

taxolutionsSM

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Charitable Giving – Good For The Heart *And* Your 1040!

With only a few weeks left in 2002, it’s time to give some serious thought to year-end tax planning. While you’re pondering your goals and deductions, consider charitable donations. A well-planned gift to charity could provide:

- The chance to be more involved in charities close to your heart,
- An income tax deduction or reduction, and
- A reduction (or avoidance) of estate tax.

But, your donation could also mean:

- The ability to maintain financial security,
- The ability to exercise control over assets both during your lifetime and after death, and
- The opportunity to take care of your heirs in the manner you choose.

You will need a plan tailored to your facts and circumstances, but following are some of the possibilities. These can be mixed, matched, and combined to provide just the right plan for you.

Gifts Of Appreciated Property

Give appreciated property to charity and escape the capital gain tax (which you would have had upon sale) while receiving an income tax deduction, usually at fair

market value. You also remove that asset from your estate, thereby reducing your potential estate tax burden.

Charitable Remainder Trust (CRT)

Need the security blanket of some money coming in for a period of time, or hate to give up use of your vacation home until the grandkids are grown? A CRT may be the charitable vehicle for you. CRTs work particularly well with appreciating assets, and can be used with stock in a family owned business or real estate. No income tax is imposed on income remaining in the trust. You also get a current income tax deduction (based on the future value when transferred to charity) and you remove the remainder value of the asset from your estate, reducing your potential estate tax. As a result, you obtain the tax benefits of giving to charity while postponing when they will receive it.

Charitable Lead Trust (CLT)

A CLT is the flip side. Give the charity the use of the asset and the right to the income generated for a period of years. Then, the asset can revert back to you, or go to whomever you choose. This could be income-producing stocks and bonds, or

(Continued on page 4)

Inside This Issue

Watch Out For Installment Sale Tax Traps!	2
Time For Year-End Tax Planning	2
They Lurk Everywhere... Hidden “Taxes”	3

Watch Out For Installment Sale Tax Traps!

If you're buying a single asset or a whole business, you may want to pay in installments over time. If you're the seller, having your payments coming in over several years or more than one may be a concession you have to make in order to clinch a sale. No one wants to pay income tax on sales of property before they have received payment. But that's exactly what can happen if you don't properly plan an installment sale. Here are some pitfalls you should be aware of:

Non-Qualifying Property – Not all property qualifies for “installment sale reporting.” For instance...

- Real or personal property sold by dealers in such property.
- Publicly traded property, such as stocks or bonds.

The Double Whammy – Even if you aren't a dealer in property, if you sell real or personal property which will be used in the trade or business of a related person, the sale cannot be set up as an installment sale. Plus, *all* of the gain from the sale will be taxed at ordinary tax rates – not at capital gains tax rates. For purposes of this rule, the definition of “related person” includes business entities, which are more than 50% controlled by the seller or by family members of the seller, or estates or trusts in which the seller or his/her spouse are beneficiaries.

Prior Deductions Bite Back – Take care when structuring installment sales of busi-

ness assets to make sure you receive the best tax treatment. For instance, gain from depreciation on tangible personal property and certain real property acquired before 1987 is taxed as ordinary income in the year of sale, even if no payments are received. This is referred to as depreciation recapture. For example, if you sell some equipment for \$60,000, and you have previously taken \$50,000 in depreciation deductions, you must pay tax on the lesser of the gain received or \$50,000 of ordinary income, regardless of how much money you receive from the purchaser in that year. Make sure you get enough cash at the time of sale to cover this tax bite.

Headaches From Related-Party Dispositions Of Property – You can't postpone your gain if your related buyer decides to sell the property. Typically, if you sell property under an installment sale to a related-party who then sells the property within 2 years, you must recognize the gain on the original sale much sooner. A “related-party” in this instance includes family members and controlled business entities, as well as certain estates and trusts, making this rule broader than the depreciable property rule discussed previously. So, for purposes of your installment sale reporting, sale by your relative or company within 2 years of your sale is considered income or payment received by you.

