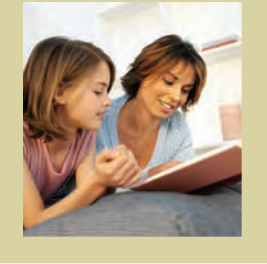




2009 – 2010

# Tax planning guide

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



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## A message from Multop Financial

*Featured in the May 2009 issue of Forbes Magazine as one of the "Most Dependable Wealth Managers in the West" and included in the Top 5% for "Best in Client Satisfaction" as published in Seattle Magazine's 2009 Five-Star Wealth Managers section (details enclosed).*

### PREFACE

Another year is coming to a close. It has been a full-time job keeping track of the tax law changes – passed and proposed – but we are ready to do everything we can to save you money and plan for maximum savings in the years ahead. Now more than ever, specialized tax planning is a crucial component for every financial plan, whether it's for a family or business. This tax guide book outlines many of the basic topics and areas of concern for the majority of our clients and prospects.

Our tax preparation team here at Multop Financial can not emphasize enough the importance of personalized planning because every situation is different and the law can be interpreted different ways depending on your fact situation.

While reviewing this book you may run across questions that you would like to ask us during your tax interview. We encourage questions and discussion because although we can do a good job on your tax return based on what has ALREADY happened, in order to help you plan for tax savings in the future we need to know what WILL be happening in your financial life. Give it some thought, make a list of questions so that you're prepared for your appointment, and then come in and let's get down to the business of creating a tax strategy so that you can keep more of what you earn.

We look forward to our appointment with you, and don't hesitate to contact us anytime with questions.

Sincerely, on behalf of

YOUR TAX PLANNING TEAM AT MULTOP FINANCIAL

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# Unlike the economy, taxes are controllable

You can't do much about economic ups and downs, but you can take steps to minimize your tax burden, no matter which way the market moves. The key is to continually adjust your tax plan in light of economic swings and changes in tax laws or your personal situation.

This guide points out the importance of starting before year end and discusses tax-planning strategies for a variety of purposes and types of income. You'll find information about ways to save tax on executive compensation, investments and real estate, as well as tax-smart ideas for funding education, saving for retirement and transferring wealth to your heirs.

But you'll also see how complicated tax planning has become, and realize that there are many other regulations and strategies we simply can't cover in the pages that follow. So be sure to check with an advisor to find out the best ways to keep your taxes under control.

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# Why you should look at 2009 income, expenses and potential tax *now*

To minimize income tax, you need to look at your income, deductible expenses and potential tax before year end. You may be able to time additional income and expenses to your advantage. But if your marginal tax rate — the rate that applies to your next dollar of ordinary income — is all you have in mind when formulating your strategy, you may be wasting your time.

Why? Because although this rate applies to income such as salary and bonuses, business income, interest, and more, there are a variety of other rates and limitations that can affect your income tax liability. These are discussed throughout this guide, but here's a look at some of the most fundamental considerations in a year-to-date review.

## Watch out for AMT triggers

The top regular income tax rate on ordinary income for 2009 remains at 35%. (See Chart 5 on page 24.) But if you're subject to the AMT, the maximum rate your ordinary income will be taxed at is 28%. Although

the top AMT rate is lower, it typically applies to a higher taxable income base, so it can result in unwelcome tax surprises. Plus your marginal AMT rate may be higher than 28% because of the AMT exemption phaseout. (See Chart 5.)

Many deductions used to calculate regular income tax aren't allowed under the AMT and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability. Common triggers include:

- State and local income taxes, especially if you live in a high-income-tax state,

- Real estate and personal property taxes,
- Interest on a home equity loan or line of credit not used to buy, build or improve your principal residence,
- Miscellaneous itemized deductions subject to the 2% of AGI floor,
- Long-term capital gains and dividend income, even though they're taxed at 15% for both regular tax and the AMT,
- Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- Tax-exempt interest on certain private-activity municipal bonds. (See the Tax Law Change Alert on page 11 for a new exception.)

Finally, in certain situations incentive stock option (ISO) exercises can trigger significant AMT liability. (See page 6.)

## Avoid or reduce AMT

With proper planning, you may be able to avoid the AMT, or at least reduce its impact — and perhaps take advantage of its lower maximum rate. The first step is to work with your tax advisor to determine whether you could be subject to the AMT:

**This year.** Consider accelerating income and short-term capital gain into 2009, which may allow you to benefit from the lower maximum AMT rate. Also consider deferring expenses you *can't* deduct for AMT purposes until 2010 — you may be able to preserve those deductions. Additionally, if you defer expenses you

### Tax Law Change Alert

## AMT patch provides reprieve, but no long-term relief

**Who's affected:** Many middle- and high-income taxpayers.

**Key changes:** Unlike the regular tax system, the AMT system isn't regularly adjusted for inflation. Instead Congress must legislate any adjustments. It did just that as part of the American Recovery and Reinvestment Act of 2009, enacting a one-year "patch" that increases the AMT exemption amounts and expands the phaseout ranges. (See Chart 5 on page 24.)

**Planning tips:** Planning for the AMT continues to be a challenge because as of this writing it's unknown whether Congress will pass more patches or provide longer-term relief. Talk to your tax advisor for the latest information and to determine the best strategy for your situation.

can deduct for AMT purposes to next year, the deductions may become more valuable because of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising ISOs.

**Next year.** Consider taking the opposite approach. For instance, defer income to 2010, because you'll likely pay a relatively lower AMT rate. And prepay expenses that will be deductible this year but that won't help you next year because they're not deductible for AMT purposes. Also, consider selling any private activity municipal bonds that don't qualify for the new tax break (see the Tax Law Change Alert on page 11) before year end.

### Look into the AMT credit

If you pay AMT in one year on deferral items, such as depreciation adjustments, passive activity adjustments or the tax preference on ISO exercises, you may be entitled to a credit in a subsequent year.

In effect, this takes into account timing differences that reverse in later years. But the credit might provide only partial relief or take years before it can be used in full. Fortunately, the credit's relatively new refundable feature can reduce the time it takes to recoup AMT paid.

### Time income and expenses

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. (See Case Study 1 on page 4.)

If you don't expect to be subject to the AMT this year or next, consider deferring income to 2010 and accelerating deductible expenses into 2009, because this will defer tax, which is usually beneficial. But if you expect to be in a higher tax bracket next year, the opposite approach may be beneficial.

**Warning:** Increases in the highest tax rates may occur at any time.

Whatever the reason you'd like to time income and expenses, here are some items whose timing you may be able to control:

Income:

- Bonuses,
- Consulting or other self-employment income,
- U.S. Treasury bill income,
- Real estate or other nonpublicly traded property sales, and
- Retirement plan distributions, if not required.

Expenses:

- State and local income taxes,
- Real estate taxes,
- Mortgage interest,
- Margin interest, and
- Charitable contributions.

**Warning:** Remember that prepaid expenses can be deducted only in the year to which they apply. For example, you can prepay (by Dec. 31, 2009) real estate taxes that relate to the year 2009 but that are due in 2010, and deduct the payment on your 2009 return. But you can't prepay real estate taxes that relate to the year 2010 and deduct the payment on your 2009 return.

### Bunch deductions

Expenses that may qualify as miscellaneous itemized deductions are deductible for regular tax purposes only to the extent

they exceed, in aggregate, 2% of your AGI. Bunching these expenses into a single year may allow you to exceed this floor.

Carefully record your potential deductions to date. If they're close to or already exceed the 2% floor — and you don't expect to be subject to the AMT this year — pay accrued expenses and incur and pay additional expenses by Dec. 31, such as:

- Deductible investment expenses, including advisory fees, custodial fees and publications,
- Professional fees, such as tax planning and preparation, accounting, and certain legal fees, and
- Unreimbursed employee business expenses, including travel, meals, entertainment and vehicle costs.

Similarly, medical expenses are generally deductible only to the extent they exceed 7.5% of your AGI and aren't reimbursable by insurance or paid through a pretax Health Savings Account (HSA) or Flexible Spending Account (FSA). So consider bunching nonurgent medical procedures and other controllable expenses into one year. If one



spouse has high medical expenses and a relatively lower AGI, filing separately may allow that spouse to exceed the AGI floor and deduct some medical expenses that wouldn't be deductible if you filed jointly.

**AMT ALERT:** For AMT purposes, only medical expenses exceeding 10% of your AGI are deductible. Also, because the AMT exemption for separate returns is considerably lower than the exemption for joint returns, filing separately to exceed the 7.5% floor for regular tax purposes could trigger the AMT.

### Plan for sales tax

You also may want to take sales tax into account in your timing strategies. For 2009 — but, as of this writing, *not*

for 2010 — you can deduct state and local sales taxes in lieu of state and local income taxes. So, if you're considering some major purchases, you may want to make them by year end to ensure you can deduct the sales tax. If, however, you live in a high-income-tax state, you may still be better off deducting your state and local income taxes.

But another option may be available if you purchase a new car, light truck, motorcycle or motor home from Feb. 17, 2009, through Dec. 31, 2009: a new deduction for state and local sales and excise taxes paid on vehicle value up to \$49,500 that's available regardless of whether you itemize.

By taking the new deduction instead of the *itemized* sales tax deduction, you'll still be eligible to take the itemized state and local income tax deduction. But the new deduction starts to phase out for joint filers with AGIs exceeding \$250,000 (\$125,000 for other filers).

