



# 2008-2009 TAX PLANNING GUIDE

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





# Saving tax is something to smile about

While paying tax is nearly unavoidable, with careful planning you can significantly reduce your taxes — perhaps even enough to smile about.

This guide provides an overview of new and proven ways to minimize your tax liability. But because tax laws are so complex, it simply can't cover all strategies that apply to you. To get the most out of the following pages, note the sections that pertain to your situation. Then contact a tax professional to learn whether the strategies discussed or others are best for minimizing your taxes and achieving your financial goals.

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## To make the most of these tax-savers, you'll need to think ahead

### DEDUCTIONS & AMT

Maximizing deductible expenses for a given year typically allows you to minimize your income tax — but not always. If you're subject to the alternative minimum tax (AMT) this year, you may be better off deferring certain expenses if you can. In other circumstances, accelerating expenses into the current year will make more sense. No matter what your situation, plan carefully to find the best strategy for you.

#### Watch out for the AMT threat

Before taking steps to maximize your deductions, consider the AMT — a separate tax system that limits some deductions and doesn't permit others, such as:

- ▼ State and local income tax deductions,
- ▼ Property tax deductions, and
- ▼ Miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) floor, including investment advisory fees and employee business expenses.

You must pay the AMT if your AMT liability exceeds your regular tax liability. Unlike the regular tax system, the AMT system isn't regularly adjusted for inflation. Instead, Congress must legislate any adjustments. For the last two years, it provided only one-year "patches," such as increasing the AMT exemption. (See Chart 7 on page 32.)

The good news is: At press time, Congress was considering additional tax relief. Work with your tax advisor to stay on top of any Congressional action and to project whether you

could be subject to the AMT this year or next. You may be able to time income and deductions to avoid the AMT, or at least reduce its impact.

## Use your home as a tax-saving tool

You can deduct interest on up to a combined total of \$1 million of mortgage debt incurred to purchase, build or improve your principal residence and a second residence. And you can deduct points related to a loan for purchasing or improving your *principal* residence. Also keep in mind these deductions and exclusions:

**Property tax deduction.** Before paying your bill early to accelerate the deduction into 2008, review your AMT situation. If you end up subject to the AMT, the prepayment will be for naught because you'll lose the deduction.

**Home equity debt interest deduction.** Interest on home equity debt used to improve your principal residence — plus interest on up to \$100,000 of home equity debt used for any purpose — is deductible. So consider using home equity debt to pay off credit cards or auto loans, whose interest isn't deductible. But beware of the AMT: If the home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes.

### Tax Law Change Alert Homeowners get tax relief

Under the Mortgage Forgiveness Debt Relief Act of 2007, from Jan. 1, 2007, through Dec. 31, 2009, homeowners who receive debt forgiveness in a foreclosure or a mortgage workout generally won't have to pay federal income taxes on that forgiveness. The law applies only to mortgages on a principal residence, not to those on second homes or rental property. It also doesn't apply to taxpayers in Chapter 11 bankruptcy. Moreover, the law extends a provision that allows taxpayers to take an itemized deduction for premiums paid or accrued on qualified mortgage insurance. The provision applies to contracts entered into after Dec. 31, 2006, and before Jan. 1, 2011.

The Housing and Economic Recovery Act of 2008 provides two significant home-related tax breaks: 1) a credit of up to \$7,500 for eligible first-time homebuyers, generally to be repaid over a 15-year period, and 2) an additional standard deduction of up to \$1,000 for joint filers (\$500 for single filers) for property taxes paid. Even if these breaks won't help you, they may help your children or parents. They're available for only a limited time; contact your tax advisor to determine if you or a loved one is eligible.

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

**Home sale gain exclusion.** When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for joint filers) of gain if you meet certain tests. Losses aren't deductible.

Because a second home is ineligible for the exclusion, consider converting it to rental use before selling. It will then be considered a business asset, and you may be able to defer tax on any gains by doing a like-kind exchange. (See page 13.) Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

### Offset health care costs

If your medical expenses exceed 7.5% of your AGI, you can deduct the excess amount. Eligible expenses include:

- ▼ Health insurance premiums,
- ▼ Medical and dental services, and
- ▼ Prescription drugs.

