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Personal Tax Plan

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Table of Contents

Page	Module

Introduction

1	How to Use This Plan
2	How the Tax System Works
3	Taxable and Non-Taxable Income
4	Make the Most of Adjustments to Income
5	Make the Most of Itemized Deductions
6	Make the Most of Personal Exemptions
7	Understand Tax Brackets
8	Make the Most of Tax Credits
9	Avoid the Alternative Minimum Tax
10	Keep Smart Records To Audit-Proof Your Return
11	Understand Audit Odds
12	Withholding and Estimated Taxes
13	Amended Returns To Claim Lost Savings

Family, Home, & Job

14	Avoid "Kiddie Tax"
15	Tax Strategies for College Savings
16	Charitable Gifts of Cash
17	Charitable Gifts of Property
18	Make the Most of Home Equity Interest
19	Tax Strategies for Energy Efficiency

Your Business

20	Strategies for Limited Liability Companies
21	Strategies for "S" Corporations
22	Strategies for "C" Corporations
23	Maximize Car and Truck Deductions
24	Buying vs. Leasing Your Vehicle
25	Make the Most of Business Meals/Entertainment
26	Make the Most of Business Gifts
27	Make the Most of Business Travel
28	Make the Most of Business Equipment
29	Separate Entities for Business Assets
30	Gift-Leasebacks for Family Tax Savings
31	Take Advantage of "Certain Fringe Benefits"
32	Hire Your Family
33	Consider Health Savings Accounts
34	Consider a Medical Expense Reimbursement Plan
35	Consider a Simplified Employee Pension (SEP)
36	Consider a 401(k) Plan
37	Consider a Defined Benefit Plan

Your Investments

38	Make Smart Use of Tax Deferral
39	Make the Most of Your IRA
40	Consider a Roth IRA
41	Tax-Smart Cash Choices

42 Fixed Annuities for Tax-Deferred Savings

Cashing Out

43 Exclude up to $500,000 in Home Sale Gains
44 Understand Capital Gains
45 Charitable Trusts for Appreciated Assets
46 Consider a Family Limited Partnership or LLC
47 Avoid Probate on Taxable Assets
48 Minimize Estate Tax

State Taxes

49 Wisconsin

Appendices

50 About Your Tax Planner

Introduction: How to Use This Plan

Filing Guide

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

Deadlines

These highlight deadlines for acting to take advantage of strategies.

Tax Savers

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.

Land Mines

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.

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

Introduction: Make the Most of Tax Credits

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.

Family, Home, and Job: Avoid "Kiddie Tax"

Filing Guide

Use Form 8814 to report your child's unearned income on your return.

Report kiddie tax on Form 8615. You can attach it to your child's return or your own.

IRS Publication 929:
Tax Rules for Children and Dependents

Land Mines

Be sure to consider the effect that shifting investments to your children will have on college financial aid. Colleges generally expect you to use 35% of your child's assets towards the family contribution, but just 6% of your own.

The "kiddie tax" is a special tax intended to stop you from shifting investment income to children, who are presumably taxed at lower rates than their parent(s). As of January 1, 2008, the tax applies to dependent children under age 19 and dependent full-time students under age 24 who report unearned income over $1,800. Here are the rules:

- If your dependent child's unearned (investment) income is under $900, no return is needed.
- If your child's unearned income is more than $900, a return is required. Unearned income from $900 to $1,800 is taxed at the child's rate.
- If your child's unearned income exceeds $1,800, the kiddie tax kicks in. (If your child itemizes deductions and has more than $900 in deductible investment expenses, the floor is $900 plus the deductible investment expenses.)
- The actual kiddie tax due is the *increase* in your total tax that results from adding the amount of your child's income subject to the tax to your *own* income.
- If you're married filing separately, use the larger separate taxable income to calculate the kiddie tax.
- If you're divorced, use the income of the parent who has custody for the greatest part of the year to calculate the tax.
- Your child's income doesn't increase your AGI for purposes of figuring limits on deductions or credits. For example, it won't keep you from contributing to a Roth IRA.
- If your child's income is $9,000 or less and derives solely from interest and dividends, you can report it on your own return using Form 8814. You'll pay your child's regular tax plus whatever kiddie tax is due. This avoids filing a separate return for your child. However, this does increase your AGI for purposes of figuring limits on deductions or credits.

The kiddie tax rules crimp your ability to cut tax by shifting investment income to your children. But you can still save tax by shifting investment income up to the kiddie tax threshold into your child's name. And the new special dividend rates narrow the difference between your tax and theirs. You can also invest your child's assets in vehicles that don't generate current income:

- U.S. Savings Bonds that mature after the child is no longer subject to the tax.
- Municipal bonds
- Education IRAs
- Section 529 plans
- Rental real estate, oil & gas, or equipment leasing programs using depreciation deductions to shelter income.

Filing Guide

IRS Publication 970:
Tax Benefits for Higher Education

Tax Savers

Section 529 plans offer estate-tax breaks in addition to income-tax breaks:

- Contributions are considered complete gifts for gift tax purposes.
- You can contribute up to $12,000 per year per student, or $24,000 jointly with your spouse (2008), with no gift tax effect.
- You can give a beneficiary up to $60,000 in a single year, or $120,000 jointly with your spouse, so long as you give no more for the next four years.
- Plan assets aren't included in your taxable estate unless you “front-load” contributions in a single year then die before the end of that period.

Tax Savers

If you lose money in a 529 plan, you can close your account and deduct the loss as a miscellaneous itemized deduction. You can transfer accounts from one plan to another, but not more than once per year.

Tax Savers

If you’re saving for college and you own permanent life insurance, you can stuff savings into your policy and take tax-free cash for college. If you later surrender the policy, any gains exceeding your total premiums are taxed as ordinary income when you surrender the policy.

Internet Resources

www.savingforcollege.com
www.collegesavings.org

Saving for college can be harder than saving for retirement. The clock starts ticking the day your child is born - and the closer college draws, the less risk you can take. Consider these tax-advantaged tools:

- **Coverdell Education Savings Accounts** (“ESAs”) let you save up to $2,000 per year per student. Earnings grow tax-deferred, and withdrawals are tax free for education costs.
- **Section 529 Plans** are state-sponsored college savings plans. Each state sets its own lifetime contribution limit, which ranges between $100,000 and $300,000+. Traditional “prepaid tuition” plans cover specific units of tuition such as a credit hour or course. Newer “college savings” plans invest contributions in mutual funds for potentially higher growth, generally adjusting portfolios from stocks to bonds and cash as your child ages. You can choose any state’s plan; however, some states offer deductions for contributions to their own plans.
- **U.S. Savings Bonds** let you defer tax on gains until you redeem the bond. Interest on Series EE Savings Bonds issued after 1989 to individuals age 24 or above may be tax-free if you use it the year you redeem the bond for “qualified educational costs” (tuition and fees minus tax-free scholarships, qualified state tuition plan benefits, and costs for which you claim the Hope Scholarship or Lifetime Learning credit). The exclusion phases out for households with “modified AGI” from $67,100-82,100 (singles and heads of households) or $100,650-130,650 (joint filers) and isn’t available for married couples filing separately.

Plan	Coverdell ESA	Section 529 Plan
Donor AGI Limit	$110,000 ($160,000 joint)	None
Contribution Limit	$2,000 per year	$115,000-315,000 lifetime (varies by state)
Federal Deduction	None	None
State Deduction	None	Some
Withdrawals	Tax-free for elementary, secondary, and college costs, including reasonable room and board. Expenses paid out of ESA accounts do not qualify for Hope Scholarship or Lifetime Learning credits. Withdrawals not used for education are taxed as ordinary income.	Tax-free for “qualified higher education expenses.” Withdrawals don’t disqualify student for Hope Scholarship or Lifetime Learning credits. Withdrawals not used for college are taxable only if they exceed contributions.
Age Limit	Use by age 30. Otherwise, pay tax on gains or roll into a family member’s ESA.	Designate new beneficiary if child chooses not to attend college.

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 $250 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

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.

Filing Guide

Single-member LLCs file Schedule C (trade or business activities) or Schedule E (rental real estate activities). LLCs taxed as partnerships file Form 1065; then pass through income and expenses on Form K1. LLCs taxed as corporations file Form 1120, 1120-A or 1120S.

Tax Savers

You can use LLC losses up to your "basis" in the business to offset outside income from salaries, investments, and other businesses. Basis includes cash and stock you contribute to the corporation, loans you make to the corporation, and loans you personally guarantee for the company. This makes LLCs appropriate for businesses you plan to finance yourself and which you expect to lose money at first.

Tax Savers

"Proposed" regulations treating LLC members as general partners have no binding force. This lets you treat some of your LLC income as if paid by a limited partnership, attributable to "capital," and not subject to self-employment tax. The key to making this work is to justify and document the portion of your return from the business that derives from your investment in the business rather than the services you perform. If you're married and your spouse is not active in the business, you might consider placing part of the business in his or her name to bypass self-employment tax.

Sources

[1]Regs. §301.7701-3(b)(1).
[2]IRC §1402(a).
[3]Prop. Regs. §1.1402(a)-2.

Potential Savings

Up to $29 for every $1,000 no longer subject to employment tax, plus $279 in income and employment tax for every $1,000 shifted to lower-bracket taxpayers.

Limited liability companies ("LLCs") are associations of one or more members operating the business themselves or through appointed managers. Your liability for business obligations is limited to your investment in the business. LLCs offer the limited liability of a corporation and flexibility to allocate income and losses of a partnership, without the ownership limits of an S corporation or double taxation of a C corporation. This versatility is making the LLC the entity of choice for most new businesses.