### Review AGI-based reductions

If your AGI exceeds certain levels, your ability to benefit from many tax breaks is reduced. For example:

**Personal exemptions.** You'll lose a portion of the \$3,650 (for 2009) per exemption deduction from your taxable income if your AGI exceeds \$166,800 if single, \$208,500 if head of household, \$250,200 if married filing jointly, or \$125,100 if married filing separately. Your tax advisor can help you determine the amount of exemption you're eligible for.

**Itemized deductions.** For 2009, most itemized deductions are reduced if AGI is over \$166,800 (\$83,400 for married filing separately). Itemized deductions for medical expenses, investment interest, casualty losses and gambling losses aren't subject to the reduction.

You may be able to time income and above-the-line deductions to reduce your AGI enough to minimize the impact of these reductions. If that's not possible, keep them in mind in your tax planning — especially when timing expenses subject to the itemized deduction reduction.

### Consider employment tax

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. The amount of income subject to the 12.4% Social Security tax (the 12.4% is split equally between employee and employer) is limited to \$106,500 for 2009, but all earned income is subject to the 2.9% Medicare tax.

#### Case Study 1

## The wrong year end strategies could cost you

Say you and your spouse are subject to the maximum ordinary income rate of 35% and take these steps by Dec. 31, 2009, to maximize tax deferral:

Defer billing of consulting fees earned in 2009 to Jan. 1, 2010	\$ 50,000
Pay 2009 real estate tax bill due in early 2010 and fourth quarter 2009 state estimated income tax payment due in 2010	30,000
Make charitable contributions in 2009 that would otherwise be made in 2010	20,000
<b>Total reduction of 2009 taxable income</b>	<b>\$100,000</b>
Federal tax rate	35%
<b>Tax deferred to next year</b>	<b>\$ 35,000</b>

But, if you have to pay the AMT in 2009 (and not in 2010), these year end strategies can cost you:

The deferred consulting fees will be subject to your regular tax rate of 35%, rather than the lower 28% AMT rate if collected in 2009	\$ 3,500
The prepaid real estate taxes and fourth quarter 2009 state estimated tax payment aren't deductible for AMT purposes, so they'll generate no tax benefit	10,500
The charitable contributions will generate a tax benefit of only 28%, rather than 35% if made in 2010	1,400
<b>Total additional taxes</b>	<b>\$ 15,400</b>

If you're self-employed, your employment tax liability doubles, because you also must pay the employer portion of these taxes. As a result, self-employment income can be taxed at an effective federal rate as high as 48% compared to about 43% for income from wages. Why isn't the difference greater? Because you receive a deduction for 50% of the self-employment tax you pay.

There are also special considerations if you're a business owner who also works in the business, depending on the business' structure:

**Partnerships and limited liability companies.** Generally all trade or business income that flows through to you for income tax purposes is subject to self-employment tax — even if the income isn't actually distributed to you.

**S corporations.** Only income you receive as salary is subject to employment tax. So to reduce your employment tax, you may want to keep your salary relatively low and increase your distributions of company income. But to avoid potential back taxes and penalties, you must take a reasonable salary — generally what would be paid to an outside individual performing the same services for your company.

#### Tax Law Change Alert

### Estimated tax payment requirements temporarily eased for some

**Who's affected:** Many small-business owners.

**Key changes:** Under the American Recovery and Reinvestment Act of 2009, qualified taxpayers must pay only 90% of their 2008 tax liability through estimated payments or withholding to avoid underpayment penalties. Taxpayers generally will qualify if their AGI for 2008 was less than \$500,000 and if more than 50% of their 2008 gross income was generated from a "small business" (defined as a business that, on average, had fewer than 500 employees during 2008).

**Planning tips:** Take advantage of the lower payment requirements to help maintain your business's cash flow. You may end up owing more on April 15, 2010, because you won't have prepaid as much tax. But until then, you'll have more cash in your pocket to use as needed.

**C corporations.** Only income you receive as salary is subject to employment tax. You may prefer to take more income as salary (which is deductible at the corporate level) because the overall tax paid by both the corporation and you may be less.

**Warning:** The IRS is cracking down on misclassification of corporate payments to shareholder-employees, so tread carefully.

#### Pay tax during the year

You can be subject to penalties if you don't pay enough tax during the year through estimated tax payments or withholding.

To avoid such penalties, make sure your estimated payments or withholding equals at least 90% of your tax liability for 2009 or 110% of your 2008 tax (100% if your 2008 AGI was \$150,000 or less). For 2009 only, there's a special break for certain small-business owners — see the Tax Law Change Alert above.

Here are some strategies that also can help you avoid underpayment penalties:

**Use the annualized income installment method.** This method often benefits taxpayers who have large variability in income by month due to bonuses, investment gains and losses, or seasonal income, if it's skewed toward the end of the year. Annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period.

**Estimate your tax liability and increase withholding.** If you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by Dec. 31. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters. ■



# Special rewards require special planning

If you're an executive with a larger company, you likely receive stock options, restricted stock or nonqualified deferred compensation. But these special rewards come with complicated tax consequences that require special planning.

## Evaluate ISO options

Although incentive stock options (ISOs) receive tax-favored treatment, they must comply with many rules. ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price equal to or greater than the stock's fair market value (FMV) at the date of the grant.

Therefore, the ISOs don't provide a benefit until the stock appreciates in value. When it does you can buy shares at a price below what they're

trading for, as long as you've satisfied the applicable ISO holding periods. Here are the key tax consequences:

- You owe no tax when the ISOs are granted.
- You owe no *regular* tax when you exercise the ISOs.
- If you sell the stock *after* holding the shares at least one year from the date of exercise and two years from the date the ISOs were granted, you pay tax on the sale at your long-term capital gains rate.
- If you sell the stock *before* long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary income rates.

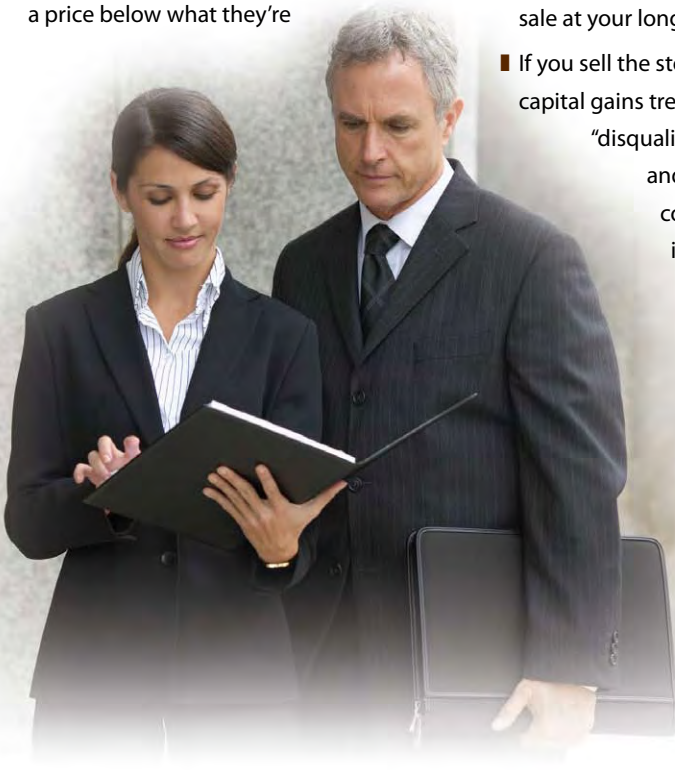
**AMT ALERT:** *In the year of exercise, a tax "preference" item is created on the difference between the stock's FMV and the exercise price (the "bargain element") that can trigger the AMT.*

If you've received ISOs, plan carefully when to exercise them and whether to immediately sell or hold shares received from an exercise. Waiting until just before the expiration date to exercise ISOs (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. But there also is market risk to consider.

In several situations, acting earlier can be advantageous:

- Exercise early to start your holding period so you can receive long-term capital gains treatment sooner.
- Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate your AMT liability.
- Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.
- Sell early in a disqualifying disposition and pay the higher ordinary income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares' value drops below your exercise cost, and may create a tax cost if the preference item from the exercise generates an AMT





liability. (See Case Study 2, below.) With the help of your tax advisor, evaluate the risks and crunch the numbers using various assumptions to determine the best strategy for your situation.

### Understand NQSO differences

The tax treatment of nonqualified stock options (NQSOs) is different from that of ISOs. NQSOs create compensation income (taxed at ordinary income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don't create an AMT preference item.

You may need to make estimated tax payments or increase other withholding to fully cover the tax on the exercise. Also consider state tax estimated payments.

### Consider Sec. 83(b) election for restricted stock

Restricted stock is stock that's granted subject to a substantial risk of forfeiture. Income recognition is normally deferred until the stock is no longer subject to that risk or you sell it. You then pay taxes on the stock's FMV at your ordinary-income rate.

But, under IRC Section 83(b), you can elect to instead recognize ordinary income when you receive the stock. This election,

which you must make within 30 days after receiving the stock, can be beneficial if the income at the grant date is negligible or the stock is likely to appreciate significantly before income would otherwise be recognized. Why? Because the election allows you to convert future appreciation from ordinary income to long-term capital gains income, and defer it until the stock is sold.

There are some disadvantages of a Sec. 83(b) election: First, you prepay tax in the current year. But if a company is in the earlier stages of development, this may be a small liability. Second, any taxes you pay because of the election can't be refunded if you eventually forfeit the stock or its value decreases. But you'll have a capital loss when you sell or forfeit the stock.

Work with your tax advisor to map out whether the Sec. 83(b) election is appropriate for you.

