.67-1T(a)(1(ii).
[3]Regs. §1.212-(1)(g).
[4]Rev. Rul. 84-146.
[5]Rev. Rul. 70-627.
[6]Regs. §1.212-(1)(f).
[7]IRC §163(d).
[8]IRC §163(d)(2); Rev. Rul. 95-16.
[9]IRC §163(d)(4)(a).
[10]IRC §163(d)(4)(b); IRC 1(h)(2).
[11]Regs. §1.163-8T.
[12]IRC §67(b)(1).
[13]IRC §68(c)(2).

Investment expenses you pay to generate taxable income are deductible[1] up to net investment income subject to the 2% floor on miscellaneous itemized deductions.[2] These include:

1. Asset management and investment advisory fees paid to investment managers or financial planners, legal and accounting fees relating to investments, and bookkeeping and secretarial fees relating to investments[3]
2. Books and subscriptions relating to investments
3. Computer and online costs relating to investments
4. IRA custodial fees you pay with separate funds[4]
5. Dividend reinvestment plan fees[5]
6. Safe deposit boxes for storing investment information[6]
7. Investment-related travel (mileage to and from your broker, trips to meet with investment advisors and manage investment property, etc.)
8. 50% of investment-related meals and entertainment (lunch with advisors, members of your investment club, etc.)

Investment interest you pay to buy or hold most taxable investments is deductible up to your "net investment income" (investment income minus investment expenses).[7] If investment interest exceeds net investment income, you can carry forward the excess against future investment income.[8]

- "Investment income" is gross income from property held for investment (interest and dividends, annuities, and royalties and capital gains not derived in the ordinary course of your trade or business).[9] You can elect to treat capital gains as investment income; however, you'll lose the benefit of lower tax rates on those gains.[10]
- You have to show that you use your investment debt to buy or hold taxable investments. You can't deduct investment interest you pay to finance personal expenses the way you can with home equity interest.[11]
- Investment interest isn't subject to the 2% floor on miscellaneous itemized deductions,[12] nor is it subject to the phaseout of itemized deductions for AGIs above $159,950.[13]

Filing Guide

Use Schedule D to report taxable home sale gains.

IRS Publication 523:
Selling Your Home

Tax Savers

You can use the exclusion to save tax when you sell vacation or rental property. You do so by moving into the property yourself and occupying it as your primary residence. You'll have to treat any depreciation you've taken as "unrecaptured Section 1250 gain" when you convert rental property to residential use. No further tax is due unless your final gain exceeds your $250,000 or $500,000 exclusion.

Tax Savers

If your spouse dies while you own your home jointly, their basis is "stepped up" to half of the home's fair market value on the date of their death (100% in community property states). You can exclude up to $500,000 in remaining gain if you file jointly in the year in which your spouse dies.

Tax Savers

If you're forced to sell your home at a loss, and you own your own business taxed as a partnership or corporation, consider selling the home first to the business, then to the ultimate buyer. This lets the corporation deduct closing costs to salvage at least some deduction for your loss.

Land Mines

If you sell your home to your spouse as part of your divorce, those payments don't increase the buyer's basis. If your ultimate goal is to sell the home, your best bet may be to sell to a third-party before the divorce to claim the full $500,000 exclusion.[5]

Sources

[1]IRC §121(a).
[2]IRC §121(b)(2).
[3]Regs. §1.121-3(b).
[4]IRC §1250.
[5]IRC §1041.

The Taxpayer Relief Act of 1997 made important changes when you sell your primary residence. The old law, effective for sales before May 5, 1997, let you roll unlimited gains into a new home and offered a one-time $125,000 exclusion if you sold your home after age 55. The new law lets you exclude up to $250,000 of gain ($500,000 for joint filers) every two years, with no need to roll your gains into a new home.

You can exclude up to $250,000 selling your home if:

- You own it for two of the last five years,
- You occupy it as your primary residence for two of the last five years, and
- You haven't used the exclusion within the last two years.[1]

You and your spouse can exclude up to $500,000 if:

- Either of you own it for two of the last five years
- Both of you use it as your primary residence for two of the last five years, and
- Neither of you has used the exclusion within the last two years.[2]

You can exclude a partial share of your gain (calculated by dividing the number of months you qualify by 24) without meeting the two-year minimum, if your move is due to:

- Change in employment (you, your spouse, a co-owner of the house, or any other person whose principal abode is in the home accepts a job whose location is at least 50 miles farther from the home than their previous place of employment);
- Health (a qualifying person or their relative moves to treat a disease, illness, or injury or to obtain or provide medical care for a qualified individual); or
- "Unforeseen circumstances" (including, but not limited to, involuntary conversion, natural or man-made disaster, or a qualifying individual's death, unemployment, change in employment or self-employment status, divorce, or multiple births from the same pregnancy).[3]

If your gain is more than your tax-free exclusion, report the excess as short-term or long-term gain on Schedule D. If you've taken any depreciation on the property, you'll have to treat it as "unrecaptured Section 1250 gain." This essentially means reporting it as income and paying tax on it, but capped at 25%.[4] A final point—there's no deduction allowed for selling your home at a loss.

Filing Guide

Report sales of business property on Form 4797.
Report sales of other property on Schedule D.

First, combine your short-term gains and losses for a short-term net. Then, combine your long-term gains and losses for a long-term net. Finally, combine short-term and long-term results for a single annual net gain or loss.[1]

If you show a net loss for the year, you can use $3,000 to offset ordinary income ($1,500 for separate filers) and carry forward the rest for an unlimited period.[2]

IRS Publication 550:
Investment Income and Expenses

IRS Publication 544:
Sales and Other Dispositions of Assets

Land Mines

Tax on gains from "collectibles" such as art and antiques is only capped at 20%, rather than the usual 15% for other assets.

Sources

[1]IRC §1222.
[2]IRC §1211(b).

"Capital gains" are profits you make from selling property held for business or investment. Gains from property held up to a year are classified as "short-term" gains. Gains from property held for more than a year are classified as "long-term" gains.

To calculate your gain, start with "adjusted selling price." This generally equals sale price, minus any cost of sale (commissions, etc.) Then subtract your "basis." This generally equals your purchase price, plus commissions, sales taxes, improvements, and the like. The resulting difference will be your gain.

Under current law, tax on most long-term capital gains is capped at just 15%. But one dollar of long-term gain can actually cost you more than 15 cents in tax. That's because capital gains can cause what is called the "AGI effect." Gains above certain levels will phase out breaks like itemized deductions and personal exemptions, child tax credits, Hope Scholarship and Lifetime Learning credits, and the rental real estate loss allowance. Capital gains also increase your provisional income for determining tax on Social Security benefits.

Tax on long-term capital gains is also capped at 15% under the Alternative Minimum Tax ("AMT.") However, long-term gains can increase the amount of ordinary income subject to AMT.

If you're selling depreciated assets, you may also have to "recapture" some of that depreciation and pay tax on it. Recaptured depreciation is taxed at ordinary rates, except for depreciation on real estate, which is capped at 25%.

If you're selling assets like a business, stock portfolio, or real estate, you can find yourself facing substantial taxes, even with lower long-term rates. The table below identifies strategies you can use to cut taxes on sales of those assets.

Capital Gain Strategy Summary

Strategy	Business	Stocks	Real Estate
Installment Sale	X		X
Structured Sale	X		X
ESOP	X		
Tax-Engineered Products		X	
Section 1031 Exchange			X
Charitable Trust	X	X	X

Cashing Out: "Tax-Engineered Products" for Single-Stock Gains

Filing Guide

IRS Publication 550:
Investment Income and Expenses

Tax Savers

Publicly-traded securities don't qualify for installment sale treatment. However, you can create similar savings by selling securities through a private annuity trust.

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If you collar an appreciated stock position *too* closely, you'll be treated as having sold it and taxed on your gains.[1] The Joint Committee on Taxation indicates a 15% spread between put and call strike prices passes muster.

Sources

[1]IRC §1259.

Potential Savings

Up to $150 in income tax for every $1,000 of long-term capital gain avoided.

"Tax-engineered products" let you protect your stock gains and monetize stock while deferring or eliminating taxes you'd pay to sell outright. Consider these advanced investment-banking strategies for six- and seven-figure gains:

- **Stock loan** programs use custom derivatives to let you borrow against your stock. These are similar to traditional margin loans, but generally let you borrow up to 90% of your equity (as opposed to the traditional 50% for margin loans).
- **Collars** use special put and call options to hedge your stock position so that you can borrow more against it. First, sell a "call" option requiring you to sell the stock at a certain price. Then use the proceeds from that call to buy a "put" option letting you sell if the stock falls below a certain price and protecting you from a fall in the price. The bank writing the contracts uses "over-the-counter" options, exercisable under "European" rules only at the expiration of the option. With the stock safely collared, you can borrow up to 90% of the position's value. You can choose a zero-cost collar, where the sale of the call generates just enough to buy the put. Or you can choose an income-producing collar to help pay the interest on the loan. While the collar is in place, you'll retain voting rights and keep some, but not necessarily all of your dividends. Your ultimate gain or loss at the collar's expiration depends on the stock's price at that time.
- **Variable prepaid forwards** are agreements to sell shares at a future date in exchange for a specified payment today. The investment bank writing the contract specifies a minimum "floor price" and maximum "cap price," writes options to hedge its risk, then prepays you the purchase price on the trade date. When the position expires, you'll deliver as much stock as it takes to fulfill your obligation, depending on its price at that time. If the price doubles, for example, you'll deliver just half of your shares to satisfy your obligation. Or you can renew the arrangement to defer the tax even further.
- **Swap funds** let you exchange your low-basis stock or other assets into a partnership made up of other investors. There's no tax due on the exchange, and you wind up owning shares in a more diversified portfolio consisting of all the investors' partnership contributions. (The partnership itself can sell those assets to further diversify its portfolio.) Your main concern is to make sure the fund gives you the diversification you need. If you're a dot-com millionaire, a fund full of other dot-com stocks isn't likely to give you the diversification you want and need.

Filing Guide

Estates file Form 706. Tax is generally payable in cash nine months after the date of death. However, you can use Form 4768 to obtain an extension of time to file and apply for an extension of time to pay.

IRS Publication 950:
Introduction to Estate and Gift Taxes

Tax Savers

The 2001 tax act gradually cuts estate taxes through 2009 by raising the unified credit amount, eliminates the tax entirely in 2010, then raises estate taxes back to their 2001 levels in 2011. This makes flexibility a crucial part of any estate plan:

Federal Estate Tax		
Year	Unified Credit	Top Rate
2006	$2.0 million	46%
2007	$2.0 million	45%
2008	$2.0 million	45%
2009	$3.5 million	45%
2010	Repealed	Repealed
2011	$1.0 million	55%

Tax Savers

"Qualified" family farms and businesses may be eligible for special valuation discounts of up to $820,000, and businesses up to $1,100,000. If the farm or business consists of 35% or more of the estate, tax payments can be spread out over 14 years.

Tax Savers

You can give up to the "annual exclusion" amount, per person, per year, to as many beneficiaries as you like ($12,000 for 2007). Gifts exceeding $12,000 to a single person in a single year are taxable and count against your unified credit. (Report taxable gifts on Form 709.) However, no actual tax is payable until your total lifetime taxable gifts exceed $1.0 million.

You can give more than $12,000 per person for educational expenses (tuition only) or medical expenses so long as you make the gift directly to the educational institute or healthcare provider.

$ Potential Savings

46-90% of assets above $2.0 million.

Federal income tax rates top out at 35%. This may seem high to those who missed rates as high as 90% during the Eisenhower administration. But federal estate and gift taxes start at 46% for estates of $2 million or more (2007). This makes avoiding estate tax at least as high a priority as avoiding income taxes for most affluent families. Briefly, here's how it works:

1. Add up the gross value of all assets you own (in your name or through most trusts) at your death. This includes real estate; stocks and bonds; mortgages, notes, and cash; life insurance you own or control; annuities; miscellaneous property; and any other property you enjoy a power of appointment over during your life. Accurate valuation is crucial — in 2004, the IRS audited 26.57% of estates reporting gross assets of $5.0 million or more.
2. Subtract allowable deductions. These include funeral costs; estate administration costs; mortgages and debts; bequests to charity; and bequests to your surviving spouse.
3. Add back taxable gifts made after December 31, 1976.
4. Calculate your tentative estate tax.
5. Subtract gift taxes paid on post-1976 gifts.
6. Subtract a "unified credit exemption equivalent" designed to eliminate taxes on estates below a certain amount (see table).
7. Subtract credits for state death taxes paid and federal gift taxes on pre-1977 gifts to calculate final tax.
8. There may be an additional "generation skipping" tax equal to the estate tax rate on transfers to "skip persons" (more than one generation below the decedent) exceeding $2,000,000.