- Single-member LLCs are disregarded for federal and most state taxes, unless you elect to be taxed as a corporation.[1] You'll generally file Schedule C or Schedule E:
  - Income and loss from trade or business activities is treated as self-employment income and subject to self-employment tax.[2]
  - Income and loss from rental real estate is passive income and loss. Income is subject to ordinary income but not self-employment tax. Losses can offset passive income and may be available to offset ordinary income if you qualify for the rental real estate loss allowance or as a "real estate professional."

- If you're actively involved in managing the LLC's trade or business, you're treated as a "general" partner:
  - The IRS has issued proposed regulations treating income from trade or business activities as ordinary income, subject to income and self-employment tax.[3]
  - Income and losses from rental real estate activities is "passive" income and loss. Income is subject to ordinary income tax, but not self-employment tax. Losses can offset passive income and may be available to offset ordinary income if you qualify for the rental real estate loss allowance or as a "real estate professional." Losses you can't currently use are "suspended" until you have passive income to offset or you dispose of the activity.

- If you work less than 500 hours per year, you're not personally liable for any LLC debt, and you play no role in managing the business, you're treated as a "limited" partner. Your income from both trade or business and real estate activities is passive income, subject to ordinary income but not self-employment tax. Losses can offset passive income, but not ordinary income. Losses you can't currently use are "suspended" until you have passive income to offset or you dispose of the passive activity.

Filing Guide

S corporations file Form 1120S then report pass-through income and deductions to shareholders on Schedule K-1.

IRS Publication 542: Corporations

Tax Savers

You can use S corporation losses, up to your "basis" in the business, to offset outside income from salaries, investments, and other businesses. Basis includes cash and stock you contribute to the corporation and loans you make to the corporation, but *not* loans you personally guarantee for the corporation. If you finance a startup that you expect to lose money at first, consider using an LLC to boost your deductible losses.

Land Mines

S corporations limit qualified plan and IRA contributions based on a percentage of your income.[6] Consider SIMPLE IRA, 401(k), or defined benefit plans for contributions not strictly limited to a percentage of salary income.

Land Mines

Some states impose special taxes on S corporation pass-through income. For example, California imposes an $800 franchise fee plus a 1½% tax. Be sure to include these taxes in your planning.

Sources

[1]IRC §1362(a).
[2]Rev. Rul. 59-221.
[3]IRC §3101(a); IRC §3121(d)(1).
[4]*Radtke v. Comm'r,* 895 F.2d 1196 (7th Cir. 1996).
[5]IRC §6651.
[6]*Durando v. U.S.,* 70 F.3d 548 (9th Cir. 1995).
[7]IRS Data Book, 2006

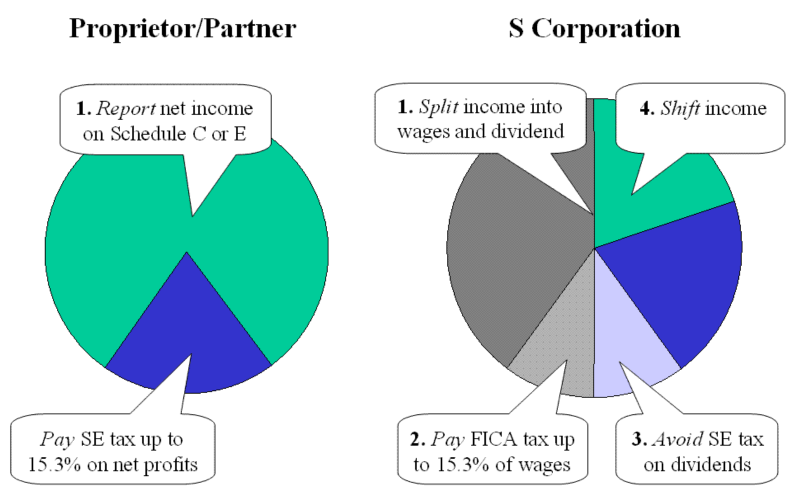
Potential Savings

Up to $29 for every $1,000 no longer subject to employment tax, plus $279 in income and employment tax for every $1,000 shifted to lower-bracket taxpayers.

"S" corporations are corporations that elect not to pay tax themselves, but to pass income and expenses directly through to shareholders. S corporations can have up to 100 shareholders, all of whom must be individuals (no nonresident aliens), estates, or certain trusts. S corporations can have just one class of shares; however, they can own taxable or "qualified subchapter S" subsidiaries.[1] S corporations offer these advantages:

- **Avoid Self-Employment Tax.** Shareholder-employees draw salaries, reported on Form W-2 and subject to FICA tax. Corporate profits are passed through to their personal returns on Form K1, taxed as ordinary income, but not subject to FICA or self-employment tax.[2] (For 2008, this is 15.3% of W-2 compensation or net self-employment income up to $102,000 plus 2.9% above that.[3]) You still have to pay yourself a reasonable salary.[4] Otherwise, the IRS can recharacterize your dividend as wages and impose employment tax.[5] "Reasonable compensation" varies from industry to industry, so be sure you can justify the salary you choose.
- **Shift Income.** You can use an S corporation to shift income to lower-bracket shareholders. You can give shares in the corporation to children or other lower-bracket beneficiaries so that their share of profits is taxed at their lower rate.
- **Avoid Audits.** S corporations can cut audit risk substantially. For FY 2006, the IRS audited 3.78% of Schedule Cs reporting incomes up to $25,000, 2.09% of Schedule Cs reporting incomes from $25,000 to $99,999, and 3.90% of Schedule Cs reporting income of $100,000 or more — but just 0.38% of all S corporations.[7]

Self-Employment vs. S Corporation



Your Business: Strategies for "C" Corporations

Filing Guide

C corporations file Form 1120 or 1120-A. Report dividends to shareholders on Form 1099-DIV, and include them on Schedule B. Report "PS 58" costs for insurance benefits in Box 12 of Form W-2.

IRS Publication 542: Corporations

Corporate Tax Rates (2008)	
Taxable Income	Rate
0 - $50,000	15%
$50,001 - 75,000	25%
$75,001 - 100,000	34%
$100,001 - 355,000	39%
$335,001 - 10,000,000	34%
$10,000,001 - 15,000,000	35%
$15,000,001 - 18,333,333	38%
$18,333,334+	35%

Land Mines

Personal service corporations ("PSCs") are those whose principal activity involves personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting *and* substantially all of whose stock is owned by employees, retirees, their estates or heirs. These are taxed at a flat 35% to stop professionals from sheltering income inside the corporation.

Land Mines

Personal holding companies ("PHCs") are closely held C corps earning 60% or more of their income from passive sources like interest, dividends, rents, and royalties. PHCs pay a special 15% tax on retained PHC income to stop shareholders from using them as personal tax shelters.

Sources

[1]IRC §11(b).
[2]Regs. §1.162-7(b).
[3]PLRs 8027088; 9741035.
[4]IRC §7872(c)(3)(A).
[5]Regs. §1.7872-5T.
[6]IRC §7872(a)(1).
[7]Regs. §1.414(c)(4)(b)(5)(ii).

"C" corporations pay tax on their income at corporate rates.[1] They can retain after-tax profits or pay them to shareholders as dividends. Dividends are taxed again as personal income at preferential rates up to 15%. This "double taxation" is more bark than bite if you "zero out" profits by paying them as salary or bonus. This avoids corporate tax as long as your salary is "reasonable compensation" for the services you provide.[2]

C corporations have none of the ownership limitations that apply to S corporations. And C corporations offer you the widest range of deductible benefits. In fact, many businesses include C corporations in their entity structure specifically to pay benefits.

- If your personal tax rate is 28% or more, you can keep up to $50,000 in profit to be taxed at 15%, then distribute the remaining after-tax net as a "qualified corporate dividend" to be taxed at 15%. This yields an effective tax of just 27.75%.
- If your corporation pays for your life insurance (other than group term coverage up to $50,000), the corporation pays tax on the premium and you pay tax on the value of the coverage (valued at the "PS 58" rates used to value group term life or the insurer's annual renewable term rate, whichever is less). Those combined taxes may be less than you'd pay for insurance personally with after-tax dollars.
- Your corporation can deduct employee disability insurance premiums; however, benefits are then taxable. If you pay premiums yourself (and forego the deduction) benefits are tax-free. This sounds like a hard choice—but the IRS has ruled that you can deduct premiums until the year in which you become disabled, then forego that year's deduction and take benefits tax-free.[3]
- You can borrow up to $10,000 tax-free from the corporation[4] so long as you show a business purpose other than avoiding tax.[5] If you borrow more than $10,000, you need to pay interest at least equal to the applicable federal rate ("AFR") or pay tax on the difference between your rate and the AFR.[6]
- If you own up to 50% of a partnership, LLC, or corporation, you'd like to deduct benefits for yourself, but you can't afford to include rank-and-file employees, consider establishing a C corporation to deduct benefits for yourself without including parent entity employees. (If you own more than 50% of the parent, your corporation is part of a "controlled group" and you'll have to offer equal benefits for both businesses.) (Your spouse can establish or use a separate business to offer deductible benefits, so long as they don't own an interest in your parent entity or serve as director, fiduciary, or employee of that entity.[7])

Filing Guide

IRS Publication 463:
Travel, Entertainment, Gift, and Car Expenses

Tax Savers

You can deduct costs to plaster your name and logo on your car or truck. But this won't convert personal/commuting miles into business miles.[5]

Tax Savers

The IRS approves four methods to track business miles. All of them require "adequate records or other sufficient evidence" to support business use. This means logging mileage at least weekly[6] and keeping receipts for all expenses over $75.[7]

1. **"Brute Force."** Record every business mile for the year. Divide by the year's total miles to calculate BUP. (If you use more than one car for business, this is the method you have to use.[8])
2. **"90 days."** Record business miles for a "typical" 90-day period. Calculate BUP for that period, and use it for the entire year.[9]
3. **"First Week."** Record business miles for the first week of each month. Calculate BUP and use it for the entire year.[10]
4. **"Simplified."** Record starting and ending mileage for a 90-day period. Record personal and commuting miles for that period, and assume all the rest are for business. Calculate BUP and use it for the entire year.[11]

Vehicle Actual Costs (2008)			
	Miles/Yr, ¢/mile		
Vehicle	10K	15K	20K
Small Sedan	55.1	42.1	35.7
Med. Sedan	71.9	55.2	46.9
Large Sedan	85.8	65.1	54.8
4WD SUV	91.0	69.7	59.1
Minivan	74.9	57.6	49.1

Sources

[1]Rev. Rul. 94-47.
[2]IRS Pub. 17, page 193 (2003).
[3]IR 2005-138.
[4]Rev. Proc. 2002-61.
[5]IRS Pub. 17, page 193 (2003).
[6]IRC §280F(d)(5).
[7]Regs. §1.274-5T(c)(3)(ii)(A).
[8]Regs. §1.274-5T(c)(3)(ii)(B).
[9]Regs. §1.274-5T(c)(3)(ii).
[10]Regs. §1.274-5T(c)(3)(ii).
[11]*Frankel v. Comm'r*, 27 TCM 817 (1968).