### Know your NQDC plan

Nonqualified deferred compensation (NQDC) plans pay executives in the future

for services to be currently performed. They differ from qualified plans, such as 401(k)s (see page 20), in several ways. For example, NQDC plans can favor certain highly compensated employees, and any NQDC plan funding isn't protected from your employer's creditors.

One important NQDC tax issue is that employment taxes (see page 4) are generally due when services are performed or when there's no longer a substantial risk of forfeiture, whichever is later — even though compensation isn't actually paid or recognized for income tax purposes until later. So your employer may withhold your portion of the tax from your salary or ask you to write a check for the liability. Or it may pay your portion, in which case you'll have additional taxable income.

Moreover, the rules for NQDC plans recently have been tightened and clarified. The penalties for noncompliance can be severe: You could be taxed on plan benefits at the time of vesting, and a 20% penalty tax and potential interest charges also could apply. So check with your employer to make sure it's addressing any compliance issues. ■

#### Case Study 2

## Fallen stock prices present ISO danger

If you exercise incentive stock options (ISOs) and the stock price falls after the exercise, the tax consequences can be costly. Let's say you were granted an ISO to buy 50,000 shares of your company stock at \$15 a share, exercisable within five years.

When eligible one year later, you exercise 10,000 shares at the trading price of \$25. You might be subject to an AMT liability as high as \$28,000. That's because the exercise results in a \$100,000 tax preference item on the bargain element (the difference between the \$250,000 trading price and the \$150,000 exercise price), which could be taxed at the top AMT rate of 28%. This might be a problem because exercising the option doesn't generate any cash with which to pay the tax.

The problem is magnified if the stock price drops after the exercise. For example, if you pay the AMT but the trading price per share later falls back to \$15, you'll have paid the tax even though the selling price of your shares is equal to the price you paid for them. Fortunately, you'll be able to claim a credit for the AMT paid, and rules have been liberalized to make the credit much more usable.



## INVESTING

# The more you plan, the more you gain (or don't lose)

In a typical market, investment planning focuses on managing capital gains and balancing your portfolio. In a down market, planning is largely a matter of determining how you can make losses work for you. The trick is to use losses to offset gains over the short- and long-term.

### Understand capital gains tax

Appreciating investments that don't generate current income aren't taxed until sold, deferring tax and perhaps allowing you to time the sale to your tax advantage — such as in a year when you have losses to absorb the capital gain. (See Case Study 3, below.)

Realized capital gains are netted against realized capital losses to determine capital gains tax liability. The applicable tax rate depends, in part, on whether the net gain is long-term (you held the asset for more than one year) or short-term.

Net long-term capital gains generally are taxed at 15% for both regular tax and AMT purposes. Keep in mind, though: You have only through 2010 to take advantage of the 15% rate, unless Congress extends it. (Check with your tax advisor for the latest information.) Also, higher long-term gains rates apply to certain types of assets. (See Chart 1.)

Net short-term capital gains are subject to ordinary income rates. Therefore, they could be taxed at a rate as high as 35%.

**AMT ALERT:** *Substantial net long-term capital gains can trigger the AMT.*

### See if a loved one qualifies for the 0% rate

The long-term capital gains rate is 0% through 2010 (unless Congress extends it) for gain that would be taxed at 10% or 15% based on the taxpayer's regular income tax rate. If you have adult children in one of these brackets, consider transferring appreciated or dividend-producing assets to them — the 0% rate also applies to qualified dividends. **Warning:** If the child is under age 24, first make sure he or she won't be subject to the kiddie tax. (See page 19.) Also, consider any gift tax consequences. (See page 22.)

### Use losses to your advantage

Losses aren't truly losses until they're realized — that is, until you sell the investment for less than what you paid for it. So while it's distressing to see an account statement that shows a large loss, the loss won't affect your current tax situation as long as you still own the investment.

If your net losses for the year exceed your net gains, you can deduct only \$3,000 (\$1,500 for married taxpayers filing separately) of the losses against ordinary income. You can carry forward excess losses to future years.

By determining your year-to-date gains and losses now, you can time sales of other investments before year end to achieve your tax planning goals. For example, loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings

### Case Study 3

## Turning a capital loss into a tax-saving opportunity

Let's say your investments overall are down significantly and, to date, your net realized losses are \$125,000. Your portfolio includes \$300,000 of a manufacturing company stock that was worth \$400,000 a year ago but that you paid only \$180,000 for. Even before the downturn you'd been thinking about selling it to diversify your portfolio, but you were concerned about the capital gains tax.

Now might be a good time to sell it because your \$120,000 gain would essentially be tax free: It would absorb almost all of the \$125,000 of losses, leaving you with a \$5,000 net loss, \$3,000 of which you could use to offset ordinary income and \$2,000 of which you could carry forward to offset gains — or even ordinary income — next year.

or a closely held business that might generate substantial future gains.

Also, if you may be able to use the loss next year to offset short-term gains, rather than using it this year to offset long-term gains, the carryover may be worthwhile. Your tax savings will be based on the type of gain you reduced or eliminated, not on whether you used a net short-term or long-term loss.

In some situations, it could take a long time to fully absorb a substantial loss carryover. So you may want to realize gains before year end to absorb excess losses. Remember that capital gains distributions from mutual funds can also absorb capital losses.

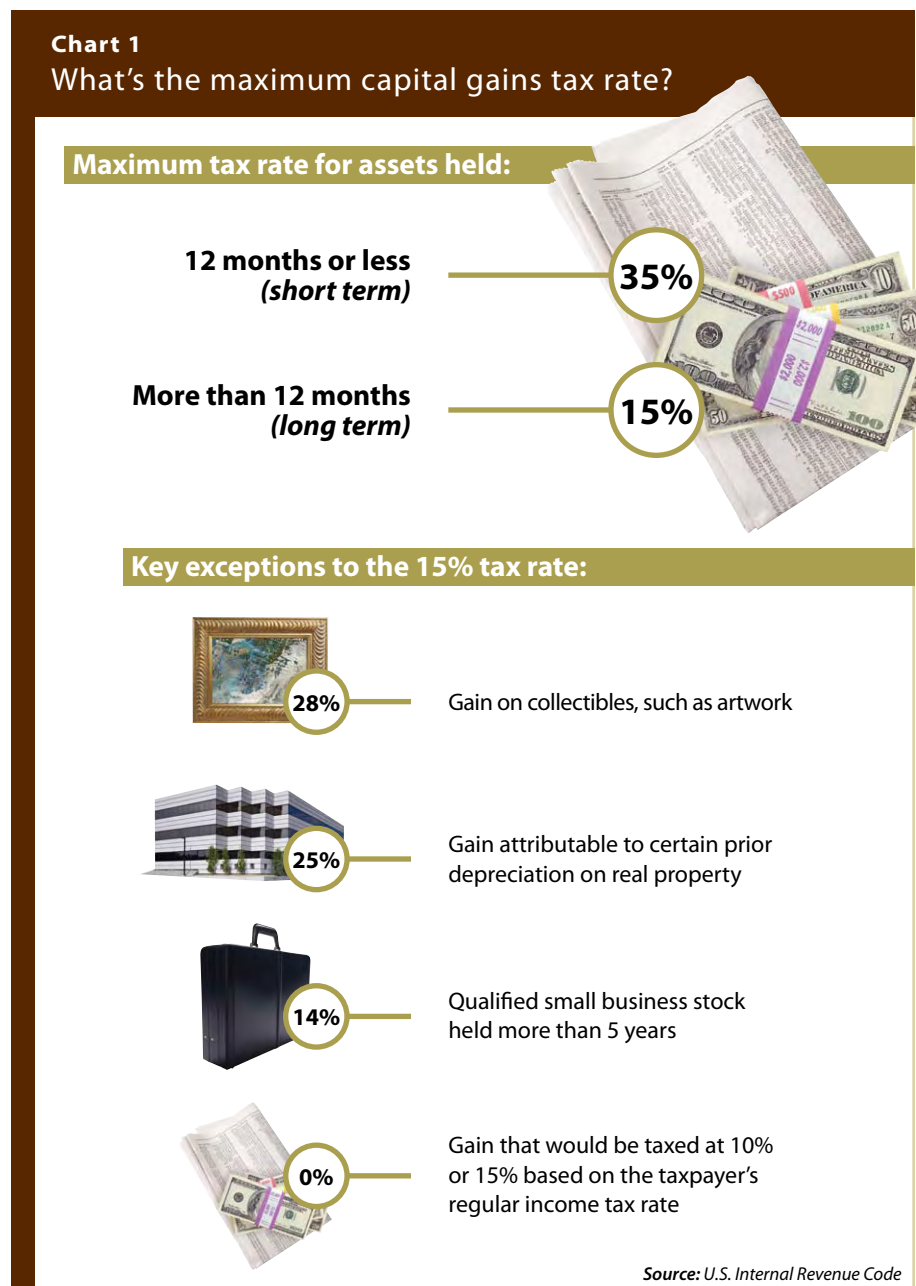
### Balance tax and investment concerns

In the current market, you may not have enough gains to absorb losses. So if you want to minimize loss carryovers, think twice before selling an investment at a loss. After all, if you hold on to the investment, it may recover its lost value. In fact, a buy-and-hold strategy works well for many long-term investors because it can minimize the effects of market volatility.

Of course, an investment might continue to lose value. That's one reason why tax considerations shouldn't be the primary driver of investment decisions. If you're ready to divest yourself of a poorly performing stock because, for example, you don't think its performance will improve or your investment objective or risk tolerance has changed, don't hesitate solely for tax reasons.