If your net worth is sufficient to subject your estate to tax, consider these strategies:

- Lifetime gifts cut your taxable estate and shift future appreciation on gifted assets to your beneficiaries. In some cases, it may make sense to use up part or all of your unified credit during your lifetime.
- Locking assets inside family limited partnerships and limited liability companies can create valuation discounts and let you start gifting assets to your heirs without giving up control.
- "Credit shelter" trusts ensure that both you and your spouse take full advantage of the unified credit.
- Private annuities and private annuity trusts let you eliminate assets from your taxable estate when you sell.
- Irrevocable life insurance trusts let you exclude death benefits from your taxable estate and finance a tax-free pool to pay estate taxes. This is commonly referred to as "paying taxes with discounted dollars."

State Tax Summary: Florida

Standard Deductions
N/A
Personal Exemptions
N/A
Rates/Brackets (single filers)
No state income tax

Interest/Dividends: N/A

Capital Gains/Losses: N/A

Pension/Retirement Income:

- **Private:** N/A
- **Public:** N/A
- **Military:** N/A
- **Social Security:** N/A

Unemployment Compensation: N/A

Disability Income: N/A

Federal Taxes: N/A

Municipal Bonds: N/A

Itemized Deductions:

- **Medical:** N/A
- **Taxes:** N/A
- **Mortgage Interest:** N/A
- **Charitable Gifts:** N/A

Section 529 Plan: N/A

Other:

Land Mine

New York is notorious for high state taxes, especially for those in NYC and Yonkers. As with federal taxes, itemized deductions phase out as AGI tops certain limits ($100,000 for singles and separate filers, $150,000 for heads of households, and $200,000 for joint filers). There are also surcharges for high-income taxpayers to eliminate benefits of lower marginal tax rates.

Standard Deductions	
Single	$7,500
MS	$6,500
HH	$10,500
Joint	$14,600
Personal Exemptions	
Single/Joint	N/A
Dependents	$1,000
Rates/Brackets (single filers)	
4%	$0 - 8,000
4.5%	$8,001 - 11,000
5.25%	$11,001 - 13,000
5.9%	$13,001 - 20,000
6.85%	$20,001 - 100,000
7.25%	$100,001 - 500,000
7.7%	$500,001 +

Interest/Dividends: U.S. government obligations exempt

Capital Gains/Losses: Same as federal

Pension/Retirement Income:

- **Private:** Exclude up to $20,000 (age 59 1/2+)
- **Public:** Exempt
- **Military:** Exempt
- **Social Security:** Exempt

Unemployment Compensation: Same as federal

Disability Income: Same as federal

Federal Taxes: Nondeductible

Municipal Bonds: Taxable (except NY obligations)

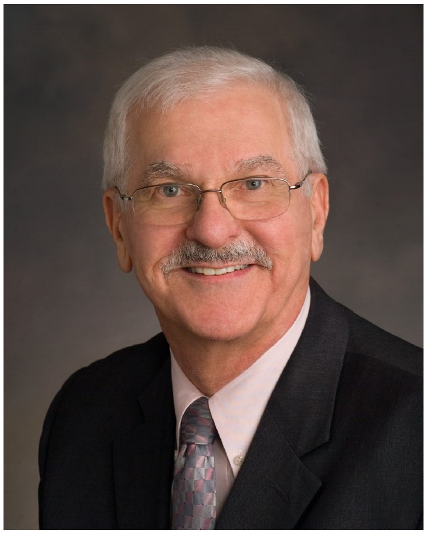
Itemized Deductions:

- **Medical:** Same as federal
- **Taxes:** State/local/foreign taxes nondeductible
- **Mortgage Interest:** Same as federal
- **Charitable Gifts:** Same as federal

Section 529 Plan: $5,000 single/$10,000 joint

Other:

About Your Tax Planner



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Don studied at California State University, Long Beach and graduated with his Bachelors of Science with a concentration in Accounting in 1977. Upon graduation, Don began working in private industry as a Controller. He then ventured into the public industry where he began working for a large accounting firm in Bakersfield. In 1982, he received his certification to practice as a public accountant. After receiving his certification, Don ventured back into the private industry as a Controller for a medium-sized construction company in the Bakersfield area. Don began his own accounting firm in 1986 while maintaining the construction company as his primary client The services Don provides range from work in the construction industry, taxes for all entities, estates, a broad range of consulting engagements, and business development services. As a C.P.A., Don has had the opportunity to work with a large variety of clients and has obtained an increased amount of experience in all areas of business. He is able to use this knowledge and experience for any business situation. Don was born and raised in Bakersfield. He servied in the US Navy and was stationed in Southern California. Don and his wife, Bev, have been married for 38 years.