Potential Savings

Up to $279 in income and employment tax for every $1,000 in extra car & truck deductions.

Car and truck expenses for trips on behalf of your trade or business are a deductible business expense.

Your first step involves calculating your Business Use Percentage ("BUP;" see sidebar) for your vehicle. The IRS divides mileage into three categories: 1) business; 2) commuting; and 3) personal. Ordinary commuting and personal trips are nondeductible. Trips from home to your first business stop and trips from your last business stop to home are personal. (Daily trips to the bank, post office, and similar stops where you perform no service don't qualify.)

Travel between temporary business stops is deductible. So, for example, if you leave home, make six business stops, meet a prospect for dinner, then drive home, your mileage between your first stop and the restaurant is deductible. However, if you have a regular business stop (one that you make at least 8 to 10 times in a six-month period) that you expect to last less than a year, you can count those as business miles, too.[1] If home is your principal place of business, then all business trips are deductible.[2]

Once you've calculated your BUP, you have two ways to calculate your deduction:

1. The mileage allowance is 58.5 cents/mile (July-December 2008) *plus* parking, tolls, and your BUP of interest on your car loan and state and local personal property tax on the vehicle.[3]
2. With "actual expenses," deduct your BUP of all expenses:
   - Depreciation and interest (purchased vehicles)
   - Lease payments (leased vehicles)
   - Insurance
   - Gasoline, oil, and car washes
   - Tires, maintenance, repairs
   - Licenses, tags, and personal property tax
   - Parking and tolls

Don't assume that easier recordkeeping justifies settling for the "one size fits all" allowance. It's the same for every vehicle, no matter how big or expensive. And the wrong choice can cost you thousands. The American Automobile Association estimates that 2008 actual costs per mile exceed the IRS flat rate in almost all categories of vehicles and driving habits, at a gasoline cost of $2.941/gallon (see table).

If you own rather than lease your car, you can switch from the allowance to actual expenses. You'll have to use straight-line, rather than accelerated depreciation. You can't go the other direction, switching from actual expenses to the allowance, if you've claimed any first-year expensing or accelerated depreciation.[4]

Filing Guide

Deduct car and truck expenses on Schedule C, Form 1065, or Form 1120.

Use Form 4562 to report depreciation and first-year expensing.

IRS Publication 463:
Travel, Entertainment, Gift, and Car Expenses

Tax Savers

Trucks and truck-based SUVs with gross vehicle weight ratings of more than 6,000 pounds aren't subject to the depreciation limits that apply to passenger cars. Code Section 179 lets you deduct up to $25,000 of the purchase price for those types of vehicles in the first year.[5]

- You can use first-year expensing for a vehicle you buy as late as December 31.
- You can expense a new or used vehicle.
- BUP must be above 50%.
- If BUP later drops below 50%, you'll have to recapture the difference between your actual deduction and what you could have depreciated using the straight-line method.

First-year expensing doesn't let you deduct more than you could otherwise depreciate. You just get to deduct it faster. And you're still responsible for financing, maintaining, and insuring the vehicle. So don't buy an SUV just for the tax breaks. But don't miss the savings if it's what you really want.

Sources

[1]Rev. Proc. 2005-13.
[2]IRC §1231(a).
[3]Rev. Proc. 2005-13.
[4]IRS Pub. 463, page 23 (2005).
[5]IRC §179.

Choosing whether to buy or lease your vehicle is a common dilemma. Buying — especially full-size trucks, vans, or SUVs weighing over 6,000 pounds — yields bigger up-front deductions, and possible gain or loss when you sell. Leasing yields steadier deductions as you go along. Most authorities agree that leasing costs more — but gets you more car for the money in the short run.

If you *buy* your vehicle, you'll depreciate it over five or more years. Your actual deduction depends on your business use percentage ("BUP").[1]

- If BUP is more than 50%, use "accelerated" depreciation: 20% in Year 1 (or 5% if you buy after September 30), 32% in Year 2, 19.2% in Year 3, 11.52% in Years 4 and 5, and 5.76% in Year 6.
- If BUP is 50% or less or you're subject to the Alternative Minimum Tax, use straight-line depreciation: 10% in Year 1, 20% in Years 2-5, and 10% in Year 6.
- Special dollar limits cap deductions for passenger vehicles with gross vehicle weights under 6,000 pounds. Those limits are $3,060 in Year 1; $4,900 in Year 2; $2,850 in Year 3; and $1,775 thereafter. For 2008 only, you can claim up to $8,000 in "bonus depreciation" for qualifying new (not used) passenger cars.
- Your actual deduction equals your BUP times the annual percentage limit — but not more than the annual dollar limit.
- Selling your vehicle may produce a taxable gain or loss. Start with your basis when you place the vehicle in service (actual cost if placed in service new, or fair market value if used). Subtract any depreciation taken to calculate your adjusted basis, then subtract your sale price to calculate gain or loss. If your sale price is *more* than your adjusted basis, you'll "recapture" any gain attributable to business use. This is ordinary income, but not subject to self-employment tax.[2] If your sale price is *less* than your adjusted basis, you can deduct any loss attributable to business use.
- If selling the vehicle outright will result in a taxable gain, you can trade it in instead, treat is as a 1031 exchange, and roll the gain into the replacement vehicle.

If you *lease* your vehicle, you'll deduct the BUP of your lease payment — along with these twists:

- If the vehicle's value when you place it in service tops $15,500 ($16,400 for trucks and vans), you'll add back a small "exclusion" amount intended to limit your deduction to what you could have depreciated had you *bought* the vehicle.[3]
- If you make advanced rent or capitalized cost reduction payments, you can deduct them over the course of the lease.[4]

Filing Guide

IRS Publication 463:
Travel, Entertainment, Gift, and Car Expenses

Tax Savers

You can deduct 100% of your expenses for meals and entertainment for sales seminars and similar events where the meal is integral to the presentation.[7] You can also deduct 100% of the cost of sporting events you organize to benefit charity[8] and recreation expenses for employees.[9]

Tax Savers

You can't deduct membership dues for private nonbusiness clubs. But you can deduct the costs of meals you host there.

Tax Savers

You can deduct the cost of meals that you furnish employees (and yourself, unless you're taxed as a proprietor) for the convenience of the business and not for compensation. These include meals you furnish on-premises to let employees stay available for emergency calls, meals you furnish during short lunch periods (up to 45 minutes), meals you furnish where there aren't adequate eating places near the workplace, and any meals you furnish to over 50% of employees.[10] You can also deduct off-premises meals you provide as part of required business meetings.[11]

Sources

[1]Regs. §1.274(c)(7).
[2]Regs. §1.274-5(b)(3).
[3]Rev. Rul. 95-96.
[4]Regs. §1.274-2(d)(4).
[5]IRC §274.
[6]IRS Pub. 463, page 25 (2003).
[7]*Matlock v. Comm'r,* TC Memo 1992-324.
[8]IRC §274(l).
[9]IRC §274(n)(2).
[10]IRC §119; Regs. §1.119-1.
[11]*Mabley v. Comm'r,* TC Memo 1965-323.

Potential Savings

Up to $279 in income and employment tax for every $1,000 in additional deductible meals and entertainment.

Meals and entertainment you host in the course of your business are deductible if they're directly related to the active conduct of your business or they take place directly before or after substantial, bona fide discussion directly related to the active conduct of your business. You can deduct 50% of most meals. Specific deductions include meals, drinks, taxes and tips.

- Surroundings must be conducive to business discussion.[1]
- To prove your deductions, you'll need a diary, day planner, or similar log to record your business appointments. Record the information listed in the table below.[2]
- You'll need receipts for expenses *over* $75.[3] Credit card statements work *if* you corroborate them by recording the business purpose of the expense in your business diary.
- You can't deduct meals with your spouse unless you're traveling together for business. However, you can include the cost of a spouse or other "closely connected" person (such as children or parents) if your guest brings *their* spouse.[4]
- You can deduct costs for small gatherings at your home. If you invite more than 12 guests, you can deduct "reasonable" costs if your primary purpose is business. Include employees; let guests know your business purpose; discuss and display your product or service to support your deduction.[5]
- Entertainment expenses are 50% deductible if they take place directly before or after a substantial, bona fide discussion directly related to the active conduct of your business. Deductions include the face value of tickets to sporting and theatrical events, food and beverages, parking, taxes, and tips.

Business Meals[6]

Amount	Time	Place/ Description	Purpose/ Relationship
Cost of the meal	Date of the meal	Establishment where the meal takes place	Purpose: Business purpose for the expense, or the business benefit gained or expected. Relationship: Occupations or other information (such as names, titles, designations) about your guest that show their relationship to you.

Your Business: Make the Most of Business Gifts

Filing Guide

IRS Publication 463:
Travel, Entertainment, Gift, and Car Expenses

Sources

[1]IRS Pub. 463, page 25 (2003).

