



YEAR-END INCOME TAX PLANNING

FOR INDIVIDUALS

INTRODUCTION

Each year, we work with our clients to maximize tax savings through year-end planning. Traditionally, we have recommended that you make sure your income is taxed at the lowest possible rate, and that you postpone your taxes by deferring taxable income and accelerating deductions. These time-honored strategies are still generally beneficial for 2003. In addition, recent tax legislation makes tax planning for 2003 even more critical. The "Jobs and Growth Tax Relief Reconciliation Act of 2003" offers several tax planning opportunities primarily due to the following three law changes: reducing the individual income tax rates on ordinary income; lowering the tax rate for most long-term capital gains and dividends to 15%; and providing generous write-offs to businesses for qualifying asset purchases. We are sending you this letter to bring you up-to-date on the many new tax planning opportunities under the 2003 Tax Act, and to remind you of several "tried and true" year-end tax planning strategies.

Please keep in mind that moving income from one tax year to another may reduce your personal exemptions and itemized deductions, or may subject you to the alternative minimum tax (AMT). It is projected that approximately 2.4 million taxpayers will be hit with AMT in 2003. Consequently, you should not adopt any tax planning strategy contained in this letter without first computing the impact of the strategy on your overall tax liability, including your alternative minimum tax liability for 2003 and 2004. Therefore, **we suggest that you call our firm before implementing any tax planning technique discussed in this letter.** You cannot properly evaluate a particular planning strategy without calculating your overall tax with and without that strategy. Please be careful!

Please Note! This letter contains ideas for Federal Income tax planning only. State income tax issues are not addressed.

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HIGHLIGHTS OF THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003

The Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into law May 28, 2003. This major tax legislation contains several provisions that will have a significant impact on "individual" taxpayers for 2003. These new law changes should be considered as you evaluate year-end tax planning strategies.

More Income Taxed At 10% Effective January 1, 2003. **Retroactive to January 1, 2003**, the new law increases the amount of income taxed at 10% from \$6,000 to \$7,000 for single filers (a maximum savings of \$50) and from \$12,000 to \$14,000 for joint filers (a maximum savings of \$100). For heads of households, the 10% tax bracket was not changed and continues to apply to the first \$10,000 of taxable income. **Planning Alert!** The new expanded 10% tax bracket for joint and single filers **only applies for 2003 and 2004**. For 2005 through 2007, the 10% bracket reverts back to the \$6,000 and \$12,000 amounts. The 10% rate does not apply to trusts or estates.

Acceleration Of Rate Reductions To January 1, 2003. The new law accelerates individual marginal tax rate cuts that were previously scheduled to be fully effective in 2006. **Effective January 1, 2003**, the top four tax rates are reduced to 25%, 28%, 33%, and 35% (down from 27%, 30%, 35%, and 38.6%). For income taxed in the highest bracket, this is a 3.6% rate decrease. For income taxed in the 27%-35% tax brackets, it is a 2% rate decrease. However, due to the sunset provisions of the 2001 Act, these new rates will increase to 28%, 31%, 36%, and 39.6% after 2010. **Planning Alert!** Certain itemized deductions and personal exemptions are reduced as your adjusted gross income exceeds certain thresholds. Therefore, your "effective tax rate" is usually greater than these "official rates." **Caution!** Even though the tax rates for 2003 have been reduced, if your total tax liability for 2003 is greater than your total liability for 2002 (e.g., because your income is up or your deductions are down), reducing your withholding without careful planning could result in an underpayment penalty. **If we worked with you to establish the amount of your 2003 withholding and your withholding has been reduced during 2003, please call our firm. We may need to increase your withholding before year end to avoid underpayment penalties.**

Alternative Minimum Tax Exemption Increased. We actually have two tax systems. The regular tax system and the alternative minimum tax system (AMT). Your tax is calculated under each system and you pay the higher amount. The AMT was originally enacted so individuals who reduced their taxes with aggressive deductions (e.g., tax shelter deductions, accelerated depreciation, etc.) would pay some "minimum tax." However, each year the number of individuals paying the AMT increases. One reason more people are paying the AMT is that income levels are increasing, but, the amount of income exempt from the AMT has not increased significantly. **For years beginning in 2003 and 2004**, the AMT exemption amount is increased from \$49,000 to \$58,000 for married taxpayers, and from \$35,750 to \$40,250 for single taxpayers. **Planning Alert!** These increased exemption amounts do not solve the alternative minimum tax problem. However, they provide a small amount of temporary relief.

Child Tax Credit Increased. For 2002, you were allowed a \$600 tax credit for each child under age 17 and the credit was reduced if your "modified adjusted gross income" on a joint return exceeded \$110,000 (\$75,000 if single). **For 2003 and 2004**, the new law increases the child tax credit to \$1,000. **Tax Tip.** The Act does not increase the income phase-out thresholds. However, by increasing the credit from \$600 to \$1,000, you can now earn more income before completely phasing out your credit. For example, if you have one qualifying child, and you file a joint return, last year your credit would have phased out completely if your modified adjusted gross income exceeded \$121,000. For 2003, with one qualifying child, your credit will not completely phase out unless your income exceeds \$129,000. Also remember, you may be entitled to a refund of your child credit even if the credit exceeds your federal income tax liability. For 2003, you may receive a refundable credit to the extent of 10% of your "earned income" in excess of \$10,500.

- **You May Have Received An Advance Payment Check This Year.** If you claimed the child credit on your 2002 return and your child will not be age 17 or older by the end of 2003, you may have received a check from the IRS of up to \$400 per eligible child. **Tax Tip.** This advance payment will reduce your 2003 child credit because, in effect, it represents an advanced payment of your 2003 credit. However, if you did get a check, and it turns out to be greater than the child credit that you are



actually entitled to on your 2003 return, you will not be required to return the excess.

- **Where Is My Check?** If you didn't get a check and you think you might be entitled to one, simply go to the IRS website (www.irs.gov) and click on "Individuals," and then click on "where's my advance child tax credit?" for information on the status of your payment.

Marriage Penalty Relief. If you are married and file a joint return with your spouse, you may be paying more income tax than the total you and your spouse would pay if you were each single. This so-called "marriage penalty" generally occurs when each spouse has significant income. Sometimes, this penalty makes it advantageous for engaged couples (both of whom have significant income) to postpone November or December weddings until January of the following year to save taxes. The new law reduces the tax penalty for marriage by increasing the standard deduction and the size of the 15% tax bracket on a joint return.

- **Increased Standard Deduction For Married Taxpayers.** For 2003 and 2004, the basic standard deduction for a joint return is increased to twice the standard deduction for a single person. Therefore, the new law increases the standard deduction on a joint return from **\$7,950 to \$9,500 for 2003.** **Planning Alert!** If your itemized deductions (e.g., home mortgage interest, state and local taxes, etc.) exceed this increased standard deduction, you will receive no tax benefit from this change. However, you may benefit from the increase in the 15% tax bracket for married taxpayers discussed below.
- **Married Taxpayers Will Have More Income Taxed At 15%.** Prior to the law change, the ending point of the 15% tax bracket on a joint return was 167% of the ending point of the 15% tax bracket on a single person's return. For 2003 and 2004, the ending point of the 15% tax bracket on a joint return is double the ending point of the 15% tax bracket on a single person's return. **Tax Tip.** If you are a joint filer, this change could reduce your taxes by as much as **\$935** for 2003.