### Beware of the wash sale rule

If you're trying to achieve a tax loss with minimal change in your portfolio's asset allocation, keep in mind the wash sale rule. It prevents you from using a loss on a security if you buy the same — or substantially identical — security within 30 days before or after you sell the security that created the loss.



There are ways to avoid the wash sale rule. For example, you may immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold. You also can do a bond swap, where you sell a bond at a loss and then immediately buy another bond of similar quality from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical.

### Get the details right

If you don't pay attention to the details, the tax consequences of a sale may be different from what you expect. For example, the trade date, not the settlement date, of publicly traded securities determines the year in which you recognize the gain or loss.

And if you want to sell high-tax-basis shares to reduce gain or increase a loss and offset other gains, but you bought the same security at different times and

prices, be sure to specifically identify in writing which shares are to be sold by the broker.

### Avoid mutual fund pitfalls

Investing in mutual funds is an easy way to diversify your portfolio. But beware of the tax pitfalls. First, earnings on mutual funds are typically reinvested. Unless you (or your broker or investment advisor) keep track of these additions to your basis, you may report more gain than required when you sell the fund.

Second, equity mutual funds often declare a large capital gains distribution at year end. If you own the shares on the record date of the distribution, you'll be taxed on the full distribution amount even though it may include significant gains realized by the fund *before* you owned the shares. Worse yet, you'll end up paying tax on those gains in the current year — even if you reinvest the distribution and regardless of whether your position in the fund has appreciated.

#### Tax Law Change Alert

### A tax break for QSB stock gets bigger

**Who's affected:** Investors considering diversifying their portfolios with qualified small business (QSB) stock.

**Key changes:** Generally, taxpayers selling QSB stock are allowed to exclude up to 50% of their gain as long as they've held the stock for at least five years. The American Recovery and Reinvestment Act of 2009 increases the exclusion to 75% if the stock is issued after Feb. 17, 2009, and before Jan. 1, 2011.

Keep in mind that the taxable portion of the gain will be subject to the lesser of your ordinary marginal tax rate or 28%, rather than the regular long-term gains rate. (See Chart 1 on page 9.) Thus, if the 28% rate applies, the effective rate on the QSB gain will be 7% (28% x 25%).

**Planning tips:** Stock in smaller companies provides additional tax benefits as well — see below. Work with your tax and investment advisors to see whether such stock may be right for your portfolio.

### Benefit from small business stock

If you buy stock in certain small businesses, you may enjoy preferential tax treatment:

**Conversion of capital loss to ordinary loss.** If you sell Section 1244 small business stock at a loss, you can treat up to \$50,000 (\$100,000, if married filing jointly) as an ordinary, rather than a capital, loss — regardless of your holding period. This means you can use it to offset ordinary income, reducing your tax by as much as 35% on this portion of the loss. Sec. 1244 applies only if total capital invested is not more than \$1 million.

**Tax-free gain rollovers.** If within 60 days of selling qualified small business (QSB)

stock you buy other QSB stock with the proceeds, you can defer the tax on your gain until you dispose of the new stock. The rolled over gain reduces your basis in the new stock. For determining long-term capital gains treatment, the new stock's holding period includes the holding period of the stock you sold.

To be a QSB, a business must be engaged in an active trade or business and must not have assets that exceed \$50 million. Another tax break for QSB investors recently has been expanded — see the Tax Law Change Alert above.



Keep in mind that these tax benefits are subject to specific requirements and limits. Consult your tax or financial advisor to be sure an investment in small business stock is right for you.

### Plan for passive losses

If you've invested in a trade or business in which you don't materially participate, remember that passive activity losses generally are deductible only against income from other passive activities. You can carry forward disallowed losses to the following year, subject to the same limits.

To avoid passive activity treatment, typically you must participate in a trade or business more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. (Special rules apply to real estate; see page 13.) If you don't pass this test, consider:

**Increasing your involvement.** If you can exceed 500 hours, the activity no longer will be subject to passive loss limits.

**Disposing of the activity.** You're then allowed to deduct all the losses — including any loss on disposition (subject to basis and capital loss limitations). But the rules are complex, so consult your tax advisor.

**Looking at other activities.** Limit your participation in another activity that's

generating income to less than 500 hours or invest in another income-producing trade or business that will be passive to you. Under both strategies, you'll have passive income that can absorb your passive losses.

### Be smart with income investments

While qualifying dividends generally are taxed at the reduced rate of 15%, interest income is taxed at ordinary income rates up to a maximum of 35%. So, dividend-paying stocks may be more attractive from a tax perspective than other income investments, such as CDs and bonds. But there are exceptions.

Some dividends are subject to ordinary income rates. These may include certain dividends from:

- Money market mutual funds,
- Real estate investment trusts (REITs),
- Regulated investment companies (RICs), and
- Certain foreign investments.

Some bond interest is *exempt* from income tax. For example, interest on U.S. government bonds is taxable on your federal return, but it's generally exempt on your state and local returns. On the other hand, interest on state and local government bonds is excludible on your federal return.

If state or local bonds were issued in your home state, interest also may be excludible on your state return.

Although state and municipal bonds usually pay a lower interest rate, their rate of return may be higher than the after-tax rate of return for a taxable investment. But be careful with private activity bonds. (See the Tax Law Change Alert below.)

### Deduct investment interest expense

Investment interest — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — is deductible. But special rules apply.

Your investment interest deduction is limited to your net investment income, which generally includes taxable interest, nonqualified dividends and net short-term capital gains (but not long-term capital gains), reduced by other investment expenses. Any disallowed interest is carried forward, and you can deduct it in a later year if you have excess net investment income.

You may elect to treat net long-term capital gain or qualified dividends as investment income in order to deduct more of your investment interest. But if you do, that portion of the long-term capital gain or dividend is taxed at ordinary income rates.

Payments a short seller makes to the stock lender in lieu of dividends may be deductible as an investment interest expense. But interest on debt used to buy securities that pay tax-exempt income, such as municipal bonds, isn't deductible.

Also keep in mind that passive interest expense — interest on debt incurred to fund passive activity expenditures — becomes part of your overall passive activity income or loss, subject to limitations. ■

#### Tax Law Change Alert

### AMT risk lifted for some private activity bonds

**Who's affected:** Bond investors vulnerable to the AMT.

**Key changes:** The American Recovery and Reinvestment Act of 2009 excludes from the AMT any income from tax-exempt bonds issued in 2009 and 2010, along with 2009 and 2010 re-fundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009. Previously, tax-exempt interest from private activity municipal bonds could trigger AMT liability.

**Planning tips:** Those who've hesitated to invest in private activity bonds because of the potential negative AMT consequences may want to reconsider them. Those holding private activity bonds that don't fall under the new provision, however, still need to be wary of the AMT. (For more on the AMT, see page 2.)



## REAL ESTATE

# Tax breaks abound for home owners and real estate investors

Even though property values in many areas have fallen, investing in a home or other real estate can be a very smart move. In addition to providing various deductions, your investment may enable you to defer gains on a property sale or exchange while improving your portfolio. But to get the most for your money, you'll need to know the rules and plan carefully.

### Take advantage of home-related tax breaks

Whether you own one home or several, it's important to maximize your deductions:

**Property tax.** If you're looking to accelerate or defer deductions (see page 3), property tax is one expense you may be able to time. You can choose to pay your 2009 bill that's due in early 2010 by Dec. 31, 2009, and deduct it this year. Or you can wait until the due date and deduct it in 2010.

**AMT ALERT:** *Property tax isn't deductible for AMT purposes. If you're subject to the AMT this year, a prepayment will be for naught because you'll lose the deduction.*

**Acquisition debt.** You generally can deduct interest on up to a combined total of \$1 million of mortgage debt incurred to purchase, build or improve your principal residence and a second residence. And you can deduct points related to a loan for purchasing or improving your *principal* residence.

**Home equity debt interest.** Interest on home equity debt used to improve your principal residence — and interest on home equity debt used for any purpose (debt limit of \$100,000) — may be deductible. So consider using home equity debt to pay off credit cards or auto loans, whose interest isn't deductible.

**AMT ALERT:** *If home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes and could trigger the AMT.*

### Beware of home rental rules

If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses associated with the rental aren't deductible.

If you rent out your principal residence for 15 days or more, you'll have to report the income, but you also may be entitled to deduct some or all of your rental expenses — such as utilities, repairs, insurance and depreciation. However, you can deduct expenses only to the extent of your rental income. Any excess can be carried forward to offset rental income in future years.

If the home is classified as a rental property for tax purposes, you can't deduct any interest that's attributable to your personal use of the home. But you can take the personal portion of property tax as an itemized deduction and deduct rental expenses, including losses (subject to the passive activity rules). In some situations,

#### Tax Law Change Alert

### Expanded break for first-time homebuyers

**Who's affected:** First-time homebuyers (defined as taxpayers who've had no ownership interest in a principal residence in the United States during the prior three-year period).

**Key changes:** Last year, a credit of up to \$7,500 on the purchase price of a principal residence was made available to qualified first-time homebuyers. The American Recovery and Reinvestment Act of 2009 extends its availability to qualifying purchases made before Dec. 1, 2009, and, for those made after Dec. 31, 2008, increases the maximum credit to \$8,000. Perhaps most significant, the act generally eliminates the repayment obligation for qualifying purchases after Dec. 31, 2008. The credit starts to phase out for joint filers with modified AGIs exceeding \$150,000 (\$75,000 for single filers), and there are other limitations.