Gifts you give to business associates are deductible up to $25 if you can show a business purpose for the expense or business benefit to be gained. (Married couples count as one person for this rule—you can't deduct $25 for each.) This includes family and friends if they qualify as bona fide clients, prospects, or referral sources. Gifts are nontaxable to the recipient.

- If you give gifts of entertainment or sporting tickets, you can choose to deduct up to $25 as a gift, or 50% of the cost as an entertainment expense. If tickets you give cost more than $50, you'll save more by counting them as entertainment.
- If you give a gift to a group of recipients, such as a family or an office, you can deduct $25 for each member of the group.
- Ad specialties with a value up to $4 each are deductible as advertising and don't count against the $25 per person annual limit for business gifts. Contest prizes you give to customers (but not employees) also qualify.

Business Gifts[1]

Amount	Time	Place/ Description	Purpose/ Relationship
Cost of the gift	Date of the gift	Description of the gift	Purpose: Business purpose for the gift, or the business benefit gained or expected. Relationship: Occupations or other information (such as names, titles, designations) about the recipients that show their relationship to you.

Your Business: Make the Most of Business Travel

Filing Guide

IRS Publication 463:
Travel, Entertainment, Gift, and Car Expenses

IRS Publication 1542:
Per Diem Rates

Tax Savers

Want to write off weekends? You can treat them as business days if they fall between business appointments[7] or you stay over (before or after your business) to qualify for airline "Saturday stay" discounts.[8]

Tax Savers

If you travel to find investment property, amortize the cost of the trip over the first 60 months you place the property in service. If you don't find property to buy, deduct the cost of the trip as a business loss.

Sources

[1]Rev. Rul. 54-497.
[2]Regs. §1.274-4(d)(2)(iii).
[3]Rev. Rul. 63-145.
[4]IRC §274(m)(3).
[5]Regs. §1.274-(c)(2)(iii).
[6]IRS Pub. 463, page 25 (2003).
[7]Regs. §1.274-4(d)(2)(v).
[8]PLR 9237014.

Travel costs are deductible for trips you take on behalf of your trade or business:

- You're "traveling" when you're away overnight or long enough to need sleep.[1]
- "Business days" are those you spend traveling to business destinations, days where you spend the majority of working hours on your trade or business (four hours and one minute), and days where your personal presence is required at a particular place for a specific and bona fide business purpose.[2]
- "Business day" costs include 50% of meals and entertainment plus 100% of lodging, local transportation, incidentals, and your first load of laundry and dry cleaning back home.[3]
- If your spouse is a bona fide employee, traveling for a bona fide business purpose, you can deduct their costs.[4]
- Save receipts for all lodging and for any expense over $75.[5]
- Transportation costs include cars, planes, trains, and boats:

Deducting Transportation Costs[6]

INSIDE the United States		
TRIP LENGTH	BUSINESS %	DEDUCT:
Less than 1 week	More than 50%	100% of transportation costs
"	50% or less	No transportation costs
1 week or more	More than 75%	100% of transportation costs
"	75% or less	Business % of transportation costs
OUTSIDE the United States		
TRIP LENGTH	BUSINESS %	DEDUCT:
Less than 1 week	75% or more	100% of transportation costs
"	Less than 75%	Business % of transportation costs
1 week or more	Any	Business % of transportation costs

Your Business: Make the Most of Business Equipment

Filing Guide

Claim depreciation and first-year expensing on Form 4562, then carry the total to the appropriate business form or schedule. Report gains and losses on sales on Form 4797.

IRS Publication 946:
How to Depreciate Property

IRS Publication 544:
Sales and Other Dispositions of Property

Tax Savers

The Economic Stimulus Act of 2008 offers a special 50% "bonus depreciation" deduction for most property purchased and placed in service in 2008. This temporary bonus, along with the temporarily high first-year expensing limit, make 2008 a great year for business equipment purchases.

Tax Savers

If you've missed depreciation deductions or calculated them incorrectly, you can use Form 3115 to depreciate them retroactively to the date you placed them in service.

Land Mines

First-year expensing is a powerful strategy for accelerating deductions. But, if your BUP for a given asset later falls below 50%, you'll owe tax on the difference between the amount you expense and the amount you would have been able to depreciate under straight-line rules. And you'll likely report more gain on a sale than if you had chosen regular depreciation.

When you buy capital equipment for your business, you can depreciate it over a period of time intended to approximate its useful life. You can also use first-year expensing to deduct some purchases immediately rather than depreciating them over time. Your deduction turns on the property's asset class and business use percentage ("BUP").

- Asset class tells you how fast to depreciate purchases. Computers, for example, are "5-year" property, deductible over five years. The IRS publishes pages of depreciation schedules for different asset classes.
- BUP tells you how much of your purchase to depreciate each year. If BUP tops 50%, you'll generally qualify for "accelerated" depreciation, which lets you deduct your purchase faster. If BUP is 50% or less, or you're subject to the AMT, you'll generally use straight-line depreciation.

First-year expensing lets you deduct the full cost of some items the year you buy, rather than depreciating them over time:

- You can expense up to $250,000 of "tangible personal property," new or used (other than certain automobiles) (2008). This limit is unusually high in 2008 (due to the Economic Stimulus Act of 2008). It falls to $128,000 (plus an inflation adjustment) for 2009, and falls again to $25,000 for property placed in service January 1, 2011 or later.
- You can expense property you buy as late as December 31.
- Your BUP must be more than 50% to qualify for expensing.
- Your first-year expensing deduction for an activity can't exceed your taxable net income from the activity. However, you can carry forward unused deductions to future years.
- The deduction phases out by one dollar for each dollar of business income above $800,000 (2008).

When you sell property you've depreciated or expensed, your basis is your original cost, minus depreciation, expensing, and any costs of selling. Gains are recaptured as ordinary income; losses are deductible in the year of sale.

> **Example:** On May 1, 2008, you pay $2,000 for a computer (5-year property) to use 100% for business and deduct the full $2,000. If you later sell the computer for $1,000, you'll owe tax on your "recaptured" $1,000 gain.

Tax Savers

Establishing a separate entity to own business assets can be even more valuable if you operate as a "C" corporation. That's because any gains on assets you dispose of are taxed twice, first at the corporate level and second at your personal level. It makes no sense to "zero out" those gains by taking them as salary or bonus because it converts them from capital gains, taxed at preferential rates, to ordinary income.

If your business involves real estate or capital equipment, consider establishing a separate entity or entities to own the property, then lease it to the business. This offers several tax and asset protection advantages. The biggest may be shifting income from the business to the leasing entity. This lets you draw income in the form of tax-advantaged rent (sheltered by depreciation), rather than compensation or profits taxable as ordinary income. Here's how it works:

1. You pay $400,000 for an office condominium, individually or in an LLC, to house your business. You put $40,000 down and finance the remaining $360,000 for 30 years at 7%. Your monthly payment is $2,395 per month.
2. Your business leases the property for $3,250 per month under a "triple-net" lease with the business assuming all operating expenses, including utilities, insurance, and property taxes.
3. At the end of the year, your real estate activities show income of $39,000. $28,426 is deductible as interest, leaving just $10,574 of net income. Depreciation offsets most or all of this, leaving you with little or no taxable income.

Leasing business assets offers these additional advantages:

- You can sell or gift interests in the property without diluting your ownership or control of the business. For example, you can transfer the real estate into a family limited partnership and make gifts of partnership interests to reduce your taxable estate without giving interests in the actual business.
- You may qualify to title the entity in your spouse's name to establish employee benefit programs such as retirement plans or medical expense reimbursement plans you might not wish to establish for your primary business. (This may not work if your spouse is active in your primary business.)
- You can refinance business assets to tap equity and draw income in the form of nontaxable loans.
- You protect business assets by segregating them in different entities, making it harder for creditors of one to reach assets held in another.

Filing Guide

Report rental income from personal property on Form 1040 (line 21, Other Income). Report rental income and expenses from real property on Schedule E. Lease income isn't subject to self-employment tax so long as you're not in the business of renting property.[5]

Report gifts over $12,000 (including "split" spousal gifts between $12,001 and $24,000) on Form 709.

Sources

[1]IRC §2512.
[2]IRC §2513.
[3]*Lerner v. Comm'r,* 71 TC 290; *Rosenfeld v. Comm'r,* 706 F.2d 1277 (2d Cir. 1983).
[4]*Logan Lumber Co. v. Comm'r,* 365 F.2d 846 (5th Cir. 1966).
[5]IRC §1402(a).

Potential Savings

Up to $250 in income tax for every $1,000 in lease income created.

Gift-leasebacks (and sale-leasebacks) let you transfer income from yourself to lower-bracket taxpayers such as your children. You, the donor, give or sell business property to the taxpayers you wish to shift income to or to an irrevocable trust for their benefit (if they are under age 18). Then, lease it back from the recipient. This strategy essentially lets you give depreciated property to your kids, and deduct it again.

Your gift is valued at its fair market value as of the date of the gift.[1] If you give more than $12,000 in a single year to a single donor, you'll need to file a gift tax return; however, no actual tax is payable until your lifetime taxable gifts exceed $1 million. You and your spouse can jointly give $12,000 to $24,000 by consenting in writing to "split" the gift.[2]

Once you've made appropriate gifts, follow these rules to qualify for deductions:[3]

- You can't retain substantially the same control over the property you transfer. If you give property to a trust, you can avoid this issue by appointing an independent trustee.
- The lease should be in writing and specify timely payment of reasonable rent. Have the property appraised before transfer and maintain the payment schedule you specify. (You might consider a "net lease" that requires you to pay, and thus deduct, maintenance, repairs, and the like.)
- You'll need to pay commercially reasonable rent.[4]
- You can't retain any disqualifying equity in the property after the lease—preferably, not even a reversionary interest in property gifted in trust.

