

TAXOLUTIONS



►► *ideas on taxes*

TAX PLANNING FOR RETIREES

After years of saving and planning for retirement, many people approaching the end of their careers fail to take into account the tax burden they will face even after they stop working. While you will likely see a reduction in the amount of taxes you owe after the age of 65, you still need to plan ahead if you want to avoid handing over a large chunk of your retirement income to the IRS.

Depending upon your total income and marital status, a portion of your Social Security benefits may be taxable. For a rough estimate of your potential tax liability, add half of your Social Security benefits to your projected income from all other sources. This income figure must be your adjusted gross income (AGI), plus any tax-free interest income from municipal bonds or foreign-earned income. Up to half of Social Security benefits are taxable if this sum, your provisional income, exceeds \$25,000 for singles or \$32,000 for married couples filing jointly. However, up to 85% of Social Security benefits are taxable if your provisional income is above \$34,000 for single filers or \$44,000 for married couples filing jointly.

Use the Social Security Benefits Worksheet in the instructions for Form 1040 to calculate the exact amount of taxes

owed. Rather than writing a large check once a year, you can arrange to have taxes withheld from your Social Security benefits checks by completing Form W-4V and filing it with the Social Security Administration.

In addition to collecting Social Security benefits, most retirees receive their income from a variety of sources, including distributions from 401(k) accounts, individual retirement accounts (IRAs), company pensions, and annuities, or income from investments.

Contributions and earnings growth are tax-deferred on 401(k)s and traditional IRAs, but distributions from these accounts are fully taxable, though penalty-free if withdrawals are made after age 59½. If you have savings in

401(k) accounts or traditional IRAs, you will have to begin making withdrawals from these accounts—and paying taxes on the distributions—by April 1 of the year following the year in which you turn age 70½. If you are at least 59½ years old and made contributions to a Roth IRA or Roth 401(k) at least five years ago, withdrawals are completely tax free. There are no minimum distribution requirements for Roth accounts.

Most retirees with nest eggs or pension income of any size will pay at least some taxes on their retirement income, but there are strategies you can use to reduce the amount owed. While it usually makes sense to delay taking taxable distributions from retirement accounts until the funds are needed,

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THE ZERO-PERCENT CAPITAL GAINS TAX RATE

From 2008 through 2010, taxpayers in the 10% and 15% tax brackets will owe no taxes on qualified dividends and long-term capital gains. While many investors earn too much to benefit from this temporary tax break, certain categories of taxpayers, including middle-income workers, retirees, and families with children, may be able to take advantage of the 0% rate.

With the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Congress lowered the maximum capital gains tax rate from 20% to 15% for taxpayers in tax brackets of 25% and higher, and from 10% to 5% for people in the lower two tax brackets. Under JGTRRA, the 0% rate for lower-income taxpayers was slated to be in effect for 2008 only. But, with the passage of the Tax Prevention and Reconciliation Act of 2005 (TPRA), the 0% rate was extended for two more years. The long-term capital gains rate will remain unchanged at 15% through 2010 for tax-

payers in higher brackets. All of these reduced capital gains rates are currently set to expire in 2011.

To qualify for the 0% long-term capital gains rate in 2008, married couples filing jointly are permitted to have taxable incomes of up to \$65,100, and single filers may have taxable incomes of up to \$32,550. If, however, a large gain lifts a taxpayer's income above these levels, only a portion of the gains will qualify for the 0% rate.

Lower-income retirees with investments in taxable accounts may want to consider liquidating those assets while the 0% capital gains rate is in effect. Meanwhile, adult children of retired parents on lower incomes may want to give their parents stocks and bonds to sell at the 0% rate in lieu of providing cash support. Because such gifts could impact a retiree's tax liability and eligibility for certain benefits, professional advice should be sought before making these types of transfers.

Parents of younger children who do not qualify for the 0% long-term capital gains rate could still benefit from this tax break by giving appreciated assets to their children to sell. However, an expansion of the so-called "kiddie tax" that goes into effect in 2008 could make it more difficult for parents to transfer investment income to a child. In 2008, children will owe no taxes on the first \$900 of unearned income and will be taxed at their own rate on the next \$900. For unearned income above these amounts, children will be taxed at their parents' marginal rate.