**Planning tips:** Even though you likely won't qualify, your adult children or grandchildren might. So if you've been thinking about making a gift to help them fund a down payment, now may be a great time to do it. In addition to benefiting from the credit, they also can take advantage of low housing prices and low interest rates. But be sure to first consider the gift tax consequences. (See page 22.)

it may be beneficial to reduce personal use of a residence so it will be classified as a rental property.

### Look at real estate activities

If you hold investment real estate or rental property, keep in mind that losses from these real estate activities are passive by definition — unless you're a real estate professional. Then you can deduct rental real estate losses in full. Each year stands on its own. To qualify as a real estate professional, you must annually perform:

- More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- More than 750 hours of service in these businesses during the year.

Note that there are other nuances that you must be aware of, as well. If you fail either test and you have passive losses, you may want to increase your hours to meet the test and convert current-year passive losses into deductible losses. (See page 11 for more on passive loss rules.)

### Plan home sales carefully

When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for

joint filers) of gain if you meet certain tests. To support an accurate tax basis, maintain thorough records, including information on your original cost and subsequent improvements, reduced by casualty losses and any depreciation that you may have claimed based on business use.

The home sale gain exclusion won't apply to the extent that it relates to a home's "nonqualified use period." Generally, this is any period beginning on or after Jan. 1, 2009, during which the property isn't used as your principal residence. So if you convert a vacation home or rental property to your principal residence, part of any gain on its future sale may be taxable even if you've used it as a principal residence long enough to otherwise meet the gain exclusion's use test.

There's an exception for homes that are first used as a principal residence and then converted to nonqualified use. So, even if you don't live in your home while trying to sell it, you still may be eligible for the full gain exclusion, provided you meet the exclusion's other tests.

Losses on a principal residence aren't deductible. But if part of your home is rented or used exclusively for your business, the loss attributable to that portion will be deductible, subject to various limitations.

Because a second home is ineligible for the gain exclusion, it might make sense to convert it to rental use before selling. It will then be considered a business asset, and you may be able to defer tax on any gains by doing a like-kind exchange. (See below.) Or you may be able to deduct a loss — but only to the extent attributable to a decline in value *after* the conversion.

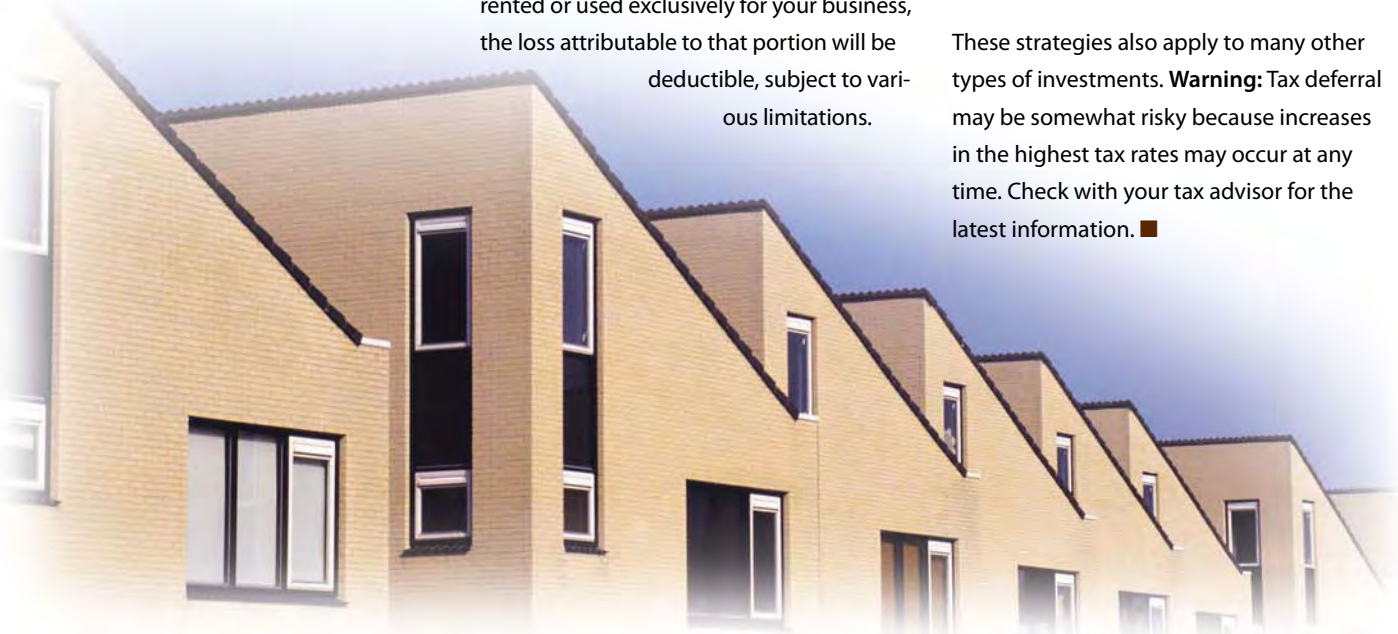
### Defer gains on investment property

With proper planning, you can divest yourself of appreciated investment real estate or rental property and defer the tax liability through one of these strategies:

**Like-kind exchange.** Also known as a Section 1031 exchange, this technique may allow you to defer paying tax on the gain until you sell the replacement property. **Warning:** Restrictions and significant risks apply.

**Installment sale.** An installment sale allows you to defer gains by spreading them over several years as you receive the proceeds. **Warning:** Ordinary gain, including certain depreciation recapture, is recognized in the year of sale, even if no cash is received.

These strategies also apply to many other types of investments. **Warning:** Tax deferral may be somewhat risky because increases in the highest tax rates may occur at any time. Check with your tax advisor for the latest information. ■





# Don't neglect long-term planning in hard economic times

If you own a business, it's likely your biggest investment. Unfortunately, it may be facing many of the same economic challenges as investments in the stock market and real estate. You may simply be trying to survive these challenges. But it's critical to think about long-term considerations as well.

## Save for retirement

If most of your money is tied up in your business, retirement can be a challenge. So if you haven't already set up a tax-advantaged retirement plan, consider setting one up this year. Keep in mind that, if you have employees, they generally must be allowed to participate in the plan, provided they work enough hours. Here are a few options:

**Profit-sharing plan.** This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2009 contributions (see Chart 2 on page 15 for limits) as late as the due date of your 2009 income tax return, including extensions — provided your plan exists on Dec. 31, 2009.

**SEP.** A Simplified Employee Pension (SEP) is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish the SEP in 2010 and still make deductible 2009 contributions (see Chart 2 for limits) as late as the due date of your 2009 income tax return, including extensions. Another benefit is that a SEP is easier to administer than a profit-sharing plan.

**Defined benefit plan.** This plan sets a future pension benefit and then actuarially

calculates the contributions needed to attain that benefit. The maximum annual benefit for 2009 is generally \$195,000 or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the 2009 contribution needed to attain the projected future annual benefit may exceed the maximum contributions allowed by other plans, depending on your age and the desired benefit.

You can make deductible 2009 contributions until Sept. 15, 2010, provided your plan exists on Dec. 31, 2009. **Warning:** Employer contributions are generally *required* and must be paid quarterly if there was a short-fall in funding for the prior year.

## Plan your exit

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting your money. This requires planning well in advance of the transition. Here are the most common exit options:

**Buy-sell agreements.** When a business has more than one owner, a buy-sell agreement can be a powerful tool. The agreement controls what happens to the business when a specified event

occurs, such as an owner's retirement, disability or death. Among other benefits, a well-drafted agreement:

- Provides a ready market for the departing owner's shares,
- Sets a price for the shares, and
- Allows business continuity by preventing disagreements caused by new, unwanted owners.

A key issue with any buy-sell agreement is providing the buyer with a means of funding the purchase. Life or disability insurance often helps fulfill this need and can give rise to several tax and nontax issues and opportunities.

One of the biggest advantages of life insurance as a funding method is that proceeds generally are excluded from the beneficiary's taxable income. There are exceptions, however, so be sure to consult your tax advisor.

**Succession within the family.** You can pass your business on to family members or close relatives by giving interests, selling interests or doing some of each. Be sure to consider your income needs, how family members will feel about your choice, and the gift and estate tax consequences.

Now may be a particularly good time to transfer ownership interests. If your business has lost value, you can transfer a greater number of shares without giving away more value for gift tax purposes. You also can leverage your annual gift tax exclusion (see page 22) by gifting

ownership interests, which may be eligible for valuation discounts.

So, for example, if the discounts total 30%, you can gift ownership interests equal to as much as \$18,571 per recipient tax free in 2009 because the discounted value doesn't exceed the \$13,000 annual exclusion. But the IRS may challenge the value; a professional appraisal is strongly recommended. Also, as of this writing, legislation has been proposed that might limit or eliminate discounts in this context; check with your tax advisor for the latest information.

Keep in mind that, if you still own your business at your death, some estate tax relief may be available under either a Section 303 redemption or a special estate tax deferral, which is allowed if closely held business interests exceed 35% of your adjusted gross estate.

**Nonfamily succession.** If family members aren't interested in or capable of taking over your business, one option is a management buyout. This may provide for a smooth transition because there may be little learning curve for the new owners. Plus you avoid the time and expense of finding an outside buyer.