The gift-leaseback has been especially useful for children age 18 or above in college or grad school:

> **Example:** You own a fully depreciated SUV you use 100% for business. The truck's fair market value is $20,000. You and your spouse give it to your college-age daughter, and lease it back for $400 per month. Your arrangement creates $4,800 in new deductions, and eliminates any self-employment tax you would otherwise have paid on that income.

But be aware that, beginning January 1, 2008, the "kiddie tax" applies to dependents under age 19, and full-time students under age 24, thus greatly limiting this strategy.

Your Business: Take Advantage of "Certain Fringe Benefits"

Filing Guide

Deduct fringe benefits as "employee benefits" on theappropriate business form or schedule.

IRS Publication 15-B:
Employer's Tax Guide to Fringe Benefits

Sources

[1]IRC §274(j).
[2]IRC §132(j)(4).
[3]IRC §132(m).
[4]IRC §132(e).

$ Potential Savings

Up to $279 in income and employment tax for every $1,000 in qualifying deductible benefits.

Code Section 132 lets you deduct "certain fringe benefits" you provide your employees—including yourself or your spouse if you qualify:

- You can pay employees a "length of service" award of up to $400 in property (not cash) as often as every five years.[1]
- You can deduct the cost of a gym or athletic facility located on your premises, operated by you, and substantially all the use of which is by your employees, their spouses, and their dependents. Facilities include your swimming pool, tennis court, and fitness equipment.[2] Depreciate personal property and land improvements such as pools, and deduct operating expenses such as chemicals and cleaning.
- If you offer a retirement plan (including a SIMPLE IRA or SEP) you can deduct "qualified retirement planning services" you provide employees and their spouses. Services aren't limited solely to your employer plan, but don't include related services like tax prep, accounting, or legal services.[3]

You can also deduct a range of "de miminis" fringe benefits. These are property and services (not cash) that the IRS doesn't tax because their value is "so small as to make accounting for it unreasonable or administratively impractical." The generally accepted threshold for these items is $25.[4]

- Occasional meals or "supper money" and transportation (car service, etc.) to let employees work late.
- Occasional cocktail parties, group meals, or picnics for employees and guests.
- Traditional birthday or holiday gifts of property (not cash) with a low fair market value ($25 or less).
- Occasional theatre or sporting event tickets.
- Coffee, juice, and doughnuts you provide for employees at the office.
- Flowers, fruits, books, or similar property you provide to employees under special occasions, such as illness, outstanding performance, or family crisis.

These may be mere rounding errors for the Microsofts of the world. But they can really add up! Most months have at least one holiday. And, while you can't write off season tickets as a block, those trips to the ballet or local amusement park can add up.

Filing Guide

Pay your family employee's wages the same as you would pay any other employee on Schedule C, Form 1065, or Form 1120. They should complete Form W-4 for your records. File Form 941 (quarterly) or Form 944 (annually) to report employment taxes, Form 940 annually for unemployment taxes, plus any applicable state or local employment taxes. If you pay $600 or more, prepare a Form W-2 and file it, along with Form W-3, annually. (If this sounds like a hassle, introduce your child to the joys of bureaucracy by having them manage their payroll!)

IRS Publication 15:
Circular E, Employer's Tax Guide

IRS Publication 15-B:
Employer's Tax Guide to Fringe Benefits

Land Mines

Some planners suggest hiring your child under age 7 to model for your advertising. But this is untested—if you try, you'd better have a very cute kid!

Sources

[1]Rev. Rul. 73-393.
[2]IRC §1(c).
[3]*Eller v. Comm'r*, 77 TC 934.
[4]*Denman v. Comm'r*, 48 TC 439 (1967).
[5]Regs §1.162-7(a).
[6]IRC §3121(b)(3).
[7]IRC §3306(c)(5).

Potential Savings

Up to $279 in income and employment tax for every $1,000 paid to a "zero-bracket" taxpayer.

"Allowance" and other financial aid you extend to your children, grandchildren, or even parents is a deductible business expense if you pay them to perform bona fide work for your business and pay them reasonable compensation for that work.[1] Of course, at that point, it isn't allowance. It's wages. If you're hiring your kids, they might even learn not to treat you like "The First National Bank of Mom and Dad":

- Your child can earn up to the standard deduction for single taxpayers ($5,450 for 2008) before they owe tax on their income. The next $8,025 is taxed at just 10%. Earned income isn't subject to the "kiddie tax" for children under 19 (or full-time students under age 24).[2] Other family employees pay tax at their regular rate.
- The Tax Court approves wages for children as young as 7.[3]
- Your family employee's work should be directly related to your business.[4]
- Pay your employee a reasonable wage for their age and the service they perform. Their wages should be similar to amounts paid for similar services by similar businesses under similar circumstances—with adjustments made for their age and experience.
- To verify your deduction and audit-proof your return, keep a timesheet showing the dates, hours, and services performed.[5] Pay your child by check, and deposit the check in an account in the child's name. This can be a Roth IRA, Section 529 college savings plan, or custodial account. You can't use custodial assets for your obligations of parental support; however, parental support doesn't include "extras" like private or parochial school tuition, summer camps, and similar expenses.
- If your business is taxed as a proprietorship or partnership, you don't owe Social Security or Medicare taxes on your child's wages until they reach age 18.[6] You don't owe unemployment tax until they reach age 21.[7]
- Hiring family members to help work in your business also lets you establish employee benefit programs such as a medical expense reimbursement plan, education assistance plan, and retirement plans.

Your Business: Consider Health Savings Accounts

Filing Guide

Report HSA deductions and distributions on Form 8889, then carry any balance to Form 1040.

IRS Publication 969:
Medical Savings Accounts

IRS Notice 2004-2:
Guidance on Health Savings Accounts

Tax Savers

If you qualify, a Section 105 medical expense reimbursement plan offers higher, more flexible contributions than an HSA. If you qualify for both, you can still fund an HSA for supplemental retirement savings.

Internet Resources

www.hsainsider.com
HSA news and resources

Sources

[1]IR 2004-2; IR 2004-50.
[2]IR 2004-23.
[3]Rev. Rul. 2004-38.

Potential Savings

Up to $725 in income tax for single coverage and $1,450 for family coverage.

Health Savings Accounts ("HSAs") have replaced Archer Medical Savings Accounts ("MSAs"), effective January 1, 2004. The concept is simple. First, choose high-deductible health insurance to cut monthly premiums. Then establish deductible savings accounts for routine medical costs. You and your employees can establish HSAs if you meet four tests:[1]

1. You're covered by a high deductible health plan ("HDHP") with deductibles of at least $1,950 (singles) or $3,850 (families) and out-of-pocket limits up to $3,850 (singles) or $7,050 (families). The plan can't provide any benefit, other than certain preventive care benefits, until that year's deductible is satisfied.[2] You're not eligible if you're covered by a separate plan or rider offering prescription drug benefits before the minimum annual deductible is satisfied.[3]
2. You're not covered by any plan that isn't an HDHP, either individually, as a spouse, or as a dependent.
3. You're not eligible for Medicare.
4. You can't be claimed as a dependent on anyone else's return.

Eligible participants contribute under these rules:

- You can contribute up to $2,900 (singles) or $5,800 (families) per year.
- You can contribute the full annual amount as late as April 15 of the following year, so long as the plan itself is in place by December 1.
- If you or your spouse is age 55 or older, you can make extra "catch up" contributions up to $900 (2008).
- You can roll an existing MSA into a new HSA.
- You can invest your account in cash for easy access or securities for longer-term growth.
- Withdrawals for "qualified medical costs" are tax-free. These include any deductible medical expense or nonprescription drug that isn't reimbursed by insurance.
- You can use your HSA to pay for qualified long-term care premiums, COBRA continuation coverage, health insurance while you receive unemployment compensation, and Medicare premiums (but not "medigap" coverage).
- Withdrawals for any other purpose are taxed as ordinary income plus a 10% penalty.
- At your death, your account balance passes to your chosen beneficiary. If it's your spouse, proceeds are tax-free. If not, proceeds are taxed as ordinary income.

Medical expense reimbursement plans (“MERPs”) let you reimburse your employees, their spouses, and their dependents for uninsured medical costs.[1] Plan benefits are deductible by the business, and nontaxable to the employee. Here’s how they work:

- You have to establish the plan for employees. If you run your business as a proprietorship, partnership, LLC, or “S” corporation, you're considered “self-employed,” and not eligible.[2] If you’re single, you can establish a C corporation and pay benefits to yourself as an employee. If you’re married, you can hire your spouse and pay the benefits through him or her.[3] If you operate as an S corporation, you and your spouse are both considered self-employed. (In that case, segregate part of your income through a proprietorship or C corporation and pay benefits through that entity.)
- You can’t discriminate in favor of highly compensated employees.[4] However, you can use a classification test (such as “all participants in Employer’s group health plan”) to qualify participants.[5] You can also exclude those under age 25; those who regularly work less than 35 hours per week; those who work less than nine months out of the year; and those who have worked for you for less than three years.[6]
- You can’t reimburse employees for costs they incur before the plan effective date.[7]

Paying medical expenses through a MERP offers several advantages:

- You can deduct 100% of your employees’ health insurance. Deductible health insurance costs include major medical and supplemental premiums, Medicare premiums, qualified long-term care premiums, and Medicare supplemental ("Medigap") policies.
- Out-of-pocket medical costs include routine expenses such as co-pays, deductibles, and prescriptions; occasional expenses such as eyeglasses and dentistry; big-ticket items like orthodontics, fertility treatments, and schools for learning-disabled children.[8] It also includes nonprescription medicines and health-care supplies.[9] You can reimburse employees or pay health-care providers directly.[10]
- The plan lets you deduct 100% of your out-of-pocket costs, bypassing the usual 7.5% floor for itemized deductions. You’ll also avoid any self-employment tax you would otherwise pay on amounts you deduct as plan benefits.