Long-Term Capital Gains Tax Reduced. The new law generally reduces the tax rate on long-term capital gains from 20% to 15%. The new 15% rate applies only to capital gains "properly taken into account" **after May 5, 2003 and before 2009.** For pass-through entities (e.g., S corporations, partnerships, LLCs, etc.), the determination of when capital gains are "properly taken into account" is made at the entity level. This means that the new 15% rate will apply to the owner of a calendar or fiscal year pass-through entity so long as the qualified long-term capital gain is properly taken into account by the pass-through entity after May 5, 2003. If the long-term capital gains would otherwise be taxed in the 10% or 15% regular tax bracket, the long-term capital gain rate is reduced from 10% to 5% from May 6, 2003 through 2007. **For 2008 only,** the tax rate on qualifying long-term capital gains for taxpayers who would otherwise be in the 10% or 15% tax bracket is **zero**. Also, the 18% and 8% rates for assets held more than five years are repealed until 2009. Each of these rate changes sunset after 2008, and on January 1, 2009, the tax rates on long-term capital gains revert back to 20%, 10%, 18% or 8%.

The following are important points to keep in mind regarding these new rate reductions for long-term capital gains:

- **The New 15%/5% Rates Do Not Apply To All Capital Gains.** The new 15%/5% capital gains rates only apply to capital gains that would otherwise qualify for the 20% or 10% rates under the old rules. Therefore, the maximum capital gains rate on "collectibles" (e.g., artwork, antiques, etc.) and "qualified small-business stock" (which qualifies for a 50% capital gains exclusion) remains at 28%. Likewise, if you sell a depreciable building, the gain attributable to the straight-line depreciation you took on the building is taxed at a maximum capital gains rate of 25% and does not qualify for the new 15%/5% rates. **Tax Tip.** Any gain on the sale of a building held for over one year that exceeds the portion allocable to previously-taken straight line depreciation (i.e., a building sold for greater than its original cost), will qualify for the new 15%/5% tax rate. Furthermore, if you sell the assets of an operating business (other than assets owned by a regular "C" corporation), any gain attributable to sale of "goodwill" taxed to an individual owner should also qualify for the new 15%/5% tax rates—provided that you have owned and operated the business for over one year.



- **Lower Income Taxpayers.** As mentioned above, if your long-term capital gains would otherwise be taxed in the 10% or 15% ordinary income tax rate bracket, your capital gains rate is reduced to 5% (down from 10%) from May 6, 2003 through 2007. **For 2008 only**, the long-term capital gains rate will be **zero** for taxpayers in the 10% or 15% tax bracket. **Tax Tip.** If you plan to sell an appreciated long-term capital gain asset before 2008, you might consider giving the property to a child over age 13 (who would be exempt from the “kiddie” tax) prior to the sale. If the child sells the property and the gain would otherwise be taxed in the child’s 10% or 15% tax bracket, you could reduce the tax on the sale of the property from 15% to 5%. If the child sells the property in 2008 and the gain would otherwise be taxed in the child’s 10% or 15% tax bracket, the tax on the long-term capital gain would be **zero**. **For example**, in 2003, a single child over age 13 can have income of up to \$28,400 taxed no greater than 15%. Thus, assuming the child has no other income, shifting a long-term capital gain to the child could save up to \$2,840 [$\$28,400 \times 10\%$] in federal taxes. **Planning Alert!** Be sure to give the property to the child before you contract to sell it. If the property is under contract before the gift, there is case law suggesting that the gain should be taxed to you. **Caution!** The proceeds from the sale belong to the child.
- **Prior Year Installment Sales May Qualify For New Rates.** The new 15%/5% capital gains rates apply to any long-term capital gains “properly taken into account” after May 5, 2003. Consequently, if you are reporting long-term capital gains on collections from a qualified installment sale of property that occurred prior to May 6, 2003, capital gains triggered by collections after May 5, 2003, that were previously taxed at 20%, will now qualify for the new 15%/5% capital gains rates.
- **New Capital Gains Rates Apply In Calculating AMT.** The new law makes it clear that the lower capital gains rates apply for both regular tax and “alternative minimum tax” purposes. **Planning Alert!** State income taxes on capital gains are not deductible for AMT purposes and, therefore, may trigger AMT. Please call our office if you anticipate a large capital gain and we can help you time your payment of state income taxes to minimize your AMT exposure.

Maximum Tax On Dividends Reduced From 38.6% To 15%. Tax relief for qualifying dividends is one of the key provisions of the 2003 Tax Act. The new legislation provides that dividends paid to individuals **in 2003 through 2008** will be taxed at a maximum rate of 15%. **For 2003 through 2007**, the rate is 5% for taxpayers who would otherwise be in the 10% or 15% ordinary income tax bracket. **For 2008 only**, the tax rate on dividends for taxpayers who would otherwise be in the 10% or 15% tax bracket is **zero**. After 2008, dividends will no longer qualify for these special rates and will once again be taxed at the regular individual tax rates. The reduced tax rate on dividends applies for both regular and alternative minimum tax purposes.

The following are points to keep in mind concerning the new rules for taxing dividends:

- **Closely-Held Corporation Stock Qualifies.** Although earlier proposals would have allowed tax relief only to dividends paid by “publicly-traded corporations,” the final legislation generally applies the new lower tax rates to dividends paid by most domestic corporations (closely-held as well as publicly-traded). However, only dividends from “qualifying” foreign corporations qualify for the reduced rates.
- **Certain Dividends Do Not Qualify.** There is a laundry list of dividends that do not qualify for the new lower rates such as dividends from various tax exempt organizations and farmers’ cooperatives, certain dividends paid by mutual savings banks, payments made “in lieu of dividends,” dividends on certain stock that is held for 60 days or less, and deductible dividends paid on ESOP stock. Generally, dividend distributions from Regulated Investment Companies (RICs) and distributions from Real Estate Investment Trusts (REITs) will qualify for the 15%/5% rates to the extent that the RIC (mutual fund) or the REIT receives and distributes qualifying dividend income. Please call our firm if you want more information on what constitutes a “qualifying” dividend.
- **Stock Redemptions (Dividends Vs. Capital Gains).** Historically, if your corporation redeemed all of your stock, you might be taxed at the preferential capital gains rates, but only if you satisfied very rigid requirements. Where family members also owned stock, this often meant that you could not be a



stockholder, officer, director, or employee of the corporation after the redemption. If you failed those requirements, your stock redemption was taxed as a “dividend.” **Tax Tip.** Under the 2003 Tax Act, for 2003 through 2008, your corporation might just pay a dividend. The new lower rates on dividends provide a shareholder a way to “bail out” corporate cash accumulations at 15% or 5% tax rates, while continuing to be a shareholder, officer, director, or employee. **Planning Alert!** Qualifying the distribution as a stock redemption producing long-term capital gain may still save you taxes if: **(1)** you have a **high basis** in your stock (dividend treatment does not allow you to offset stock basis), **(2)** you have **significant capital losses** (you can’t offset capital losses in excess of \$3,000 against dividend income), **(3)** your state provides special tax rates or exclusions for long-term capital gains but not for dividends **and/or** **(4)** the dividend is paid with a **promissory note** from the corporation (if the distribution is treated as a dividend, the value of the note will be taxed in the year of distribution not as the note is collected).