You Lose On Big Installment Sales – Interest is due the IRS on sales of over \$5 million. This rule applies to any installment

sale with a total sales price greater than \$150,000 if the total amount of installment obligations that arose during the year and remained outstanding at the end of the year was greater than \$5 million. In that case, interest must be paid on the tax that was deferred as a result of the installment sale. This isn't as bad as having to pay the entire amount of the tax, but the benefit from deferral is lost because you have to pay for the time value of the money.

Heirs Pay The Price – Ordinarily, if a person dies owning appreciated property, the income tax basis of the property is stepped-up, or increased, to its fair market value on the date of death. However, this rule doesn't apply to installment sale obligations owned by a decedent. Instead, the decedent's heirs will continue to report the gain on the sale as installment payments are received. Installment sale planning intersects with estate planning when you want to minimize the income tax hit to your heirs.

Remember, you aren't stuck with installment sale reporting – you can elect out of installment treatment and pay the tax all in the year of sale. This might be beneficial if the sale is in a year where your taxable income is unusually low, or if you have capital losses, which can offset the capital gain portion of a sale. Be sure to consult with us before you finalize the paperwork on any proposed installment sales. ▲

Time For Year-End Tax Planning

Don't put your year-end tax planning off any longer. Here are some ways to make your 2002 tax liability as small as possible:

- Remember that old stand-by: Shift income to next year and accelerate deductions into this year.
- Lower your own taxable income by shifting income to other family members. But plan around the “kiddie tax.”
- Check your withholding and estimated tax payments against your projected taxable income. Adjust as needed to avoid underpayment penalties.
- Determine which type of IRA is best for you. To get a deduction in 2002, establish an account before the end of the year and make your contribution before April 15, 2003.
- Review your gains and losses. Consider sales to offset existing gains or losses. You can only deduct up to \$3,000 of capital losses in excess of your capital gains.
- Consider charitable donations. Contributions of property can get you a deduction without a cash outlay.
- Watch out for AMT. Having too many deductions, exemptions, and credits can be risky.

They Lurk Everywhere... Those Nasty Hidden "Taxes"

If you're like most people, you focus on your *marginal* tax rate, the top rate used to calculate your tax. But what counts is what you are really paying. Your *effective* rate can significantly top your marginal rate due to various add-ons and limitations. These can easily push the top effective rate over 40%!

Deductible Or Not?

That expense or loss you incurred may not be fully deductible due to a variety of deduction restriction or limitation provisions. These limitations can be a percentage of income amount, a specific amount, or a percentage amount. They may be allowed to the extent of some income or other item, or may be phased out based on income level. For example...

Percentage of income

Medical expenses	7.5% of Adjusted Gross Income (AGI)
Miscellaneous itemized deductions	2% of AGI
Contributions – individual	Generally 50% or 30% of AGI

Specific amount

Capital losses	\$3,000 annually (in excess of capital gains)
Higher education expenses	\$3,000

Percentage of expense

Meal & entertainment expenses	50% allowed
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Deduction to the extent of income

Capital losses (in excess of \$3,000 annually)	Allowed to extent of capital gains
Investment interest expense	Allowed to extent of investment income
Passive activity losses	Allowed to extent of passive income

The Disappearing Act

You may be familiar with the deductions and credits which are phased out at certain income levels. These phase-outs apply to: exemptions, deductible IRA contributions, child and adoption credits, education credits and benefits, and other items.

What may be overlooked is the phase-out of overall itemized deductions. This begins at different income levels based on your filing status. Those at the top end could lose up to 80% of itemized deductions! A typical taxpayer's situation won't be that extreme, but they may lose 5% to 10% of their itemized deductions. These phase-outs are scheduled to be repealed gradually, starting in 2006.

Business owners or the self-employed should consider the following actions:

- Postpone income until after year-end if possible.
- Plan your purchases to take advantage of the new 30% bonus depreciation and Section 179 expensing, and to avoid the mid-quarter convention, which limits depreciation.
- Lower your business taxable income. Buy business supplies at the end of a profitable year and accelerate other expenditures.
- Get the most from your compensation deductions. Plan for bonuses and incentive compensation that is paid at year-end.
- Make sure you've captured all expenses by paying amounts due related parties (and certain others) before year-end. Some expenses are deductible only when paid, not when accrued. ▲

A Merciless Tax Trap

The phase-out limitations may sound bad; but, alternative minimum tax, or AMT, is surely the most insidious hidden tax. Meant as a safeguard against the wealthy paying little or no tax, AMT now affects millions of taxpayers who claim exemptions, deductions, or credits which don't offset AMT.