Filing Guide

You’ll need a written plan document and summary plan description to establish the plan. No special filings are required until the plan covers 100 or more employees. Report MERP benefits as “employee benefits” on the appropriate business form or schedule.

Tax Savers

If you hire your spouse to qualify for a MERP, you can pay them in benefits only, rather than cash. This avoids managing payroll formalities and filing Form W-2. The key to making this work is to document your spouse’s bona fide employment. Consider executing a written employment contract. Track their hours, weekly or monthly, to substantiate your deduction.[11] You’ll also need to pay expenses out of the business (or show actual reimbursements to employees)[12] and show that they are “reasonable compensation” for the work your employee-spouse performs.[13]

Tax Savers

If you and your spouse are eligible for both a Section 125 plan and a MERP, consider which saves more. If your spouse buys health insurance through a Section 125 plan, they split the FICA savings with their employer. If you reimburse them through a MERP, you’ll keep all the self-employment tax savings yourself. If you’re eligible for both, consider which strategy saves more.

Sources

1 IRC §105(b).
2 IRC §105(g).
3 Rev. Rul. 71-588; PLR 9409006.
4 IRC §105(h)(2).
5 IRC §105(h)(3)(A)(ii).
6 IRC §105(h)(3)(B); Regs. §1.105-11(c)(2)(iii).
7 Rev. Rul. 2002-58.
8 IRC §105(b).
9 Rev. Rul. 2003-102.
10 IRC §105(b) (“amounts are paid, directly or indirectly.”).
11 UIL No. 162.35-02, *Speltz v. Comm'r*, TC Summary 2006-25.
12 *Snorek v. Comm'r*, TC Memo 2007-34.
13 *Francis v. Comm'r*, TC Memo 2007-33.

Potential Savings

Up to $279 in income and employment tax for every $1,000 in qualifying expenses.

Filing Guide

Complete Form 5305-SEP and file it with your records to open a SEP. If you're self-employed, deduct contributions for yourself as an adjustment to income on Form 1040 and contributions for your employees on Schedule C, Schedule E, or Form 1065. If you're incorporated, deduct contributions for yourself and your employees on the appropriate corporate form.

Deadlines

You can open and fund your SEP as late as your due date for filing the business's tax return (including extensions).

Tax Savers

If you're expecting a refund and you'd like to use it to finance your SEP contribution, you can file your return, collect the refund, and use it to fund your SEP so long as you make the deposit before your filing deadline (including extensions).

Tax Savers

If you qualify to contribute to a SEP IRA and convert a regular IRA to a Roth, you can effectively create a "Roth" SEP. Do this by making your deductible SEP contribution, then converting the account to a Roth. Your deduction and conversion offset each other, leaving you in essentially the same place as if the Roth contribution limit was the same as for the SEP.

Tax Savers

You have to use the same formula to calculate each employee's contributions. However, you can use an "integrated" plan to contribute more on behalf of higher-paid employees—presumably including yourself. Integrated plans contribute a base amount for all income, plus an "integrated" percentage of up to 5.7% more of covered comp above a certain threshold (usually the Social Security wage base — $102,000 for 2008). For example, you might contribute 10%, plus 5.7% of covered comp above $102,000.

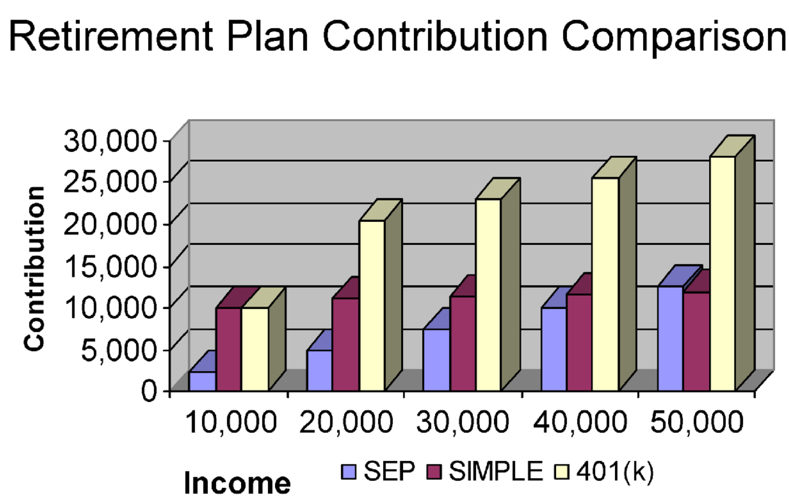
Potential Savings

Up to $250 in income tax for every $1,000 in deductible contributions.

Simplified Employee Pensions ("SEPs") are "super-IRAs" that let you contribute more than the usual $5,000 IRA limit for yourself and your employees. They resemble profit sharing plans, except you make contributions to individual IRA accounts rather than a qualified plan trust. Here are the rules:

- If you're taxed as a proprietor or partner, you can contribute up to 25% of net income up to the "covered compensation" limit ($230,000 for 2008), but not more than $46,000. "Covered comp" is net income, minus ½ of your self-employment tax and your SEP contribution itself.
- If you're incorporated, you can contribute up to 25% of your W-2 income up to the covered comp limit, but not more than $46,000.
- You can contribute up to 25% of your employees' W-2 income up to the covered comp limit, but not more than $46,000.
- You have to include all employees age 21 or older who have worked 3 of the last 5 years and earn $500 or more per year.
- There are no annual administrative or reporting requirements with SEPs as there are with true qualified plans.

A SEP may not be the best choice for owners who draw salaries or net self-employment income below $42,000. That's because contributions are limited to a percentage of your income. Consider a SIMPLE IRA or 401(k) for contributions not limited to a percentage of your income.



Figures based on maximum deferral plus a 25% contribution of W-2 income

Your Business: Consider a 401(k) Plan

Filing Guide

If your plan includes employee assets or totals more than $100,000, you'll need to file Form 5500 reporting plan contributions and assets annually.

IRS Publication 560:
Retirement Plans for Small Business

Deadlines

Adopt your 401(k) by December 31 of the calendar year for which you want to deduct contributions. Employer matching and profit-sharing contributions must be made by the due date for the business's return.

Tax Savers

You can claim a credit for the cost of establishing a new small employer pension plan. It's available for employers with less than 100 employees who have not operated a qualified retirement plan. The credit equals 50% of startup costs up to $1,000 in each of the first three years of the plan. This is part of the general business credit.

Land Mines

Plan loans are the easiest way to access your account before retirement. But loan interest isn't deductible. This means you'll repay the loan with after-tax dollars then pay tax again when you withdraw your money from the plan.

Land Mines

If your plan is "top-heavy" (more than 50% of vested account balances are held for owners and highly compensated employees), you'll have to contribute at least 3% of each employee's pay. Be sure to consider this if you expect little or no contributions from non-family employees.

Potential Savings

Up to $3,875 in income tax for deferral contributions, plus $250 for every $1,000 in deductible employer contributions.

401(k) plans are profit sharing plans that let you and your employees defer current income into the plan. You can match your employees' deferrals, make discretionary profit sharing contributions, or both. These may be your best choice if you want to let your employees fund the bulk of their own accounts:

- You can defer up to 100% of your "covered compensation" or $15,500, whichever is less. (Covered comp is wages, salary, and bonus up to $230,000.) "Highly compensated employees" (those owning more than 5% of the business or making more than $105,000) may be limited by anti-discrimination rules if employees don't contribute a sufficient percentage of income.
- You can let employees age 50 or older make extra "catch-up" contributions of up to $5,000 not limited by antidiscrimination rules.
- You can match part or all of employee deferrals and make profit sharing contributions. These are nontaxable until participants start withdrawing funds from their accounts.
- Total "annual additions" from employee deferrals (but not catch-ups), employer matches, and employer profit-sharing contributions are limited to 100% of covered compensation, but not more than $46,000.
- You can let employees take tax-free loans from their account. Most loan provisions allow loans up to $50,000 or 50% of the vested account balance, whichever is less, and repay it in substantially level installments, at least quarterly, over five years. If employees leave their job and take their account with outstanding loans, the unpaid balance is taxable unless they repay it from another source.
- You can let employees take "hardship withdrawals" of their own deferrals (but not employer contributions or earnings) for "immediate and heavy" financial needs: medical bills, a down payment on a house, college costs, or amounts needed to prevent eviction or foreclosure on their primary residence. If the plan allows loans *and* hardship withdrawals, employees have to take the maximum loan before taking a hardship withdrawal. Employees who take hardship withdrawals can't make new deferrals for 12 months.
- Plan withdrawals are taxed as ordinary income. There's a 10% penalty for withdrawals before age 59½ except for specified exceptions: death, permanent and total disability, health insurance while unemployed, amounts deductible as medical or dental expenses, college costs, early retirement at age 55 or older, or qualified domestic relations orders.
- Rollovers to another qualified plan or IRA are nontaxable.

Filing Guide

IRS Publication 560:
Retirement Plans for Small Business

Deadlines

Adopt a defined benefit plan by December 31 of the year for which you want deduct contributions.

Tax Savers

You can claim a credit for the cost of establishing a new small employer pension plan. It's available for employers with less than 100 employees who have not operated a qualified retirement plan. The credit equals 50% of startup costs up to $1,000 in each of the first three years of the plan. This is part of the general business credit.

Tax Savers

You can combine a DB plan with a defined contribution plan such as a SEP, profit-sharing plan, or 401(k) plan. Combined contribution limits are the same as for the DB plan alone. This gives you flexibility to contribute up to the DB limit without requiring annual contributions at that level.

Land Mines

The IRS has issued rules intended to stop "abusive" 412(i) plans featuring insurance contracts with artificially low "springing" cash values that let you withdraw them from the plan at temporarily depressed rates, then "spring" to full value, thus avoiding tax on the difference. If you're looking at a 412(i), make sure your contract doesn't violate the new rules.[1]

Sources

[1]Regs. §1.402(a)-1(a)(2); Rev. Ruls. 2004-20, 2004-21.