Expenses that are reimbursed (or reimbursable) by insurance or paid through an HSA or FSA (see below) aren't deductible.

To take advantage of the deduction, consider "bunching" your nonurgent medical procedures and other controllable expenses into one year. But keep in mind that for AMT purposes only medical expenses in excess of 10% of your AGI are deductible.

You also can save tax by paying for medical expenses with funds from an HSA or FSA:

**HSA.** If you're covered by qualified high-deductible health insurance, a Health Savings Account (HSA) allows contributions of pretax income (or deductible after-tax contributions) to an account bearing interest or invested in CDs, annuities, stocks, bonds or mutual funds. (See Chart 1.)

Withdrawals for qualified medical expenses are tax free, and you can carry over a balance from year to year. You may be eligible to roll over amounts from your FSA (see below) or IRA (see page 23) into your HSA.

**FSA.** You can redirect pretax income to an employer-sponsored Flexible Spending Account (FSA) up to an employer-determined limit. The plan then pays or

Chart 1  
2008 HSA contribution limits



reimburses you for medical expenses that weren't covered by insurance. What you don't use by the end of the plan year, you lose — though, if your plan allows, you can be reimbursed for expenses incurred up to 2½ months after the plan's year end. If you have an HSA, your FSA is limited to funding dental, optical and other "permitted" expenses.

### Give to charity

Donations to qualified charities are generally fully deductible. For large donations, discuss with your tax advisor both the types of assets to give and the best ways to give them. For example:

**Appreciated assets.** If you donate property you've held more than one year, you may be able to take a charitable deduction equal to its current fair market value. Plus you'll avoid paying tax on the long-term capital gain you'd incur if you sold the property. For instance, instead of giving cash, donate appreciated publicly traded securities.

But beware: Gifts of appreciated assets are subject to tighter deduction limits than cash contributions. Excess contributions may be carried forward for up to five years.

**CRTs.** To benefit a charity while helping ensure your own financial future, consider funding a charitable remainder trust (CRT), which pays an annual amount to you for a given term. At the term's end, the trust's remaining assets pass to one or more charities. You receive an income tax deduction for the present value of the amount that will go to charity (the remainder interest). And you can contribute appreciated assets and avoid paying capital gains tax on their sale. ▲



# Raise your kids and fund college without breaking the bank

## FAMILY & EDUCATION

Raising children and helping them pursue their educational goals — or pursuing your own — can be highly rewarding. But it also can be extremely expensive. Fortunately, a variety of tax breaks can offset some of the costs, helping you keep your family financially secure and their future bright.

### Maximize familywide savings

Many tax breaks are available to families with children; most you're probably aware of, but some you may not be:

**Tax credits.** Tax credits are especially valuable because, instead of reducing the amount of income you pay tax on, they reduce your actual tax bill dollar-for-dollar. So make sure you're taking every credit you're entitled to:

- ▼ If you have children who will be under age 17 at the end of the calendar year, you may be able to claim a \$1,000 credit per eligible child. For 2008, the credit starts to phase out when adjusted gross income (AGI) is \$75,000 for single filers and \$110,000 for joint filers, and it's phased out completely when AGI is \$95,000 or greater for single filers and \$130,000 for joint filers. The phaseout end for both single and joint filers is higher for families with more than one eligible child.
- ▼ If you have children under age 13 (or other qualifying dependents), you may be eligible for a credit for child (or dependent) care expenses of either \$3,000 or \$6,000, depending on whether you have one or two qualifying children or dependents. The credit doesn't phase out

## Tax Law Change Alert

### “Kiddie tax” expands its reach

Beginning in 2008 the “kiddie tax” applies to children age 18 and younger, as well as to full-time students under age 24 (unless the students provide over half of their own support from their earned income). In 2007, the kiddie tax applied only to those *under* 18.

These age changes dramatically affect a popular tax-saving strategy: shifting income to children. Under this strategy, parents give their children income-producing assets so the family can benefit from the child’s lower marginal tax rate. But for those subject to the kiddie tax, unearned income beyond \$1,800 (for 2008) is taxed at their parents’ marginal rate. Now a lot more children will be subject to the kiddie tax. So consider how this may alter your current tax and estate planning strategies.