Beginning in 2008, the cutoff age for the kiddie tax, which rose from 14 to 18 in 2006, increases to age 19. Also starting in 2008, full-time college students under the age of 24 will be taxed at their parents' rate on unearned income above \$1,800, unless the earned income of the students is greater than one-half of their annual support. ■

DO YOU OWE ESTIMATED TAXES?

If you are self-employed or have additional sources of income outside of your regular job, you may fall into the category of Americans who are required to file their federal taxes not just once a year in April, but four times annually. While no one likes having to pay estimated taxes to the IRS, you can make the process easier by setting aside money regularly and keeping good records.

You may need to file estimated taxes if you start your own business or work as a freelancer, or if you sell investments or other property, thus triggering capital gains taxes. Even a sudden change in the types of deductions you are able to take could mean that your usual withholding may no longer be sufficient to cover your tax bill. In short, if you expect to be hit with a large tax bill in April because you have received

additional untaxed income or have lost important deductions, you may need to start making estimated tax payments.

Taxpayers with adjusted gross incomes (AGIs) below \$150,000 are, generally, expected to pay in advance at least the amount owed on last year's return, and people with incomes above \$150,000 must pay at least 110% of the taxes owed the previous year. The IRS does not usually penalize taxpayers for failure to file estimated taxes if their federal income tax liability is less than \$1,000 or if their withholding covers 90% of the tax bill. Recipients of sudden, one-time windfalls are also seldom required to make estimated payments, provided they pay the taxes due at the end of the year. Interest charges are likely, however, if the amount of underpayment is substantial and if income is received not just once, but on a regular basis.

If you are employed but have other sources of income on which you will owe taxes, you may be able to get around having to make estimated tax payments by increasing your withholding on your W-4. Self-employed people must, however, make estimated payments in quarterly installments. For the tax year 2008, the due dates for estimated tax payments are April 15, June 16, and September 15, 2008, and January 9, 2009.

Assuming your income is fairly steady over the course of the year, the IRS expects the four estimated tax payments to be in equal installments. Most taxpayers use the amount of taxes owed in the previous year in setting their estimated payments for the following year. If, however, your income fluctuates greatly, you are permitted to adjust your payment amounts using an annualized

TAX ADVANTAGES OF CHARITABLE GIFT ANNUITIES

Many charities have programs that assist donors in purchasing gift annuities, which are designed to provide long-term financial support to both the donor and the nonprofit organization. Essentially, a charitable gift annuity is a contract between the donor and the nonprofit organization that calls for the charity to make fixed lifetime payments to the donor and, in some cases, to his or her spouse. In exchange, the charity receives the remainder of the gift to further its work when the donor, or the donor's spouse, dies.

Recognized by the IRS as a form of philanthropic giving, a charitable gift annuity offers a number of potential tax advantages. The portion of the annuity purchase that is considered a gift can be included as a charitable contribution on your itemized deductions. In addition, a portion of the payments from a charitable gift annuity is tax-free until you reach your life expectancy, while another part is taxed at ordinary income rates. If you donate appreciated securities, you will owe some capital gains taxes for the sale portion of the transaction, but the taxes are payable over your expected lifetime, rather than being due immediately.

In addition, purchasing a charitable gift annuity can reduce the size of your taxable estate. You may, for example, wish to donate appreciated property that currently generates little or no income, but which would be taxable if it were sold or passed on to the next generation.

A charitable gift annuity can also be a great option if you want to donate to your favorite charity but cannot afford to make a large gift outright. If you are thinking about purchasing a charitable gift annuity, you should, however, be aware that these annuities are not identical to commercial products, which generally offer higher rates of interest. But the tax savings associated with gift annuities can help to offset the smaller payments. The interest rates paid by all types of annuities are also usually superior to those paid on savings accounts and certificates of deposit.

Purchasing an annuity can be especially attractive at more advanced ages, as the payments will be higher. If you are younger and do not yet need the income, you can select an annuity that allows you to defer payments until reaching a specific age. If you are interested in buying a charitable gift annuity but do not yet know when you might wish to start collecting payments, you can opt for a flexible annuity, which does not require you to choose the payment starting date at the time of purchase.