If you want rank and file employees to become owners as well, an employee stock

## Chart 2

### Profit-sharing plan vs. SEP: How much can you contribute?

Profit-sharing plan	SEP
<b>2009 maximum contribution:</b> \$49,000 or \$54,500	<b>2009 maximum contribution:</b> \$49,000
<b>Eligibility:</b> You can't contribute more than 100% of your compensation. To qualify for the higher limit, your plan must include a 401(k) arrangement and you must be eligible to make catch-up contributions (that is, be age 50 or older). Additional rules may further limit your contribution.	<b>Eligibility:</b> You can't contribute more than 25% of your eligible compensation (net of the deduction for the contributions). So, to contribute \$49,000, your eligible compensation must exceed \$245,000.

ownership plan (ESOP) may be the ticket. An ESOP is a qualified retirement plan created primarily to purchase your company's stock. Whether you're planning for liquidity, looking for a tax-favored loan or supplementing an employee benefit program, an ESOP can offer you many advantages.

Finally, selling to an outsider can also be an excellent option. If you can find the right buyer, you may even be able to sell the business at a premium.

### Always consider taxes in a sale or acquisition

Whether you're selling your business as part of your exit strategy or acquiring another company to help grow it, the tax consequences can have a major impact on the transaction's success or failure. Here are a few key tax considerations:

#### Asset vs. stock sale.

With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. Buyers generally want

an asset sale to maximize future depreciation write-offs.

**Taxable sale vs. tax-deferred transfer.** A transfer of ownership of a corporation can be tax-deferred if made solely in exchange for stock or securities of the recipient corporation in a qualifying reorganization. But the transaction must comply with strict rules. Although it's generally better to postpone tax, there are some advantages to a taxable sale:

- The seller doesn't have to worry about the quality of buyer stock or other business risks that might come with a tax-deferred sale.
- The buyer benefits by receiving a stepped-up basis in its acquisition's assets and not having to deal with the seller as a continuing equity owner, as it would in a tax-deferred transfer.
- The parties don't have to meet the technical requirements of a tax-deferred transaction.

**Installment sale.** A taxable sale may be structured as an installment sale, due to the buyer's lack of sufficient cash or the seller's desire to spread the gain over a number of years. Installment sales also are useful when the buyer pays a contingent amount based on the business's performance. ■





## CHARITABLE GIVING

# Keep on giving to get substantial tax savings

In the current economy, you may be focused on holding on to what you have. But continuing to give to charity may still be a good move because of the substantial tax savings you'll get. Plus many charities are in desperate need of support. In determining your giving strategy, consider what to give, as well as how to give it.

### Keep it simple — donate cash

Outright gifts of cash (which include gifts made via check, credit card and payroll deduction) are the easiest. The key is to substantiate them. To be deductible, cash donations must be:

- Supported by a canceled check, credit card receipt or written communication from the charity if they're under \$250, or
- Substantiated by the charity if they're \$250 or more.

Deductions for cash gifts to public charities can't exceed 50% of your AGI. The AGI limit is 30% for cash gifts to nonoperating private foundations. Contributions in excess of the AGI limit can be carried forward for up to five years.

**AMT ALERT:** Charitable contribution deductions are allowed in figuring your AMT liability. But your tax savings may be less if you're subject to the AMT than they would be if you weren't. That is, if you're in the 35% tax bracket for regular tax purposes, but the 28% tax bracket for AMT purposes, your deduction may be worth only 28% instead of 35%.

### Make the most of stock gifts

Publicly traded stock and other securities you've held more than one year are long-term capital gains property, which can make one of the best charitable gifts. Why? Because you avoid paying tax on the gain you'd incur if you sold the property.

Donations of long-term capital gains property are subject to tighter deduction limits (30% for gifts to public charities, 20% for gifts to nonoperating private foundations). In limited circumstances it may be better to deduct your tax basis (generally the amount you paid for the stock) rather than the fair market value, because it allows you to take advantage of the higher AGI limits that apply to donations of cash and ordinary income property (such as stock held one year or less).

Don't donate stock that's worth less than your basis, though. Instead, sell the stock so you can deduct the loss and then donate the cash proceeds to charity.

### Make gifts over time

If you don't know which charities you want to benefit but you'd like to start making large contributions now, consider a private

foundation. It offers you significant control over how your donations will be used.

But you must comply with complex rules, which can make foundations expensive to run. Also, the AGI limits for deductibility of contributions to nonoperating foundations are lower.

If you'd like to influence how your donations are spent but avoid a foundation's tight rules and high expenses, consider a donor-advised fund. Many larger public charities offer them. **Warning:** To deduct your donor-advised fund contribution, you must obtain a written acknowledgment from the sponsoring organization that it has exclusive legal control over the assets contributed.

### Enjoy income from a CRT

To benefit a charity while helping ensure your own financial future, consider a charitable remainder trust (CRT):

- For a given term, the trust pays income to you (some of which will be taxable).
- At the term's end, the trust's remaining assets pass to one or more charities.
- When you fund the trust, you receive an income tax deduction for the present value of the amount that will go to charity.
- The property is removed from your estate.

A CRT also can help diversify your portfolio if you own non-income-producing assets that would generate a large capital gain if sold. Because a CRT is tax-exempt, it can sell the property without paying tax on

the gain at the time of the sale. Note, however, that this may end up being simply a deferral of the gain, because, depending on the CRT's future investment results, you may have to report the income and pay the tax. Regardless, the trust can invest the proceeds in a variety of stocks and bonds.

You can name someone other than yourself as income beneficiary or fund the trust at your death, but the tax consequences will be different.

### Save gift tax with a CLT

To benefit charity while transferring assets to loved ones at a reduced tax cost, consider a charitable lead trust (CLT):

- For a given term, the trust pays income to one or more charities.
- At the term's end, the trust's remaining assets pass to one or more loved ones you name as remainder beneficiaries.
- When you fund the trust, you'll be making a taxable gift equal to the present value of the amount that will go to the remainder beneficiaries.
- The property is removed from your estate.

For gift tax purposes, the remainder interest is determined assuming that the trust assets will grow at the IRC's Section 7520 rate. The lower the Sec. 7520 rate, the smaller the remainder interest and the lower the possible gift tax. If the trust's earnings outperform the Sec. 7520 rate, the excess earnings will be transferred to the remainder beneficiaries tax free.

Because the Sec. 7520 rate currently is low, it may be a good time to take the chance that your actual return will outperform it, thereby allowing you to transfer more to your heirs gift tax free. (For more on the gift tax, see page 22.)

You can name yourself as the remainder beneficiary or fund the trust at your death, but the tax consequence will be different. ■

## Chart 3 What's your donation deduction?



**Cash.** You may deduct 100%.



**Long-term capital gains property.** This includes stock held more than one year. You may deduct the current fair market value.



**Ordinary-income property.** Examples include stock held one year or less, inventory, and property subject to depreciation recapture. You generally may deduct only the lesser of fair market value or your tax basis.



**Tangible personal property.** Your deduction depends on the situation:

- If the property isn't related to the charity's tax-exempt function (such as an antique donated for a charity auction), your deduction is limited to your basis.
- If the property is related to the charity's tax-exempt function (such as an antique donated to a museum), you can deduct the fair market value.



**Use of property.** Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. There may, however, be ways to structure the gift to enable you to get a deduction.



**A vehicle.** Unless it's being used by the charity, you generally can deduct only the amount the charity receives when it sells the vehicle.

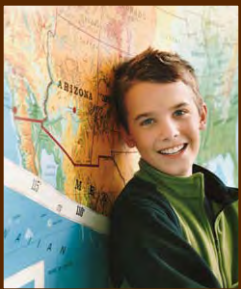


**Services.** You may deduct only your out-of-pocket expenses, not the fair market value of your services.



**IRA funds.** If you're 70½ or older, you can distribute up to \$100,000 from your IRA (Roth or traditional) to charity in 2009. No charitable deduction is allowed for any amount that would otherwise have been taxable, but you save the tax you would otherwise have owed.

*Note: Your 2009 charitable donation deductions may be reduced if they exceed certain limits based on your AGI, the type of donation and the type of charity receiving the donation. Various substantiation requirements also apply. See the main article, and consult your tax advisor for additional details.*



# Tax-smart strategies benefit kids, parents and even grandparents

Being tax-smart when it comes to your kids or grandkids benefits you both: You reduce income taxes and perhaps your taxable estate, and they benefit from an education funded by tax-advantaged programs. But remember that additional rules and limits apply to most of the strategies discussed, so consult your tax advisor before implementing them.

## Fund a tax-advantaged plan

Coverdell Education Savings Accounts (ESAs) and 529 savings plans offer parents (or anyone else, such as grandparents) a tax-smart way to fund education expenses:

- Plan assets grow tax-deferred.
- Distributions used to pay qualified expenses (such as tuition, equipment, supplies, books, fees and, generally, room and board) are income tax free for federal purposes and may be tax free for state purposes.
- Contributions aren't deductible for federal purposes.
- You maintain control of the account — even after the child is of legal age.
- You can make rollovers to another qualifying family member.

Which plan is better for you depends on your situation and goals. You may even want to set up both an ESA and a 529 plan for the same student.

## Pay for more with an ESA

Perhaps the biggest ESA benefit is that tax-free distributions aren't limited to college expenses. They also can fund elementary

and secondary school costs, including tutoring, computer costs, Internet access, and certain other costs. Another ESA benefit is that you have complete control over how your contributions are invested.

But the annual ESA contribution limit *per beneficiary* is only \$2,000. So an ESA likely won't be enough on its own to build up a sufficient college nest egg. Plus your contribution will be further limited if you're a single filer with AGI between \$95,000 and \$110,000 or a joint filer with AGI between

\$190,000 and \$220,000. The ability to contribute is eliminated if your AGI equals or exceeds the top of the applicable range.