- **Compensation Vs. Dividends.** If you are a majority stockholder and an employee of your regular “C” corporation, you have probably debated whether you would pay less taxes by paying yourself “salary or bonus” (taxed at a maximum rate of 35% and generally subject to FICA tax) or a “dividend” (taxed at a maximum rate of 15% and generally exempt from FICA tax). Although paying a dividend may appear preferable because of the low 15% tax rate, the total taxes paid by you and your corporation may actually be greater by paying the dividend. The dividend may actually cost you and your corporation taxes after you factor in the tax cost of the lost compensation deduction at the corporate level (compensation should be deductible by the corporation but dividends are not). **Planning Alert!** Bottom line—deciding whether to pay a dividend or compensation requires a careful analysis including detailed calculations. Please call us before you decide to substitute a compensation payment with a dividend payment.
- **S Corporations And Dividends.** If your corporation has always been an “S” corporation, it generally cannot make a taxable “dividend” distribution on its stock. Instead, distributions to you as a stockholder are tax free to the extent of your stock basis. A distribution exceeding your stock basis will be taxed as a long-term capital gain (taxed at the maximum 15% rate) if you have owned the stock more than a year. However, if your “S” corporation was formerly a regular “C” corporation that had “earnings and profits,” it is possible that your “S” corporation distributions are “dividends” taxed at the maximum 15% rate. **Planning Alert!** If your “S” corporation has “earnings and profits” and also generates too much “passive investment income” (e.g., royalties, dividends, interest, certain rents, etc.), your corporation could be subject to a 35% penalty tax and could possibly lose its “S” election. **Tax Tip.** These potential problems could be eliminated by making a special election to distribute the “C” corporation earnings and profits as a taxable dividend. Call us for more details!
- **Trusts And Estates Qualify For New 15% Rates.** For 2003, ordinary income accumulated in a trust or estate in excess of \$9,350 is taxed at the highest rate of 35%. **Tax Tip.** Trusts and estates get the benefit of the new 15% rate on qualifying dividends (for tax years beginning after 2002) and capital gains (for gains properly taken into account after May 5, 2003). Investing trust and estate assets in dividend paying and capital gain producing investments could reduce the tax rates on the income from 35% to 15%.
- **Dividends And The Investment Income Limitation.** If you borrow money to buy certain investment assets, your deduction for the interest you pay on those borrowed funds is limited to your “net investment income.” This is known as the investment interest limitation. Under the 2003 Tax Act, dividends will be treated as “investment income” (which could allow you to deduct investment interest) only if you affirmatively elect to tax the dividends at ordinary income tax rates (i.e., foregoing the new 15%/5% rates). Prior to 2003, long-term capital gains were treated as investment income for purposes of the investment interest deduction limitation only if we elected to treat the capital gains as ordinary income. Now, this rule applies both to long-term capital gains and to dividends qualifying for the 15%/5% tax rates. **Planning Alert!** Determining whether it is better to treat dividends or long-term capital gains as net investment income typically requires complex computations. Also, the election cannot be revoked without IRS consent.
- **Maximum \$3,000 Of Capital Losses Allowed Against Dividend Income.** Although most long-term



capital gains and qualifying dividend income are both taxed at the 15%/ 5% tax rates, capital losses can generally be used only to offset capital gains. Unfortunately, **capital losses do not offset dividend income in the same manner as capital gains.** However, as under prior law, capital losses in excess of capital gains may reduce up to \$3,000 of your taxable income.

PLANNING WITH CAPITAL GAINS AND LOSSES

Watch Out For Incentive Stock Options And AMT. If you exercised an incentive stock option (ISO) in 2003, the exercise could trigger the alternative minimum tax (AMT) on your 2003 return. Your alternative minimum taxable income includes the excess of the fair market value of the stock acquired upon the exercise of the option over the exercise price. This excess is not included in calculating your regular income tax for 2003 but, is included in calculating the alternative minimum tax. The exercise of the option could create a large tax bill even if the value of the stock you acquired plummets after the date of exercise. **Tax Tip.** If you exercised an ISO in 2003 and the stock you acquired has declined in value since the date of exercise, it may be possible to eliminate or reduce your AMT tax liability if you sell the stock on or before December 31, 2003. Please check with us if you have exercised incentive stock options during 2003 and the price of the stock has fallen since the date of exercise. A sale of the stock after December 31, 2003 will not affect your AMT liability for 2003. So, we must act timely for a sale to reduce 2003 taxes!

Year-End Considerations For Capital Assets. Timing your year-end sales of stocks, bonds, or other securities may save you taxes. After you have fully evaluated the economic factors, the following are several year-end tax planning ideas for sales of capital assets. **Caution!** Always consider the economics of a sale or exchange **first!**

- **Taking Capital Losses To The Extent Of Capital Gains Plus \$3,000.** If you have already recognized capital gains in 2003, you should consider selling securities that have declined in value prior to January 1, 2004. These losses will be deductible on your 2003 return to the extent of your previously recognized capital gains plus \$3,000. Capital losses in excess of \$3,000 are carried forward and offset capital gains for future years. These losses may have the added benefit of reducing your income to a level that you qualify for other tax breaks (e.g., the child credit, the HOPE credit, and IRA contributions). **Planning Alert!** If within 30 days before or after the sale of loss securities, you acquire the same securities, the loss will not be allowed currently because of the wash sale rules.
- **Making The Most Of Capital Losses.** Remember, if your stock sales to date have created a net capital loss exceeding \$3,000, consider selling enough appreciated securities before year end to decrease the net capital loss to \$3,000. Stocks that you think have reached their peak would be good candidates. All else being equal, you should sell the short-term (held 12 months or less) securities first. This will allow your short-term capital gain to absorb your net capital loss (in excess of \$3,000), while preserving your favorable long-term capital gain treatment for later years.
- **Year-End Mutual Fund Purchases.** If you are thinking about buying mutual fund shares near year-end, watch out for a common tax trap. Mutual funds typically distribute income, including capital gains, near the end of each year. If you invest in the fund near the end of the year, but on or before the record date for this payout, you generally will be taxed on a year-end distribution as if you had held the fund all year. This, in essence, treats a return of your investment as a taxable distribution. Before investing, determine the amount and timing of any year-end payout.