AMT can be more than your regular tax since it is broader based, and its two tax brackets (26% of the first \$175,000 and 28% over that) are higher than most of the regular tax brackets.

What To Do?

Now that you're aware of these hidden taxes, what can you do about them? Following are a few ideas to consider in your tax planning:

1. Offset capital losses with capital gains; match up investment interest expense and investment income.
2. Postpone or accelerate deductions to bunch more in one year and exceed the percentage limitations.
3. Consider filing separately if one spouse has significant medical, or other, expenses subject to percentage limitations (but, don't forget that the married filing separately rate is higher than the joint rate).
4. Make sure that your expenses are properly categorized. Don't apply the 50% meal and entertainment expense limitation to amounts which can be gifts, employee fringe benefits, company dinners, or other fully-deductible expenses.
5. See if your child can benefit from claiming education credits when you exceed the income limitation and are getting minimal benefit from their exemption.
6. Always consider AMT in your tax and transactional planning.

Finally, call us. Our goal is to help you develop a tax strategy that will keep those nasty hidden taxes at bay. ▲

(Continued from page 1)

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your rare book collection or a painting which you transfer to a museum for a while. You get a current income tax deduction for the value given to charity (but the trust pays income tax on its income). If a CLT is created upon your death, potential estate tax is reduced.

Give Away Your 401(K)

Instead of leaving your retirement plan assets to your heirs, think about leaving the balance in your 401(k), or other plan, to charity. A charity receiving plan assets isn't taxed on the income and your estate gets an estate tax deduction for the value of the assets passing to charity. Consider leaving your heirs something that won't be taxed, such as appreciated capital gain property for which they get a

basis step-up at your death. They could turn around and sell the property with no taxable gain.

GST, FLP, GRATS, et al

These acronyms stand for a variety of more complex strategies, which are best explained in person. Suffice it to say... there are other possibilities available. We can help you sort through this alphabet soup of charitable-giving strategies.

If it's a question of supporting the IRS or supporting favorite charities, most people will opt for the charities. So, why not plan for that charitable giving and take advantage of these added benefits? ▲

news and notes

IRS Relaxes Distribution Rules

In an effort to help investors preserve their retirement savings in this down market, the IRS recently announced that IRA owners and pension plan participants can slow their distributions. They can begin receiving fixed payments based on the value of the account as it changes from year to year instead of the value at the time payments commenced.

Without this guidance, issued as Revenue Ruling 2002-62, investors might find themselves either prematurely depleting their retirement accounts, or being subject to excise tax for reducing their distributions. We can help you determine whether a change in distributions would be beneficial. ▲

IRS Shifts Audit Focus

The IRS says it will place top priority on pursuing promoters of abusive schemes, shelters, and trusts and on identifying participants in the schemes. The new strategy will focus on six key areas of noncompliance:

1. Offshore credit card users,
2. High-risk, high-income taxpayers,
3. Abusive schemes and promoter investigations,
4. High-income nonfilers,
5. Unreported income, and
6. The National Research Program, the agency's compliance study involving 50,000 tax returns.

If you fall into one of these categories, be prepared for much more scrutiny. If you aren't in one of these focus areas, you're still not off the hook. The IRS has indicated that it will continue audits of other

areas as part of its basic tax administration and compliance function. ▲

Mileage Rate Decreases For 2003

The optional standard mileage rate for business use of autos will decrease from 36.5 cents per mile to 36 cents a mile in 2003. The IRS justifies this decrease because of the decline in gasoline prices in the past year.

Other mileage rate changes starting in 2003...

- 12 cents a mile for medical use (down from 13 cents)
- 12 cents for moving expense (down from 13 cents)

One rate stays the same: 14 cents a mile for use of a car when providing services to a charitable organization. ▲