## Save more with a 529 plan

529 college savings plans can be used to pay a student's qualifying expenses at most post-secondary educational institutions. For many taxpayers, 529 plans are better than ESAs because they typically offer much higher contribution limits (determined by the sponsoring state), and no AGI phaseouts apply.

The biggest downside may be that you don't have direct control over investment decisions; you're limited to the options the plan offers. But more flexibility for changing your investment options is available this year — see the Tax Law Change Alert. Also, you're allowed to make a tax-free rollover to a different 529 plan for the same child every 12 months.

### Tax Law Change Alert

#### 529 plans temporarily more flexible

**Who's affected:** 529 plan owners and beneficiaries.

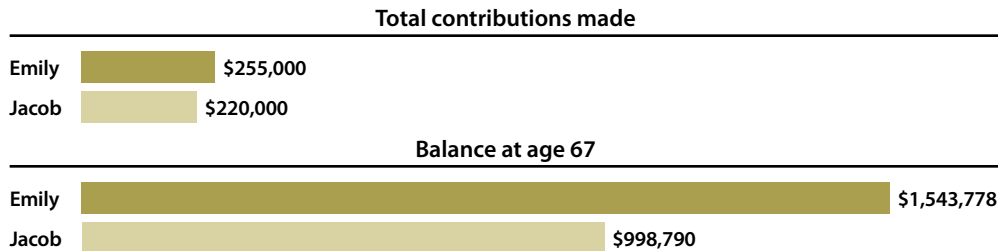
**Key changes:** For 2009 and 2010, the definition of "qualified education expense" for tax-free 529 plan distributions has been expanded to include computers, computer technology and Internet service. Additionally, you can make changes to your 529 plan investment options up to two times during 2009, rather than just once during the year or when you change beneficiaries. (Note that these limits apply only to funds already in the plan; each time you make a new contribution, you can select a different option for that contribution if you wish, regardless of how many times you contribute throughout the year.)

**Planning tips:** 529 plan owners with beneficiaries who are in college this year or will be next year may want to use plan funds to purchase computers as soon as they're eligible, in case the expanded definition isn't extended beyond 2010. Also be sure to evaluate your 529 investments regularly so you can take advantage of the added opportunity to make a change if needed.

## Case Study 4

# Teens can reap great future rewards with Roth IRAs

Roth IRAs can be perfect for teenagers — just look at how much difference starting contributions early can make: Both Emily and Jacob contribute \$5,000 per year to their Roth IRAs through age 66. But Emily starts contributing when she gets her first job at age 16, while Jacob waits until age 23, after he's graduated from college and started his career. Emily's additional \$35,000 of early contributions result in a nest egg at full retirement age of 67 that's more than \$500,000 larger!



*Note: This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume \$5,000 is contributed at the end of each year over the ages indicated and a 6% rate of return. See "Start kids on Roth IRAs," below, for more information on contribution rules.*

529 plans also are available in the form of a prepaid tuition plan, which either a state or a private institution can provide. If your contract is for four years of tuition, tuition is guaranteed regardless of its cost at the time the beneficiary actually attends the school. Perhaps the main downside of prepaid tuition plans is that there's uncertainty in how benefits will be applied if the beneficiary attends a different school.

Your state may offer tax benefits to residents who invest in its own 529 savings plan or prepaid tuition program.

### Jumpstart a 529 plan

To avoid gift taxes on 529 plan contributions, you must either limit them to \$13,000 annual exclusion gifts or use up part of your \$1 million lifetime gift tax exemption. Fortunately, a special break for 529 plans allows you to front-load five years' worth of annual exclusion gifts (\$65,000, or \$130,000 if you split the gift with your spouse) in one year. And that's *per beneficiary*.

If you're a grandparent, this can be a powerful estate planning strategy. Because

annual exclusion gifts are generally also excluded from generation-skipping transfer (GST) tax, you can avoid any GST tax liability as well. (See page 22 for more on gift and estate planning.)

### Watch out for the kiddie tax

The income shifting that once — when the "kiddie tax" applied only to those under age 14 — provided families with significant tax savings now offers much more limited benefits. The kiddie tax now applies to children age 18 and younger, as well as to full-time students under age 24 (unless the students provide over half of their own support from their earned income).

For those subject to the kiddie tax, unearned income beyond \$1,900 (for 2009) is taxed at their parents' marginal rate, rather than their own, likely lower, rate. So consider how this may alter your tax and estate planning strategies.

### Start kids on Roth IRAs

The children in your life may be able to benefit from a Roth IRA. Putting away what seems like a small amount now can

really multiply. (See Case Study 4.) Best of all, qualified distributions will be tax free.

The 2009 contribution limit is the lesser of \$5,000 or 100% of earned income from a legitimate job reported on the child's tax return. Contributions aren't deductible, but if the child earns no more than \$5,700 (the 2009 standard deduction for singles) and has no unearned income, he or she will pay zero federal income tax. If a child earns more than \$5,700, the income likely will be taxed at only 10% or 15%. So the tax-free treatment of future qualified distributions will likely be well worth the loss of any current deduction.

If your children or grandchildren don't want to invest their hard-earned money, consider giving them the amount they're eligible to contribute — but keep the gift tax in mind. (See page 22.) If they don't have earned income and you own a business, consider hiring them. As the business owner, you can deduct their pay, and other tax benefits may apply.

**Warning:** They must perform actual work and be paid in line with what you'd pay nonfamily employees. ■



## RETIREMENT

# As you save (and manage), so shall you enjoy

For those who plan and save, retirement truly can be the best time of life. But even if you've been able to put away a tidy sum for your later years, don't drop your guard. Shifts in the economy, tax laws and your personal situation can suddenly leave you with a lot less than you anticipated. So make it a point to never retire from retirement planning.

### Max out your retirement plan

Contributing the maximum you're allowed (See Chart 4) to an employer-sponsored retirement plan, such as a 401(k), 403(b), 457, SARSEP or SIMPLE, is likely a smart move:

- Contributions are usually pretax, so they reduce your taxable income.
- Plan assets can grow tax-deferred — you pay no income tax until you take distributions.
- Your employer may match some or all of your contributions — also on a pretax basis.

Unfortunately, many employers (if their plans allow) are suspending matching contributions to reduce costs in our troubled economy. If yours is among them, don't use that as an excuse to suspend your own contributions; you'll exacerbate the negative impact on your retirement nest egg, and your taxable 2009 income will increase compared to what it would be if you had contributed to the plan.

Your 401(k) or 403(b) plan also may offer an alternative "Roth" version that allows tax-free distributions, but contributions aren't pretax, and employer matches aren't

eligible to be treated as Roth contributions. Roth plans may be especially beneficial for higher-income earners who are ineligible to contribute to Roth IRAs.

If you're a business owner or self-employed, you may be able to set up a plan that allows you to make even larger contributions. (See page 14 for details.)

### Don't withdraw early

With a few exceptions, retirement plan distributions made before age 59½ are subject to a 10% penalty, in addition to income tax. This means that, if you're in the top federal tax bracket of 35%, you can lose close to half of your withdrawal to federal taxes and penalties. If you're subject to state income taxes and/or penalties, the total of your taxes and penalties may easily exceed 50%. Additionally, you'll lose the potential tax-deferred future growth on the amount you've withdrawn.

When you change jobs or retire, you'll want to avoid taking a lump-sum

withdrawal because it generally will be taxable, plus potentially subject to the 10% penalty. Here are options that will help you avoid current income tax and penalties:

**Stay put.** If you have more than \$5,000 in your account, you can leave the money there. But if you're changing employers or already have an IRA, this may not be the best option, because keeping track of multiple plans can make managing your retirement assets more difficult. Also assess the plan's investment options.



### Roll over to your new employer's plan.

This may be a good solution if you're changing jobs and it will leave you with only one retirement plan to keep track of. But first compare the new plan's investment options to the old plan's options.

**Roll over to an IRA.** This may be the best alternative because IRAs offer nearly unlimited investment choices. Plus you'll have the option (at least in 2010 or later) to convert to a Roth IRA. (See below.)

If you choose a rollover, request a direct rollover from your old plan to your new plan or IRA. Otherwise you'll need to make an indirect rollover within 60 days to avoid tax and potential penalties. **Warning:** The check you receive from your old plan may be net of 20% federal income tax withholding. If you don't roll over the gross amount (which will require making up for the withheld amount with other funds), you'll likely be subject to income tax, and potentially the 10% penalty, on the difference.

### Consider Roth conversion

If you have a traditional IRA, start thinking about converting it to a Roth IRA once the income restriction on conversions is



waived in 2010. You can convert tax-deferred future growth into tax-free growth. Additionally, a Roth IRA is a great estate planning vehicle: No distributions are required during your life, and, after your death, your beneficiary can withdraw the money tax free over his or her lifetime, while funds remaining in the account continue to grow tax free. (See page 22 for more on estate planning.)

The disadvantage of a conversion is that the rolled over amount is taxable in the year of the rollover. But for conversions made in 2010, the income can be deferred in equal installments to 2011 and 2012.

### Plan your distributions

You generally must take annual required minimum distributions (RMDs) from your retirement plans after age 70½. If you don't take your RMD, you'll be subject to a 50% penalty on the amount you should have taken (except for 2009 — see the Tax Law Change Alert). You can avoid the RMD rule for a Roth 401(k) or Roth 403(b) by rolling the funds into a Roth IRA.

So, should you take distributions between ages 59½ and 70½, or more than the RMD after age 70½? Distributions in any year your tax bracket is low may be beneficial. But also consider the lost tax-deferred growth and, if applicable, whether the distribution could cause your Social Security payments to become taxable.