Stock "Traders" May Save Taxes By Electing "Mark-to-Market." If you are a "trader" in stocks, the "mark-to-market" election could possibly save you taxes. If you invest in stocks, the IRS will generally consider you either an "investor" or a "trader" (unless you sell securities to the general public). Generally, the IRS will treat you as a "trader" if you have frequent purchases and sales of stock, you hold the stock for short-term gain (rather than long-term appreciation and dividends), and you have a high volume of stock transactions. If you qualify as a "trader," you can elect (for tax purposes) to mark your stock down or up to market at year end. This election will convert what would generally be short-term capital gains



and losses, into "ordinary" gains and losses. **Tax Tip.** This election could save taxes if you anticipate incurring significant capital losses. Each tax year you can only deduct \$3,000 of the amount by which your capital losses exceed your capital gains. However, if you make a timely "mark-to-market" election, you can fully deduct those losses as "ordinary losses." Also, making this election **will not** subject your mark-to-market stock gains to Social Security or Medicare taxes. **Planning Alert!** Unless you made the election for a prior year, the mark-to-market election, unfortunately, must be made by the due date (without regard to extensions) of your **prior year's tax return**. Even though it is too late to make the election for 2003, you may wish to make the election by April 15, 2004 for 2004 and future years. **Tax Tip.** For new taxpayers (e.g., a partnership created to trade securities), the election is due within two months and 15 days after the creation of the entity. For example, a partnership created on October 1, 2003 should have until December 15, 2003 to make the election. Please call us if you think this election might save you taxes—we will be glad to fill you in on the details.

POSTPONING TAXABLE INCOME

Generally, it's a good idea to defer as much income into 2004 as possible if you believe that your marginal tax rate for 2004 will be equal to or less than your 2003 marginal tax rate. Deferring income into 2004 could also increase various credits and deductions for 2003 that are being phased out as your adjusted gross income increases. If, after factoring in the various income thresholds for the tax benefits discussed above, you believe that deferring taxable income into 2004 will save you taxes, consider the following strategies:

Self-Employed Business Income. If you are self-employed and use the cash method of accounting, consider delaying year-end billings to defer income until 2004. **Caution!** If you have already received the check in 2003, deferring the deposit does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

Installment Sales. If you plan to sell certain appreciated property in 2003, you might be able to defer the gain until later years by taking back a promissory note instead of cash. If you qualify, the gain will be taxed to you as you collect the principal payments on the note. **Planning Alert!** Although the sale of real estate and closely-held stock generally qualify for this deferral treatment, some sales do not. For example, even if you are a cash method taxpayer, you cannot use this gain deferral technique if you sell publicly-traded stock or securities. Also, you may not want to take back a promissory note in lieu of cash if you believe that your chances of getting paid are at risk. **Caution!** As the law is currently written, the general, maximum long-term capital gains rate will increase from 15% to 20% after 2008. This increase in the long-term capital gains rate should be considered before agreeing to accept an installment note with payments due beyond the 2008 tax year.

Real Estate Swaps. If you want to sell **investment** or **business** real estate but plan to use the proceeds to purchase other investment or business real estate, consider a like-kind exchange. You could have the purchaser of your property buy the property you want and trade it to you. This way there should be no gain on the exchange. **Tax Tip.** The IRS rules in certain cases permit tax-free treatment even if you acquire the real estate you want before you transfer your existing realty. This is commonly referred to as a "reverse like-kind exchange." **Planning Alert!** Although like-kind exchanges may appear simple, they are not. It is easy to convert what appears to be a tax-free exchange into a fully taxable transaction. **Tax-free exchanges present wonderful tax planning opportunities but please do not attempt one without calling us first.**

Deferred Compensation. There are established ways to defer the taxation of 2003 compensation until 2004. These "deferred compensation" rules are extremely complex. Please call us before participating in a deferred compensation arrangement with your employer. We will help explain the rules.

Required Distributions From Retirement Plans After 70½ Or Death. If you want to postpone the distributions (and therefore the taxation) of amounts in your traditional IRA or in a qualified retirement plan as long as possible, it is critical that you name the appropriate beneficiaries. You should generally name an individual or a "qualified trust" as the beneficiary. **Caution!** If your estate is the beneficiary of your IRA or qualified plan account, your heirs will generally miss out on substantial tax deferral



opportunities after your death. In addition to naming an individual or individuals as your beneficiary, you should also name a “contingent beneficiary” in case your primary beneficiary dies before you. If you do not name a qualified beneficiary or if your estate is your beneficiary and you die before reaching age 70½, your entire retirement account generally must be distributed and taxed within **five years** of the year of your death. This will cause your beneficiaries to lose valuable tax deferral benefits. **Planning Alert!** The rules for maximizing the tax deferral possibilities for IRAs and qualified plan accounts are complicated. However, we will gladly review your beneficiary designations and offer planning suggestions. **Tax Tip.** If you are the current owner of a Roth IRA, you’ll have no minimum required distributions after you reach age 70½. However, distributions must be made to your heirs after your death.

Also, if you are the beneficiary of the IRA or qualified plan account of someone that has died, there are certain planning techniques that should be considered as soon as possible. **Tax Tip.** If the decedent named multiple beneficiaries or included an estate or charity as a beneficiary, we should review the situation as soon as possible to see if there is anything we can do to avoid certain tax traps. The rules for rearranging IRA beneficiaries for maximum tax deferral are complicated and are subject to rigid deadlines. Acting before certain deadlines pass is critical. **The best tax results can generally be achieved by making any necessary changes no later than the end of the tax year in which the owner of the IRA or retirement plan dies.** If you need assistance, please call our office as soon as possible so we can advise you.

IRA Rollovers. If you receive a distribution from your IRA or qualified retirement plan, and you want to avoid taxation, you typically must roll the distribution over into a new IRA or qualified retirement plan within 60 days. **Planning Alert!** You are allowed **only one tax-free rollover of an IRA each year.** If an IRA account is rolled over more than once each year, the amount involved in the second rollover is taxed and could be subject to a 10% penalty. However, there are no limits on the number of times you may have direct “trustee-to-trustee” transfers of your account between IRA trustees. If you wish to change your IRA trustee (e.g., from one financial institution to another), please call us and we will assist you with a trustee-to-trustee transfer.

The IRS has recently announced procedures for extending the 60-day rollover period if you satisfy certain criteria. If you failed to rollover your IRA within the 60-day period and have a “good reason” for failing to make the rollover timely, the IRS may grant you an extension of time to complete the rollover. This will generally require us to apply to the IRS for an extension of the 60-day period and the IRS will charge a user fee. **Tax Tip.** In certain situations where a financial institution causes the 60-day rollover period to be violated, we may be able to get automatic relief without applying to the IRS for a ruling and without paying a user fee. Please call us if you need further information on these relief provisions.

TAKING ADVANTAGE OF DEDUCTIONS

Accelerating Deductions Into 2003. If you are a cash method taxpayer, you can generally accelerate a 2004 deduction into 2003 by “paying” it in 2003. Accelerating an “above-the-line” deduction into 2003 may allow you to reduce your “adjusted gross income” below the thresholds needed to qualify for many tax benefits discussed elsewhere in this letter. Remember, however, that itemized deductions do not reduce your “adjusted gross income” and, therefore, will not affect your 2003 deductions and credits that are reduced as your income increases. Itemized deductions include charitable contributions, state and local taxes, medical expenses, unreimbursed employee travel expenses, and home mortgage interest. **Tax Tip.** “Payment” typically occurs in 2003 if a check is delivered to the post office, or if an item is charged on a credit card in 2003.

“Bunching” Itemized Deductions. If your itemized deductions fail to exceed your standard deduction in most years, you are not receiving maximum benefit for your itemized deductions. You could possibly reduce your taxes over the long term by bunching the payment of your itemized deductions in alternative tax years. This may produce tax savings by allowing you to itemize deductions in the years when your expenses are bunched, and using the standard deduction in other years. **Tax Tip.** The easiest deductions to shift between tax years are charitable contributions, state and local taxes, and your January home



mortgage interest payment. For 2003, the standard deduction is \$9,500 on a joint return and \$4,750 for single individuals. If you are blind or over age 64, you get an additional deduction of \$950 if you're married (\$1,150 if single).