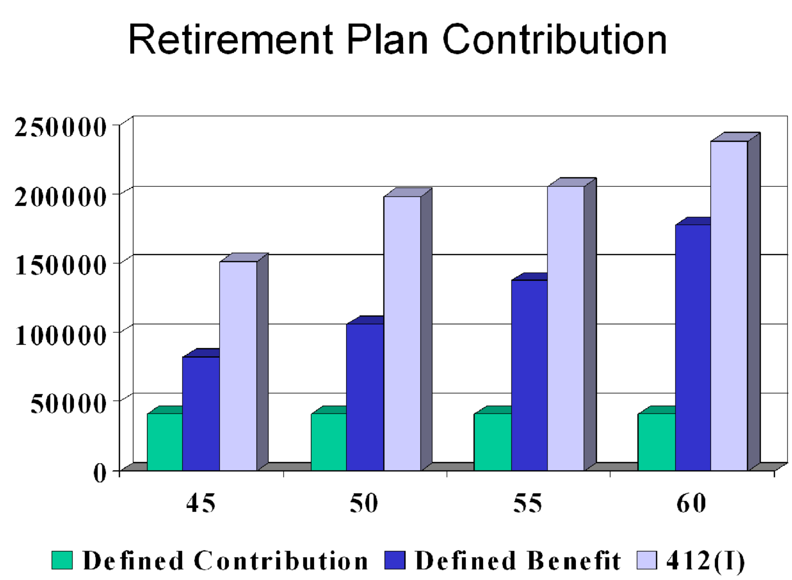
Defined benefit ("DB") plans are traditional pensions that pay a fixed income for life. These are the most expensive qualified plans to establish, administer and fund. But they also let you deduct the biggest contributions. Here's how they work:

1. Determine your desired retirement age and income—as much as 100% of your earned income up to $185,000 (2008).
2. Hire an actuary to calculate the annual contribution needed to generate a fund large enough to provide your desired benefit.
3. You can deduct as much as you need to fund your benefit.
4. Review your account balance and actuarial assumptions annually to determine your required contribution. This varies from year to year according to investment performance.
5. Annual contributions are required. This makes DB plans inappropriate if you can't commit to annual funding.

A 412(i) plan is a DB plan funded solely with life insurance, annuities, or both. These plans offer three potential advantages for older, more conservative investors:

1. The insurer calculates the premiums necessary to guarantee the benefit. This eliminates the actuary's role, making plan administration easier and cheaper.
2. The insurer guarantees benefits will be paid. This eliminates market risk and investment performance concerns.
3. Insurance and annuity contracts, with their low guaranteed rates, allow even higher deductible contributions.

The chart below illustrates just how much more you can contribute to a DB plan, according to your age and plan type. (Figures for 412(i) plans are calculated according to rules set forth in Revenue Ruling 74-123.)



Filing Guide

IRS Publication 550:
Investment Income and Expenses

Sources

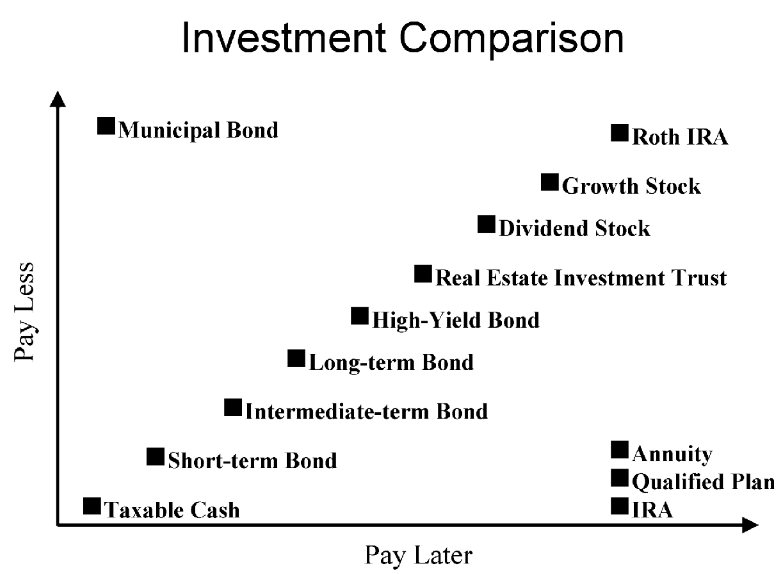
[1]Dammon, Spatt, & Zhang, "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," *The Journal of Finance,* June, 2004 (pp. 999-1037).

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.

Roth IRAs are retirement savings plans offering "back-end" tax breaks: contributions aren't deductible; but withdrawals are generally tax-free. Here's how they work:

- You can contribute to a Roth, whether you participate in an employer plan or not, if your AGI is less than $116,000 (joint filers, $169,000). Contributions phase out between $101,000 and $116,000 (joint filers, $159,000 through $169,000).
- You can contribute up to $5,000 annually to a Roth.
- If you're 50 or older, you can make "catch-up" contributions of up to $1,000 more.
- You have to contribute cash. You can't contribute securities from another account except for rollovers.
- You can withdraw funds without taxes or penalties once you've reached age 59½ and held the funds in the Roth for five *tax years* after the year you make your first contribution.

Example: On April 15, 2001, you open a Roth IRA for the 2000 tax year. The 5-year period expires January 1, 2005.

- Withdrawals within the first five years are treated first as contributions, then earnings. This lets you withdraw your contributions tax-free. Earnings are taxed as ordinary income, plus the usual 10% penalty if you're under age 59½.
- There are no required distributions from Roth IRAs as there are for ordinary IRAs. You can contribute at any age.
- At death, your Roth passes to your designated beneficiaries without passing through probate. They can withdraw the entire balance, tax-free, or, if your custodian allows, withdraw it tax-free over their life expectancies.

Choosing between traditional and Roth IRAs depends mainly on whether you expect your tax rate to be lower today, when you fund the account, or tomorrow, when you take it out. If you expect your future rate to fall, choose the deductible IRA for up-front tax savings. If you expect your rate to hold steady, choose a deductible IRA if you can afford to invest your savings in a side fund. And if you expect your rate to climb, choose the Roth for tax-free income when the tax break saves more.

You can convert your traditional IRA to a Roth if your AGI (excluding the conversion) is less than $100,000 and, if married, you file jointly. (This threshhold is eliminated beginning in 2010.) The full amount you convert is taxed as ordinary income. The same factors that guide choosing also guide converting. If tomorrow's tax savings justify today's costs, then pay now for bigger savings tomorrow.

Filing Guide

IRS Publication 590:
Individual Retirement Arrangements

Tax Savers

If your Roth IRA loses money, you can liquidate your account and deduct the loss as a miscellaneous itemized deduction, subject to the 2% floor on AGI. But this will cost you the chance to profit from tax-deferred appreciation from the remaining account balance.

Tax Savers

If your income is such that you can contribute to a SIMPLE or SEP IRA and you can convert a regular IRA to a Roth, you can effectively create a "Roth" SEP or "Roth" SIMPLE. First, make your deductible SEP or SIMPLE contribution. Then convert the account to a Roth.[1] (You'll have to wait at least two years in the case of the SIMPLE.)

Land Mines

The IRS has announced that they may challenge transactions involving transfers of business assets such as receivables to Roth IRAs (or entities controlled by Roth IRAs) for less than fair market value to avoid contribution limits and shelter gains in the Roth. The IRS may recharacterize these gains as income and even disqualify the accounts. Careful![2]

Internet Resources

www.rothira.com
Worksheets, calculators, etc.

Sources

[1]Regs. §1.408A-4.
[2]IR 2004-8.

Your Investments: Tax-Smart Cash Choices

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.

Your Investments: Fixed Annuities for Tax-Deferred Savings

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.

Cashing Out: Exclude up to $500,000 in Home Sale Gains

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.

Cashing Out: Understand Capital Gains

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

Filing Guide

IRS Publication 526:
Charitable Gifts

Tax Savers

Charitable gift annuities are partially-deductible gifts in exchange for annuities payable directly from a charity. Deductions are calculated using the same rules as for charitable trusts. This avoids establishing a trust and managing assets. But there's no flexibility to invest sale proceeds or change beneficiaries. And you have to rely on the charity to make ongoing annuity payments. (Most charities buy commercial annuities to secure payments.)

Tax Savers

Most donors use charitable trusts to sell appreciated assets. But you can also use them for supplemental retirement savings. You'll get up-front deductions for the income or remainder interests you give. There are no anti-discrimination rules; fewer annual reporting requirements than with qualified plans; and no required distribution dates or amounts. Remainder trusts leave nothing for your heirs. With income and estate taxes devouring over 80% of large qualified plan balances, this may be less of a problem than it seems. You can also use tax savings to buy life insurance in an irrevocable "wealth replacement trust."

$ Potential Savings

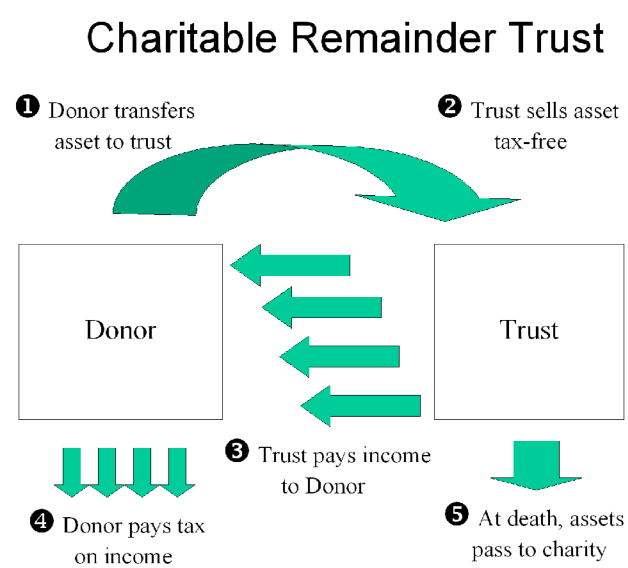
Up to $150 in income tax for every $1,000 of long-term capital gain deferred.