If you've inherited a retirement plan, consult your tax advisor regarding the distribution rules that apply to you. ■

#### Tax Law Change Alert

### RMD rules suspended for 2009

**Who's affected:** Seniors and others who otherwise would have to take required minimum distributions (RMDs) from their retirement plans in 2009.

**Key changes:** The Worker, Retiree and Employer Recovery Act of 2008 suspends the RMD excise tax for 2009 for IRAs (including inherited IRAs) and defined contribution plans, including 401(k), 403(b) and 457 plans.

The new law gives taxpayers otherwise subject to the RMD rules the option to keep funds in their plans for another year without incurring a tax penalty — providing time for their investments to perhaps recoup recent losses. Many seniors have been particularly hard hit, because those having to take RMDs in 2008 had to base their withdrawals on Dec. 31, 2007, values — which in many cases were considerably higher than current ones. This provision applies regardless of the retirement plan's account balance or whether the plan has incurred any losses.

**Planning tips:** If you're subject to the RMD rules, consider whether you can benefit from reducing or skipping your 2009 distribution. Your tax advisor can help you crunch the numbers to determine the wisest course of action.



## ESTATE PLANNING

# Make sure your heirs inherit your wealth

Yes, death and taxes are inevitable. But that doesn't mean they have to go together. By taking advantage of all the exemptions, deductions and estate planning strategies available, you can leave the legacy you desire to your loved ones, not Uncle Sam.

### Take steps to cut taxes

The top gift and estate tax rates and the generation-skipping transfer (GST) tax rate are currently 45%. As of this writing, the estate and GST taxes are scheduled to be repealed for 2010 only, while the gift tax is set to remain in place that year, albeit at a lower rate.

However, it's expected that the repeal will be repealed, and rates might remain at 2009 levels. (Check with your tax advisor for the latest information.) So taking steps to minimize these taxes is as important as ever. Fortunately, some exemptions, exclusions and deductions are available to help you do just that:

**Gift and estate tax exemptions.** During your lifetime, the gift tax exemption allows you to transfer up to \$1 million of taxable gifts without paying gift tax. At death, transfers up to the estate tax exemption amount minus any gift tax exemption used can be made free of estate tax. For 2009, the estate tax exemption amount is \$3.5 million. (See the Tax Law Change Alert.)

**Annual gift tax exclusion.** You can exclude certain gifts of up to \$13,000 per recipient each year (\$26,000 per recipient if your spouse elects to split the gift with you, or

you're giving community property) without using up any of your gift tax exemption. If you gift more than \$13,000 during the year to one person, you must file a gift tax return, even if no tax is due.

**Unlimited marital deduction.** Your estate generally can deduct the value of all assets that pass from you to your spouse at your death, provided your spouse is a U.S. citizen.

**GST tax exemption.** The GST tax applies to transfers (both during life and at death) made to people two generations or more below you, such as grandchildren. For 2009, the GST tax exemption is \$3.5 million. (See the Tax Law Change Alert.)

**Charitable deduction.** There's no limit on this deduction. If you bequeath your entire estate to charity, no estate tax will be due. (For more on charitable giving, see page 16.)

**Warning:** State gift and estate tax laws vary, so state tax could be due even when there's no federal liability.

### Start giving now

One way to reduce your taxable estate is to start giving away assets now. Consider maximizing your annual exclusion gifts (see Case Study 5) and perhaps also using part or all of your \$1 million gift tax exemption. Here are some additional strategies for tax-smart giving:

**Choose gifts wisely.** Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make. For example, to minimize *your estate tax*, gift property with the greatest future appreciation potential. In fact, an upside of the down economy

#### Tax Law Change Alert

### Estate and GST tax exemptions increase in 2009

**Who's affected:** Anyone concerned about estate and generation-skipping transfer (GST) taxes.

**Key changes:** Under 2001 tax legislation, the estate and GST tax exemptions have both gone up to \$3.5 million for 2009 from \$2 million in 2008. As of this writing, after the estate and GST tax repeal scheduled for 2010 (see main article), the exemptions are set to drop significantly for 2011, though legislation this year might extend (and perhaps increase) the \$3.5 million exemptions.

**Planning tips:** Don't take a wait-and-see attitude about reviewing your estate plan; review it now. Depending on how your plan is set up, it may require updates to avoid unexpected and undesirable results. Plus, with proper planning, you can make the most of the increased exemptions.

is that reduced asset values can allow you to transfer more shares at a lower tax cost, removing more potential future appreciation from your estate.

To minimize *your beneficiary's income tax*, gift property that hasn't already appreciated significantly since you've owned it.

And if you want to minimize *your own income tax*, don't gift property that has declined in value. Instead sell the property so you can take the tax loss and then gift the sale proceeds.

#### Plan gifts to grandchildren carefully.

Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts that don't qualify for the exclusion to be completely tax free, you must apply both your GST tax exemption and your gift tax exemption.

So, for example, if you already made an annual exclusion gift to your grandson for the year and you want to give him an additional \$30,000 to help him make a down payment on his first home, you'll have to use \$30,000 of your GST tax exemption plus \$30,000 of your gift tax exemption to avoid any tax on the transfer.

**Gift interests in your business.** If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. (See page 14.)

**Gift FLP interests.** If you don't own a business but you'd like to benefit from valuation discounts, you can set up a family limited partnership (FLP). You fund the FLP and then gift limited partnership interests. But there's some uncertainty whether discounts for such transfers will remain available. Also, the IRS is scrutinizing FLPs, so make sure you set up and operate yours properly.

**Pay tuition and medical expenses.** You may pay these expenses for a loved one

### Case Study 5

## Gifts now mean estate tax savings later

The annual gift tax exclusion can be a powerful tool. Just look at how much a married couple giving to two children and their spouses and four grandchildren can remove from their estates tax-free: \$208,000.



\$26,000 each =  
**\$130,000**



\$26,000 each =  
**\$78,000**



**\$208,000**  
removed from their estate

without the payment being treated as a taxable gift, as long as the payment is made directly to the provider.

#### Consider trusts and insurance

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. Here are some trusts you may want to consider:

- A credit shelter (or bypass) trust can help minimize estate tax by taking advantage of both spouses' estate tax exemptions.
- A qualified domestic trust (QDOT) can allow a non-U.S.-citizen spouse to benefit from the unlimited marital deduction.
- A qualified terminable interest property (QTIP) trust is good for benefiting first a surviving spouse and then children from a prior marriage.
- A qualified personal residence trust (QPRT) allows you to give your home to your children today — removing it from your taxable estate at a reduced tax cost (provided you survive the trust's term) — while you retain the right to live in it for the trust's term.

- A grantor-retained annuity trust (GRAT) works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period.
- A Crummey trust allows you to enjoy both the control of a trust that will transfer assets at a later date and the tax savings of an outright gift.
- An irrevocable life insurance trust (ILIT) can keep insurance proceeds out of your estate (and possibly your spouse's) and may be structured as a Crummey trust so annual exclusion gifts can fund the ILIT's payment of premiums.
- A GST or dynasty trust can help you leverage your GST tax exemption.

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax. Proceeds are generally income tax free to the beneficiary. And with proper planning, you can ensure proceeds are not included in your taxable estate. ■

**TAX RATES**

**Chart 5**  
2009 individual income tax rate schedules

Regular tax brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	\$ 0 – \$ 8,350	\$ 0 – \$ 11,950	\$ 0 – \$ 16,700	\$ 0 – \$ 8,350
15%	\$ 8,350 – \$ 33,950	\$ 11,950 – \$ 45,500	\$ 16,700 – \$ 67,900	\$ 8,350 – \$ 33,950
25%	\$ 33,950 – \$ 82,250	\$ 45,500 – \$ 117,450	\$ 67,900 – \$ 137,050	\$ 33,950 – \$ 68,525
28%	\$ 82,250 – \$ 171,550	\$ 117,450 – \$ 190,200	\$ 137,050 – \$ 208,850	\$ 68,525 – \$ 104,425
33%	\$ 171,550 – \$ 372,950	\$ 190,200 – \$ 372,950	\$ 208,850 – \$ 372,950	\$ 104,425 – \$ 186,475
35%	Over \$ 372,950	Over \$ 372,950	Over \$ 372,950	Over \$ 186,475

AMT brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	\$ 0 – \$ 175,000	\$ 0 – \$ 175,000	\$ 0 – \$ 175,000	\$ 0 – \$ 87,500
28%	Over \$ 175,000	Over \$ 175,000	Over \$ 175,000	Over \$ 87,500

AMT exemption				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Exemption	\$ 46,700	\$ 46,700	\$ 70,950	\$ 35,475
Phaseout <sup>1</sup>	\$ 112,500 – \$ 299,300	\$ 112,500 – \$ 299,300	\$ 150,000 – \$ 433,800	\$ 75,000 – \$ 216,900

<sup>1</sup> The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

Note: Consult your tax advisor for AMT rates and exemptions for children subject to the kiddie tax.

Source: U.S. Internal Revenue Code

**Chart 6**  
2009 corporate income tax rate schedule

Tax rate	Tax bracket
15%	\$ 0 – \$ 50,000
25%	\$ 50,001 – \$ 75,000
34%	\$ 75,001 – \$ 100,000
39%	\$ 100,001 – \$ 335,000
34%	\$ 335,001 – \$10,000,000
35%	\$10,000,001 – \$15,000,000
38%	\$15,000,001 – \$18,333,333
35%	Over \$18,333,333

Note: Personal service corporations are taxed at a flat 35% rate.  
Source: U.S. Internal Revenue Code



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