“Bunching” Medical Expenses. Many taxpayers ignore the medical expense deduction because medical expenses are deductible only if they exceed 7.5% of your adjusted gross income (10% for AMT purposes). However, if you have medical expenses that are discretionary, you may be able to “bunch” them into 2003 or 2004 and exceed the 7.5% floor. For example, braces are discretionary, and such medical procedures as radial keratotomy and laser eye surgery may be discretionary and qualify for the medical expense deduction. **Tax Tip.** You can include in your medical expense the following: medical insurance premiums, transportation essential for medical care, lodging (but not meals) while away from home primarily for medical care, and changes to your house to accommodate a physical handicap. Tuition payments to a special school for a child with severe mental or physical disabilities (which would include medically diagnosed attention deficit hyperactive disorder) may also qualify as a medical expense. However, the IRS requires that a doctor recommend that a child attend the school, and the school generally must determine the portion of the tuition payment that relates directly to the medical needs of the child. Also, the costs of programs and prescription drugs to help people stop smoking qualify as a medical expense.

Deduction For Self-Employed Health Insurance Costs. If you are self-employed, a partner, or own more than 2% of an S corporation, your tax deduction for health insurance premiums increases this year. For 2002, you could only deduct 70% of your health insurance premiums as an “above-the-line” deduction. For 2003, the “above-the-line” deduction increases to 100%.

Maximizing Employee Business Expenses. If you are incurring unreimbursed employee business expenses, you must reduce those expenses by 2% of your adjusted gross income. “Bunching” these expenses into 2003 or 2004 so the 2% threshold is exceeded may reduce your taxes. You can bunch 2004 expenses into 2003 by prepaying the 2004 amounts in 2003. **Planning Alert!** The IRS says that prepayments of expenses applicable to periods beyond 2004 (the next tax year) will not be deductible in 2003. **Tax Tip.** If you are a “statutory employee” (e.g., full-time life insurance salesperson, certain commissioned drivers, certain home workers) you are not subject to the 2% limitation for employee business expenses. The “statutory employee” box on your Form W-2 should be checked if you are classified as a statutory employee.

- **Taking Advantage Of Employer’s “Accountable Plan.”** As an employee, you can avoid the 2% rule altogether if you document your business expenses and get reimbursed by your employer under an “accountable plan.” We can help you establish a proper reimbursement arrangement with your employer. **Tax Tip!** The IRS has issued a revenue ruling approving the use of electronic expense reports and electronic receipts.
- **Avoiding The 50% Reduction For Meal And Entertainment Expenses.** You can generally deduct your meals if you are on an overnight business trip. In addition, you can generally deduct business entertainment (including a meal) if you engage in a legitimate business meeting with a bona fide business associate shortly before, during, or after the meal or entertainment. However, only 50% of your otherwise deductible business meal and entertainment expenses are deductible. **Tax Tip.** You can avoid the 50% reduction altogether if you properly document your business meals and entertainment and receive reimbursement for the expenditure from your employer under an “accountable plan.” However, your employer may deduct only 50% of the reimbursement. If you are self-employed, you can also avoid the 50% reduction if you separately bill your client (with proper documentation) for your qualifying business meal and entertainment expenses on behalf of the client. Your client, however, may deduct only 50% of the reimbursement. Consequently, you should document and obtain a reimbursement for all business meal and entertainment expenses whenever possible if you wish to avoid the 50% reduction. Individuals working in selected transportation industries and subject to the Department of Labor’s hours of service limitations are required to reduce their meal deduction by only 35% rather than 50% (e.g., pilots; interstate truck drivers and bus drivers; and railroad engineers).



Charitable Contributions.

- **Contributions Of Appreciated Property.** If you are considering a significant 2003 contribution to a public charity (e.g., church, synagogue, or college), it will generally save you taxes if you contribute appreciated long-term capital gain property, rather than selling the property and contributing the cash proceeds. By contributing capital gain property held more than one year (e.g., appreciated stock, real estate, etc.), a deduction is generally allowed for the full value of the property, but no tax is due on the appreciation. **Tax Tip.** Generally, this rule does not apply to contributions to private foundations. However, you can contribute “qualifying publicly-traded stock” to a “private foundation” and deduct the full fair market value (rather than the cost basis). With limited exceptions, for contributions of property in excess of \$5,000 (\$10,000 for non-publicly traded stock) you must obtain an appraisal of the property and submit a summary of the appraisal with your tax return. **Planning Alert!** You are allowed a full fair market value deduction for contributions of tangible personal property (e.g., artwork) to a public charity, only if the charity actually uses the contributed property in its exempt function.
- **Substantiation Requirements.** If you contribute \$250 or more to a charity, you are allowed a deduction only if you receive a qualifying **written receipt** from the charity by the time your return is filed. The receipt generally must include the amount of money and a description of any property contributed, and a good faith estimate of the value of any goods or services that were provided to you in exchange for the gift. If no goods or services were provided to you in return for the contribution, the receipt must contain a statement that no goods or services were provided. **Caution!** You must receive this receipt before we file your 2003 return, and you should retain the receipt in your tax files in case you are later audited. IRS says a canceled check is not sufficient where a receipt is required!
- **Be Sure to “Pay” Your Charitable Contribution In 2003.** A charitable contribution deduction is allowed for 2003 if the check is mailed on or before December 31, 2003, or the contribution is made by a credit card charge in 2003. However, if you give a note or a pledge to a charity, no deduction is allowed until you pay off the note or pledge.

Maximizing Home Mortgage Interest Deduction. If you are looking to maximize your 2003 deductions, you can increase your home mortgage interest deduction by paying your January, 2004 payment on or before December 31, 2003. Typically, the January mortgage payment represents interest that was accrued in December and, therefore, is deductible if paid in December.

- **Look For Deductible “Points.”** Points paid in connection with the purchase or improvement of your principal residence are immediately deductible. Points are deductible even if the bank labels them as something else. For example, points include “loan-processing fees,” “loan premium charges,” or “loan origination fees” so long as they don’t represent fees for other services (e.g., appraisal, title, inspection, attorneys’ fees, credit checks, property taxes, or mortgage insurance premiums).
- **Remember To Deduct Seller-Paid Points.** If you bought a house this year and negotiated for the seller to pay your points at closing, there’s good news for you. The IRS says you can deduct those seller-paid points as though you paid them yourself.
- **Pay Off Personal Loans First.** If you have both home mortgage interest and other personal debt, pay off the personal debt first because interest on personal debt is generally not deductible. This will maximize your interest deduction.

Casualty Losses. If you incurred a casualty loss in 2003 and the loss was insured, file a claim. You cannot deduct an insured personal loss unless you file a timely claim. **Tax Tip.** With proper planning, you can also turn a casualty loss into cash. If you suffered a disaster-related loss this year, you may be able to claim the uninsured portion of the loss on last year’s return and obtain a tax refund by amending the 2002 return. For this option to apply, the area in which your loss occurred must be one which was designated by the President as a Federal Disaster Area eligible for relief under the Disaster Relief and Emergency Assistance Act. However, if you prefer, you may take the loss on the 2003 return.