Charitable trusts let you avoid tax when you sell appreciated assets such as real estate, a business, or securities. This requires splitting the asset into two parts (an income, payable for a term of up to 20 years or a lifetime, and a remainder, payable when the income ends), and giving one to charity. The most common form is the charitable remainder trust ("CRT"). Here's how it works:

1. Establish the trust with one or more charitable beneficiaries. You can act as trustee and manage assets yourself, subject to the "prudent trustee" rule, and even change beneficiaries.
2. Give property to the trust. You get an immediate deduction equal to the present value of the remainder interest you give, calculated according to your age, the income interest you keep, and the current "Section 7520" rate. You also eliminate the value of your gift from your taxable estate.
3. The trust sells assets, tax-free, and reinvests the proceeds.
4. The trust pays you income equal to a percentage of trust assets ("unitrust") or a specific dollar amount ("annuitrust"). You can draw income now, or wait until a later date.
5. At your death, the trust remainder passes to charity.
6. Alternatively, a charitable lead trust pays income to charity and leaves the remainder for you or your heirs.

Example: You're male, age 60, with $1.0 million in stock and a basis of $250,000. The Section 7520 rate is 5.6%:

- If you sell the stock outright, you'll pay $112,500 in tax, leaving $887,500 to reinvest.
- If you give it to a CRT and keep a 6% income, you'll get a $312,349 deduction and keep $1.0 million to reinvest.



Filing Guide

Use Form 709 to report taxable gifts.

FLPs and FLLCs report income and expenses on Form 1065 then distribute them to partners and members on Schedule K1. Report these items personally on Schedule B, Schedule D, or Schedule E.

IRS Publication 541: Partnerships

IRS Publication 950: Introduction to Estate and Gift Taxes

Tax Savers

"Restricted management accounts" (RMAs) are a new alternative to FLPs for securities portfolios. The RMA lets you delegate control of your portfolio to a bank or trust company for a specified period of time, then take valuation discounts for gifts of those portfolio interests. However, these have not been tested, and some experts doubt the IRS would respect the strategy.

Tax Savers

It's not necessary to file gift tax returns for gifts under $12,000. However, filing a return for smaller gifts starts a three-year statute of limitations for the IRS to contest your valuation. If you don't file a return, the IRS can challenge your valuation at any time. With gift-tax audits running just 0.66% for Fiscal Year 2002, this seems like sound insurance to protect your transfer.

Sources

[1]Rev. Rul. 59-60; IR Notice 92-182.
[2]*Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005).

Family limited partnerships ("FLPs") and limited liability companies ("FLLCs") are multi-generational tax and asset protection tools that can shift assets and income to heirs, protect you from creditors, and cut your taxable estate:

1. Form a limited partnership with yourself (or a wholly-owned entity such as an LLC or S corporation) as general partner. (If you use an LLC, you'll enjoy limited liability as a member without needing to form a separate entity.)
2. Transfer assets into the entity. This is a tax-free transfer in exchange for the entity interest you receive in return.
3. Once you've transferred assets, you can give interests to family members. These are "complete" gifts for purposes of the $12,000 annual gift tax exclusion.
4. You can structure the entity so that your general partnership or managing member interest assures your continued control, even if you keep as little as 1% of the entity itself.

These arrangements offer three potential advantages:

1. Partners or members pay tax on income at their own rates. This lets you shift taxes on entity income to lower-bracket family members without giving up control over entity assets.
2. As you transfer interests, you can claim valuation discounts reflecting holders' lack of marketability and control.[1] That's because assets locked inside an entity aren't worth as much as assets the holder controls directly. Valuation discounts are hotly contested, but generally range from 5-30% for entities holding marketable securities, 20-40% for entities holding real estate, and 30-50% for entities holding operating businesses.
3. FLPs and FLLCs can also protect assets from creditors, who generally can't reach inside the entity to seize underlying assets. Offshore entities offer potentially stronger protection by removing assets from U.S. court jurisdiction.

FLPs and FLLCs can be powerful. But the IRS watches for abusive valuation discounts[2]. So dot your "*i*'s" and cross your "*t*'s":

- Document non-tax purposes for forming the entity, such as asset protection, cutting administrative costs, or resolving family disputes through mediation rather than litigation.
- Observe legal formalities such as separate bank accounts and tax returns.
- Get independent appraisals when you transfer property into the entity and transfer interests to family members.
- File annual gift tax returns documenting transfers.

Cashing Out: Avoid Probate on Taxable Assets

Tax Savers

The revocable living trust isn't a tax-planning tool. However, your attorney can incorporate tax-planning provisions to take advantage of unified credit and generation-skipping tax exemptions. Your estate plan will generally include these additional documents:

- The "Living Will" directs physicians to discontinue life-sustaining treatment should you fall into an irreversible coma.
- The "Durable Power of Attorney for Health Care" designates someone to make medical decisions on your behalf should you become unable to make those decisions yourself.
- The "Durable Power of Attorney for Finances" designates someone to manage non-trust assets such as retirement and annuity accounts should you become unable to manage them yourself.

Tax Savers

You can designate a living trust as beneficiary of your IRA without forcing the trustee to distribute assets and trigger taxes. To qualify, you'll need to meet five tests:

- The trust is valid under state law.
- It becomes irrevocable at your death.
- It has only people as beneficiaries — not corporations, estates, other trusts, or charities.
- The individual beneficiaries are specifically identifiable from the trust document.
- You give the IRA sponsor a copy of the document before your required beginning date for distributions.

"Probate" is the legal process of transferring assets you own at your death to your heirs. This can last up to two years in some states, and involve court costs, attorneys' and executors' fees (often fixed as a percentage of the assets probated), and unwanted publicity. Fortunately, you can avoid it by titling assets with beneficiary designations or outside your name entirely.

- Joint tenancy is an arrangement between two people (usually spouses, but sometimes a parent and child) that automatically passes title at the first death to the survivor. Joint tenancy is easy and inexpensive to establish. But it subjects each owner to the other's personal liability. And it dissolves at the first death, leaving the asset subject to probate at the second.
- Qualified plans, IRAs, life insurance, and annuities pass automatically to your designated beneficiaries. These bypass probate unless you designate your estate as your beneficiary.
- State transfer-on-death ("TOD") laws may let you pass real estate and financial accounts to designated beneficiaries.

Simple beneficiary designations aren't enough for children who aren't ready to manage their inheritance or assets such as closely-held businesses, investment real estate, and family limited partnership interests. In those cases, the revocable living trust is usually the estate-planning vehicle of choice. Here's how it typically works:

- First, you'll establish the trust. This involves designating a trustee to manage trust assets and beneficiaries who enjoy the benefit of the property. Typically, you'll designate yourself as both trustee and beneficiary during your lifetime. You'll also designate a successor trustee or trustees to take over at your death or disability.
- Next, transfer assets from yourself to the trustee. You'll enjoy the same freedom and flexibility to manage trust assets as if you owned them personally. The trust is ignored for tax purposes, and you'll report trust income on your personal return.
- At your death, your designated successor steps into your shoes to manage trust assets. Your successor can terminate the trust and distribute the assets (such as with adult children) or continue to manage them (such as for minor children).
- The trust bypasses the delays, expense, and publicity of probate because trust assets are no longer titled in your name.

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."

Filing Guide

Wisconsin requires you to keep your tax records for four years, versus the Federal standard of three years.

Standard Deductions	
Single	$8,170
MS	$6,990
HH	$10,550
Joint	$14,710
Personal Exemptions	
Single/Dependents	$700
Rates/Brackets (single filers)	
4.6%	$0 - 8,840
6.15%	$8,841 - 17,680
6.5%	$17,681 - 132,580
6.75%	$132,581 +

Interest/Dividends: U.S. government obligations exempt

Capital Gains/Losses: State-specific rules

Pension/Retirement Income:

- **Private:** Same as federal
- **Public:** Exclusion for pre-1964 participants
- **Military:** Exclusion for pre-1964 participants
- **Social Security:** Taxable up to 50%

Unemployment Compensation: Exclusion per pre-1986 law

Disability Income: Exclude up to $5,200

Federal Taxes: Nondeductible

Municipal Bonds: Taxable (except specifically excluded WI obligations, primarily those issued for public housing and higher education purposes)

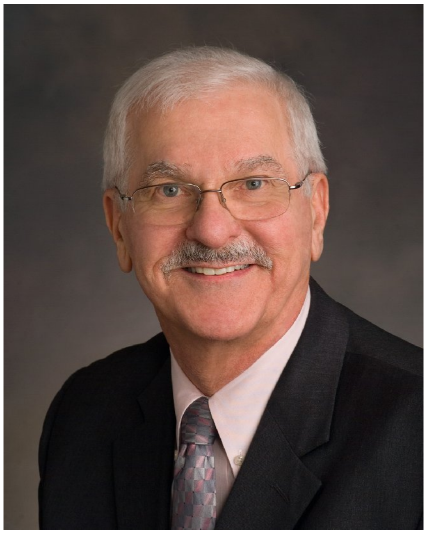
Itemized Deductions:

- **Medical:**
- **Taxes:** None
- **Mortgage Interest:** WI residences only
- **Charitable Gifts:**

Section 529 Plan: $3,000 per self, dependent, or grandchild

Other: Standard deductions phase out above certain levels of taxable income. For 2006 phaseouts begin at $12,000 for single and head of household, $16,500 for married filing jointly, and $7,850 for married filing separately.

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.