To set up a charitable gift annuity, the donor typically makes a donation of cash, stock, or other assets for a set amount—usually no less than \$5,000. Under a “single life” agreement, the charity commits to making payments to one person for the course of his or her lifetime, while under a “two lives in succession” agreement, the charity makes payments first to one person and

then to a designated survivor. If you are married, you may prefer to enter into a “joint and survivor” agreement, in which the organization splits the payments between spouses during their lifetimes and makes the full payment to a surviving spouse.

Remember, however, that annuities are irrevocable, and you will not be able to extract your funds or property once the donation has been made. Keep in mind, too, that charitable gift annuity payments are not inflation-protected, and your income from this type of annuity will not go up even if the cost of living rises. On the other hand, the annuity payments become a general obligation of the charity, and the annuity is backed by the organization's entire assets, not just by the property donated. The charity is therefore committed to continuing payments throughout the lifetime of the donor, regardless of whether the funds used to purchase the annuity have been exhausted.

Even if you are already familiar with the charity from which you are purchasing the annuity, it is nonetheless advisable to investigate the financial stability of the organization to ensure that it will be able to make payments well into the future. If the charity becomes insolvent, the funds will be lost and annuity payments will stop. Charitable gift annuities are not insured, but some states regulate this type of annuity, generally requiring charities to maintain sufficient reserves to meet its obligations to annuitants. ■

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DO YOU OWE ESTIMATED TAXES?

income calculation. Your records should reflect these variations in income, or you will not be permitted to use this method for calculating tax liability.

If the IRS finds you guilty of underpaying your taxes or of failing to pay estimated taxes on time, the agency will levy interest on the amount of the payment owed based on market rates.

Thus, penalties will vary depending on the size of the underpayment, prevailing interest rates, and the amount of time that has elapsed since the payment was due.

Fortunately, filing estimated taxes is relatively easy: You simply fill out Form 1040-ES, Estimated Tax Voucher, enclose a check for the appropriate

amount, and send your payment to the IRS. After you have made your first estimated tax payment, the IRS will send you pre-printed forms that you can use in the future. Keep in mind, however, that paying estimated taxes is not a substitute for filing a complete income tax return by April 15 of each year. ■

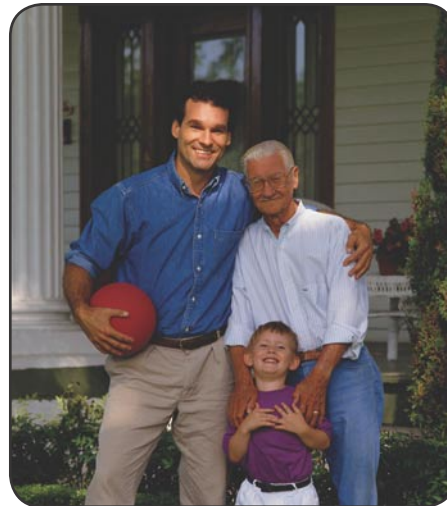
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or until distributions are required, you may want to withdraw more funds in tax years when claiming a large number of deductions temporarily lowers your tax rate. You may, for example, choose to take advantage of itemized deductions, such as the breaks for medical expenses or charitable gifts, in certain years, while taking the standard deduction in other years.

A desire to leave a portion of your assets to your family may also influence how you handle withdrawals from tax-deferred accounts. Keep in mind that, if you leave behind funds in a traditional IRA, the rules for inheritance can be complex. To avoid these issues and make it easier to pass on your estate to family members, consider converting traditional IRAs to Roth IRAs.

While you will have to pay taxes on the funds converted, moving to a Roth IRA eliminates future tax liabilities, regardless of whether you use the funds



in retirement or pass the money on to your heirs. Alternatively, you may wish to consider cashing in your traditional IRAs and using the funds to purchase tax-free bonds or a life insurance policy that will provide your heirs with a tax-free inheritance.

Depending upon the size of your taxable income and the types of investments you hold, you may also qualify for the 0% long-term capital gains rate that is in effect for the 10% and 15% tax brackets from 2008 through 2010. By selling off investments in taxable accounts, while minimizing withdrawals from tax-deferred accounts such as IRAs and 401(k)s, you may be able to take advantage of this generous tax break. ■

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