Tax-Wise Payment Of State And Local Taxes. Consider paying property taxes, state income taxes



(fourth quarter estimate and balance due for 2003), and other local taxes for 2003 prior to January 1, 2004 if your tax rate for 2003 will be higher than or the same as your 2004 tax rate. This will allow a deduction for 2003 (a year early) and possibly against income taxed at a higher rate. **Planning Alert!** You should not employ this tactic without carefully calculating the alternative minimum tax impact. Also, “overpayment” of your 2003 state income taxes is generally not advisable since a refund in 2004 from a 2003 overpayment may be taxed at a higher rate than the 2003 deduction rate. **Please consult us before you overpay state income taxes!**

Club Dues. Club dues are generally not deductible at all, unless the dues are business related and are paid to professional organizations (e.g., ABA, AICPA, AMA), civic or public service organizations (e.g., Kiwanis, Lions, Rotary, Civitan), business leagues, trade associations, chambers of commerce, boards of trade, or real estate boards. **Tax Tip.** Although you may not generally deduct dues paid to country clubs, golf and athletic clubs, and airline clubs, there is a special rule for employers who reimburse these club dues. If you document to your employer the percentage of the time you use these clubs for bona fide business purposes, your employer can reimburse you for this business portion of the club dues and elect to exclude that reimbursement from your Form W-2. However, if your employer makes this election, the employer may not deduct the reimbursement.

Companion Travel Expenses. Generally, you are not allowed a deduction for taking your spouse or other companion on a business trip unless there is a “bona fide business purpose” for taking the person, and the person is also a “bona fide” employee of the person paying or reimbursing the expenses. **Tax Tip.** If your spouse is not an employee, but there is a bona fide business reason for taking your spouse on a business trip, your employer may reimburse you for your spouse’s expenses without including the reimbursement on your Form W-2. However, you must document the amount and the business nature of your spouse’s expenses. Furthermore, if your employer chooses this option, the employer will not be allowed a deduction for the reimbursement of the expenses.

PLANNING FOR EDUCATION TAX BENEFITS

Over the past several years, Congress has enacted many tax benefits for individuals that pay qualified education costs for themselves or their family members. The following are selected “education” tax breaks for your consideration as you develop your 2003 tax planning strategies.

\$250 “Above-the-Line” Deduction For Teachers. For 2002 and 2003, if you are an “eligible educator” you will be able to deduct as an “above-the-line” deduction (deductible even if you don’t itemize) up to \$250 of your qualified classroom expenses. Your qualified expenses include books, supplies (other than non-athletic supplies for courses in health or physical education), computer equipment (including software and services), other equipment, and supplementary materials. **Planning Alert!** To be an “eligible educator” you must be a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide working at least 900 hours during the school year. **Tax Tip.** If you anticipate buying at least \$250 of school supplies during the 2003-2004 school year, remember that only supplies purchased on or before December 31, 2003 will qualify for the deduction. This deduction “sunset” after 2003.

Coverdell Education Savings Accounts. You can contribute up to \$2,000 annually to a Coverdell education savings account (formerly “education IRA”). This limit applies to the aggregate contributions that may be made by all contributors to one (or more) Coverdell education savings accounts (CESAs) established on behalf of any particular beneficiary. **Tax Tip.** You may make a contribution to CESA for 2003 by April 15th of 2004. Your \$2,000 contribution amount is phased out on a joint return as adjusted gross income goes from \$190,000 to \$220,000 (\$95,000 to \$110,000 if you are single). **Planning Alert!** The IRS says a child may make an education savings account contribution for himself or herself. Thus, if the adjusted gross income of both the parents and the grandparents exceed the limits, the child’s parent or guardian may wish to establish a CESA with the child’s funds (e.g., funds in a Uniform Gift to Minors Act account).



Although your contribution to a CESA is not deductible for tax purposes, you may make tax-free distributions from a CESA for the payment of qualified education expenses for elementary or secondary school education as well as for higher education expenses. This includes expenses for public, private, or religious schools (kindergarten through grade 12). "Qualified education expenses" include tuition, fees, academic tutoring, special need services, books, supplies, computer equipment (including related software and services), room and board, uniforms, transportation, and extended day programs (required or provided by the school in connection with the student's enrollment or attendance at that school). Therefore, if the funds accumulated in the CESA are distributed for qualified education expenses, the earnings on the funds are tax free.

Section 529 Plans. Earnings of a qualified state tuition plan (section 529 plan) may be distributed tax-free for qualified "higher" education expenses. So, unlike CESAs, K-12 education expenses should not be paid with section 529 plan funds. However, there is no \$2,000 per year limitation on the amount that may be contributed to a section 529 plan and there are no income limits above which the contribution may not be made. Instead, once the amount in a section 529 plan equals the amount necessary to fund 5-years of undergraduate education at the highest cost institution in the state, no more contributions are allowed to that particular beneficiary's plan. Many state tuition plans have limitations on total contributions of \$250,000 or more. So, if you wish to accumulate funds for qualified college education expenses (tuition, fees, and room and board), you should consider a section 529 plan. **Tax Tip.** Many individuals are using CESAs to save for private school education expenses and setting up section 529 plans to fund college expenses. You may establish both a CESA and a section 529 plan for the same individual.

Caution! Contributions to CESAs and to section 529 plans are gifts to the beneficiary of the account for gift tax purposes. However, the \$11,000 annual exclusion for gifts is available to offset these contributions for gift tax purposes. Also, there is a special rule which allows you to consider the amount of gifts to a CESA or a qualified tuition plan for a year as made over five years. Therefore, it is generally not wise, from a gift tax standpoint, to transfer the maximum amount allowed to a qualified tuition plan in one year. However, by electing the 5-year rule, you could transfer \$55,000 (\$110,000 if both husband and wife make transfers or elect split-gift treatment) in one year and there should be no federal gift tax on the transfer as long as no other gifts are made to the beneficiary of the account for the current year or the next four years.

All 50 states now have state tuition plans. Also, most states allow nonresidents to invest in their plan. If you wish to review the state tuition plans offered by your state as well as other states, please go to www.savingforcollege.com. This web site summarizes the plans for every state. **Tax Tip.** Please call us before contributing to a state tuition program. We can help you decide which plan best suits your needs. Also, some states allow a state income tax deduction for contributions to qualified state tuition plans but only if you contribute to that state's plan. We can advise you if you get additional state tax benefits by contributing to your state's plan.

Education Expense Deduction. If you pay for qualified higher education tuition and fees for yourself, your spouse, or your dependents, you may qualify for an education expense deduction. This maximum \$3,000 deduction is available whether or not you itemize. For 2003, you are not allowed this deduction if your adjusted gross income exceeds \$130,000 on a joint return (\$65,000 if single). **Planning Alert!** If you expect to take this deduction and your income is close to the \$130,000 limit (\$65,000 if you're single), we should discuss your situation and see if we can take steps to keep your income below the \$130,000/\$65,000 threshold for 2003. If you exceed the \$130,000 or \$65,000 limitation by even \$1, the entire deduction is lost.

Student Loan Interest Deduction Rules Relaxed. You may deduct (whether or not you itemize deductions) up to \$2,500 of interest on qualified student loans. So, when you bring us your 2002 income tax information, please include any interest you paid during 2003 on loans for higher education expenses. The deduction phases out as adjusted gross income goes from \$100,000 to \$130,000 on a joint return (from \$50,000 to \$65,000 on other returns).

"HOPE" Education Tax Credit. If you paid post high school education expenses for yourself, your spouse, or a dependent this year, you may be entitled to a tax credit of up to \$1,500 per student. This



credit is a per student credit and only applies to qualifying expenses **for two years** of post secondary education in a degree or certificate program. The credit phases out ratably as your modified adjusted gross income increases from **\$83,000 to \$103,000** on a joint return (**\$41,000 to \$51,000** on a single return). The HOPE credit equals 100% of the first \$1,000 (and 50% of the second \$1,000) of tuition and fees required by the educational institution. No credit is allowed for meals, lodging, transportation, or other personal living expenses.

Tax Tip. To get the full \$1,500 credit for 2003, you must pay tuition of at least \$2,000 for the student by December 31, 2003. If tuition, for example, is \$1,200 each semester, you must pay two semesters of tuition in 2003 to get the full credit of \$1,500. If your child began college in August or September of 2003, you should pay the \$1,200 tuition for the spring semester of 2004 **no later than December 31, 2003** (payments after that date will not qualify for credit during 2003). **Beware!** If you pay only \$1,200 of tuition in 2003, your maximum HOPE credit is \$1,100 for 2003. So, if you claim the \$1,100 HOPE credit for 2003, you can claim it for only **one more year** for that student. You will have wasted \$400 of the credit.

The Lifetime Learning Credit. This year, you may qualify for a Lifetime Learning credit of up to \$2,000 (up from \$1,000 in 2002). This credit equals 20% of the first \$10,000 of qualified higher education tuition and fees. The phase-out rules for the Lifetime Learning credit are the same as those for the HOPE credit discussed above. Unlike the HOPE credit, the Lifetime Learning credit is for an unlimited number of years and can be used for graduate or professional degrees (as well as undergraduate education). Also, the Lifetime Learning credit Limitation of \$2,000 is per tax return not per student. **Caution!** The Lifetime Learning credit is not available for any of the education expenses of a student for 2003 if you take the HOPE credit for education expenses for that student on your 2003 return. **Tax Tip.** In some situations, it may be better to claim the Lifetime Learning credit for qualified expenses that would otherwise qualify for the HOPE credit. For example, if a freshman's tuition is \$10,000 in 2003, the Lifetime Learning credit would give you a \$2,000 credit compared to the HOPE credit of 1,500. Your total Lifetime Learning credit on your 2003 return cannot exceed \$2,000. By contrast, you may take a HOPE credit of up to \$1,500 for each student who qualifies.

Planning Alert! If your income is more than \$103,000 (\$51,000 on a single return), you do not qualify for the Hope credit or the Lifetime Learning credit. However, the IRS says the student (e.g., your child) may claim the credits, provided you elect not to claim that child as a dependent on your tax return (even if the child otherwise qualifies as your dependent). Of course, since the HOPE and Lifetime Learning credits are non-refundable credits, your child must have an income tax liability to utilize the credits on his or her return.

TAX PLANNING FOR YOUR HOME

IRS Releases New Home Sale Exclusion Regulations. If you have owned your home and used it as your "principal residence" for at least two out of the last five years, you can exclude up to \$250,000 of the gain (\$500,000 on a joint return) when you sell it. The IRS recently issued new regulations that in several situations expand this rule. For example, contrary to an earlier IRS position, the new regulations generally allow you to exclude gain that would otherwise be allocable to your "qualified home office" (except for depreciation taken on the home office after May 6, 1997). The new rules also allow you to exclude gain when you sell land adjacent to your residence so long as the land is sold within two years of the sale of your home and the land has been owned and used as part of your residence for the required period. Furthermore, if you have two or more residences, the new regulations provide additional guidance on which residence will most likely qualify as your "principal residence" for gain exclusion purposes. The regulations also provide retroactive rules allowing you to claim a portion of the exclusion when you have not owned and used the residence for the required two year period but you sell the home because of a change in place of employment, a change in health, or because of unforeseen circumstances. **Tax Tip.** These rules are retroactive (generally for three years). If you think that you have previously filed a return reporting a gain that may be excluded under these new regulations, we can help you amend that return and recoup the taxes paid.



The Home Office Deduction. Recent tax law changes have made it easier for you to qualify for home office deductions (e.g., depreciation, insurance, utilities, repairs and maintenance). If you're self-employed, you only have to establish that you use your home office "regularly and exclusively" to perform management or administrative duties for your business and there is no other fixed location where you perform substantial management or administrative duties relating to that trade or business. If you are an employee, you must also establish that your home office is "for the convenience of your employer" (this generally means you're not provided an office at work). **Tax Tip.** The IRS says that if you have a qualifying home office, you can deduct any travel from your home office to another work location as a business expense. So, by having a qualified home office, you will generally have more deductible business travel. Furthermore, if you're an employee who qualifies for home office deductions, you should ask your employer to reimburse your home office expenses. This reimbursement should be excluded from your income if reimbursed under an "accountable reimbursement arrangement." If the home office expenses are not reimbursed, the home office expense deduction will be reduced by 2% of your adjusted gross income.

Renting Your House To A Relative Can Be Tricky. If you are renting a house to a relative as their principal residence and they pay you fair rental value, you will be able to deduct depreciation and your other rental expenses (e.g., utilities, insurance, repairs and maintenance). However, if they pay you less than fair rental value, you may only deduct interest and taxes. **Tax Tip.** Always get independent, written confirmation of the market rental value of any house you rent to a family member, and charge at least that amount if you want to deduct depreciation, insurance, repairs and maintenance.

PLANNING WITH RETIREMENT PLANS

Consider Contributing The Maximum Toward Your Retirement. As your income rises and your marginal tax rate increases, deductible retirement plan contributions generally become more valuable to you. Also, making your deductible contribution to the plan as early as possible generally increases your retirement benefits. As you evaluate how much you should contribute, consider the following:

- **IRA Contributions.** If you are married, even if your spouse has no earnings, you can deduct up to \$6,000 (\$7,000 if you're both at least age 50 by the end of the year) for contributions to your and your spouse's traditional IRAs. **Note!** No more than \$3,000 (\$3,500 if you're at least age 50) may be contributed to either your or your spouse's IRA during any one tax year (except for rollover contributions). You must have earnings at least equal to the contribution. If you are an active participant in your employer's retirement plan, your IRA deduction is phased out ratably as your adjusted gross income increases from \$60,000 to \$70,000 on a joint return (\$40,000 to \$50,000 on a single return). **Planning Alert!** Every dollar you contribute to a deductible IRA reduces your allowable contribution to a nondeductible Roth IRA.
- **Using IRA Funds For Education Or First-Time Home-Buyer Expenses.** If you have an IRA, you can withdraw funds for qualified higher education expenses or qualified first-time home buyer expenses (up to \$10,000), without having to pay the normal 10% early distribution penalty. The distribution is, however, still taxable. **Tax Tip.** The distribution for higher education expenses, although taxable, may generate a HOPE credit or a Lifetime Learning credit.
- **Workers Over Age 70½.** If you are still working and are over age 70½, you generally cannot make a contribution to a traditional IRA. **Tax Tip.** If you are working, over age 70½, have a non-earning spouse under age 70½, and otherwise qualify, you can make a deductible \$3,500 spousal IRA contribution to a separate traditional IRA for your non-earning spouse. Also, if you otherwise qualify, you can contribute to your nondeductible Roth IRA even after you reach age 70½.
- **Consider Contributing To Your Company's 401(k) Plan.** If you are covered by your company's 401(k) plan, you should consider putting as much of your compensation into the plan as allowable. The maximum amount for 2003 is \$12,000 (\$14,000 if you're at least age 50 by the end of the year). This is particularly appealing if your employer offers to match your contributions.
- **Consider A "SIMPLE" Retirement Plan.** Businesses (including self-employed persons) may, if



qualified, set up a simplified retirement plan (called a "SIMPLE" plan). SIMPLE plans are designed to be less costly and easier to administer than other qualified plans and allow an employee to contribute up to \$8,000 (\$9,000 if you're at least age 50 by the end of the year).

The Roth IRA - A Valuable Retirement Savings Option. The Roth IRA continues to be a viable retirement savings option. If you have "earned income" at least equal to the contribution, you may make a **nondeductible** contribution of up to \$3,000 (\$3,500 if your at least age 50) to a Roth IRA. Individuals can generally make a contribution for 2003 anytime on or before April 15, 2004. If you are married, you can contribute up to \$3,000 for yourself, and an additional \$3,000 for your spouse, provided your combined earnings are at least equal to \$6,000. However, the \$3,000 contribution limits are phased out as your adjusted gross income increases **from \$150,000 to \$160,000 on a joint return (\$95,000 to \$110,000 if single)**. Also, the \$3,000 amount you may contribute to a Roth IRA is reduced by any contributions you make to a regular IRA for the same tax year.

You can not deduct your contributions to a Roth IRA. However, the Roth IRA appeals to many taxpayers because qualified distributions from the Roth are tax free. If you maintain your Roth IRA for at least five years, amounts may be withdrawn completely "tax free" if you meet any of the following conditions: **(1)** you have attained age 59½, **(2)** the distribution results from your death or disability, **or (3)** the distribution is for qualifying first-time home buyer expenses. Also, distributions from a Roth IRA are deemed to come from your nondeductible contributions first. Thus, you may generally withdraw any or all of the amounts you have contributed tax free without meeting the above requirements.

Setting Up A Roth IRA For A Minor. You can set up a Roth IRA for your minor child, provided that the child has "earned income" at least equal to the Roth IRA contribution (the maximum contribution is \$3,000). Your child's earned income can include money from baby sitting or mowing lawns. Furthermore, if your child's outside earnings do not exceed \$400, the child will not be subject to Social Security taxes. If you are a sole proprietor, you don't have to pay FICA or medicare taxes on wages paid to your child who is under age 18.

OTHER ITEMS TO CONSIDER

Adoption Tax Credit. If you are considering adopting a child, the adoption tax credit may substantially reduce your tax bill. This year, you may be entitled to an adoption tax credit for qualifying adoption expenses of up to the \$10,160 per child. Also in 2003, the adoption credit is phased-out as your modified adjusted gross income increases from \$152,390 to \$192,390. **Tax Tip.** Starting in **2003**, if you finalize the adoption of a "special needs child," you may receive a minimum adoption tax credit of \$10,160 even if this is more than your adoption expenses. This credit for the excess of \$10,160 over your actual expenses is allowed only in the year the adoption is finalized.

Foreign Adoptions. If you are adopting a child who is not a citizen or resident of the U.S. when the adoption commences, you are allowed the credit only if, and when, the adoption becomes final. The IRS has recently released guidance on when a foreign adoption becomes final. Call our firm if you need more information. **Planning Alert!** Your adopted child must have a taxpayer identification number (TIN) for you to take the credit. A child's Social Security number is normally the TIN. If, after reasonable efforts, you are unable to obtain the child's Social Security number, you can apply for an "adoption taxpayer identification number" by filing a Form W-7A with the IRS.

IRS Releases New Standard Deduction Rates for Day Care Provider Food Costs. The IRS has just released optional standard meal and snack rates that day care providers can use in computing deductible costs of food provided to "eligible children." These new standard rates are generally **effective for tax years beginning after December 31, 2002.**

IRS Certifies Deduction For Clean-Fuel Vehicles. If you purchase a "qualified clean-fuel vehicle" (e.g., certain new automobiles, SUVs, pickups, etc. adapted to run on clean-burning fuels), you may be entitled to a \$2,000 above-the-line deduction whether or not you use the vehicle in your business. This deduction is available to individuals, sole proprietors, partnerships, LLCs, S corporations, and regular "C" corporations. The IRS has certified the following vehicles as qualifying for this \$2,000 deduction: Toyota



Prius (for model years 2001, 2002, 2003, and 2004), Honda Insight (for model years 2000, 2001, and 2002), and Honda Civic-Hybrid (for the model year 2003). **Tax Tip.** Please let us know if you have purchased any of these vehicles during 2003 or a prior year, so we can make sure you get the deduction

Moving Expenses. If you had a job-related move in 2003, you may be entitled to deduct unreimbursed moving expenses. Deductible moving expenses only include: **(1)** moving household goods and personal effects from your former residence to your new residence, **and (2)** travel costs (including lodging during the travel) from your former residence to your new residence. **Tax Tip.** If your employer reimburses your moving expenses, provide your employer with proper documentation of the moving expenses. Otherwise, the IRS says employer reimbursements should be included in your Form W-2.

Social Security Numbers For Dependents. All dependents **must have a social security number**, even if they are born as late as December 31, 2003. If you don't include a valid social security number for a child (or other dependent), the IRS can disallow tax benefits relating to that dependent, including the dependency exemption, child tax credit, dependent care credit, adoption expense credit, HOPE scholarship credit, Lifetime Learning credit, earned income credit, as well as the exclusion from gross income of employer-provided adoption assistance payments. If you do not have a social security number for your dependents, please apply to the Social Security Administration for the number using Form SS-5, which can be obtained from any office of the Social Security Administration.

Penalty For Under-Withholding Or Under-Estimating. One way to avoid a penalty for failing to pay or withhold sufficient income taxes for a tax year is to pay 100% of your prior year's tax liability in quarterly estimated payments or through income tax withholding. **Planning Alert!** If your 2002 AGI was over \$150,000, you must pay in 110% of your 2002 tax liability to qualify for this safe harbor in 2003. **Tax Tip.** If you have not paid sufficient estimates to avoid an underpayment penalty for 2003 and you have wages subject to withholding, you can have additional amounts withheld on or before December 31, 2003. Withholding is deemed paid equally on each quarterly installment date, even if the withholding occurs in December.

FINAL COMMENTS

Please call us if you are interested in a tax topic that we did not discuss. Tax law constantly changes due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes and will be glad to discuss any current tax developments and planning ideas with you. **Please call us before implementing any planning ideas discussed in this letter, or if you need more information.**