Shifting income to an adult child who isn’t subject to the kiddie tax but is in a lower tax bracket can still save your family tax dollars — especially if the child qualifies for the 0% long-term capital gains tax rate that goes into effect this year. (See the Tax Law Change Alert on page 11.)

altogether, but the minimum credit percentage of 20% applies to AGIs over \$43,000 for both single and joint filers.

- ▼ If you adopt in 2008, you may be able to take either a credit or an employer adoption assistance program income exclusion; both are \$11,650 per eligible child. For both single and joint filers, the credit starts to phase out at AGI of \$174,730, and the credit is phased out completely when AGI reaches \$214,730.

**FSA.** You can redirect up to \$5,000 of pretax income to an employer-sponsored child and dependent care Flexible Spending Account (FSA). The plan then pays or reimburses you for child and dependent care expenses. You can’t claim a tax credit for expenses reimbursed through an FSA. Your tax advisor can help you determine how you can best benefit from child and dependent care tax breaks.

**Roth IRAs for kids.** Roth IRAs can be perfect for teenagers because they have many years to let their accounts grow tax free. The 2008 contribution limit for minors is the same as for adults under age 50: the lesser of \$5,000 or 100% of earned income from a legitimate job reported on their tax returns. (For more on Roth IRAs, see page 23.)

**Employing your children.** If you own a business, you can hire your children and deduct their pay. Your kids benefit too:

- ▼ They can earn as much as \$5,450 and pay zero federal income tax.
- ▼ They can earn an additional \$5,000 without paying current tax if they contribute it to a traditional IRA. (See page 23.)

Your children must perform actual work for wages and be paid in line with what you'd pay nonfamily employees.

## Save for — and with — education expenses

Whether you're saving for your children's (or grandchildren's) education, paying higher education expenses for them or yourself, or even paying off student loan debt, you may be eligible for tax breaks:

**529 plans.** Section 529 plans enable parents (or grandparents) to either secure current tuition rates with a prepaid tuition program or create tax-advantaged savings plans to fund college expenses. In addition:

- ▼ For federal purposes, contributions aren't deductible, but distributions used to pay qualified expenses are income tax free. (State treatment varies.)
- ▼ The plans typically offer much higher contribution limits (determined by the sponsoring state or private institution) than ESAs, and there are no income limits for contributing.
- ▼ There generally is no beneficiary age limit for contributions or distributions.
- ▼ 529 plans provide estate planning benefits: By filing a gift tax return, you can elect to use annual exclusions for five years all at once and make a \$60,000 contribution (or a \$120,000 joint contribution with your spouse).

**ESAs.** Coverdell Education Savings Accounts (ESAs) allow more investment options than 529 plans, and they can fund expenses for elementary (including kindergarten) and secondary school as well as college. In addition:

- ▼ Contributions aren't deductible, but distributions used to pay qualified education expenses are income tax free.
- ▼ The annual ESA contribution limit is only \$2,000 per beneficiary, and your ability to contribute will be further limited if you're a single filer and your AGI is between \$95,000 and \$110,000, or you're a joint filer and your AGI is between \$190,000 and \$220,000. The ability to

contribute is eliminated altogether if your AGI equals or exceeds the top of the applicable range.

- ▼ Generally, contributions can be made only for the benefit of a child under age 18, and amounts left in the ESA when the beneficiary turns 30 must be distributed within 30 days and any earnings will be subject to tax.

**Education credits.** When your kids hit college, you may be able to claim the Hope credit (up to \$1,800 per eligible student) or the Lifetime Learning credit (up to \$2,000 per tax return). Here are some other considerations:

- ▼ If you're a single filer and your AGI is between \$48,000 and \$58,000, or if you're a joint filer and your AGI is between \$96,000 and \$116,000, the credits will be limited. If your AGI equals or exceeds the top of the applicable range, the credits aren't available to you. But your child may be able to claim one of the credits.
- ▼ Both a credit and tax-free 529 plan or ESA distribution can be taken as long as the expenses paid with the nontaxable distribution aren't used to claim the credit.

Your tax advisor can help you select the most advantageous credit mix, depending on the amount of tuition paid and the number of students in your family.

**Student loan interest deduction.** If you're paying off student loans, you may be able to deduct up to \$2,500 of interest (per tax return). This deduction is also limited when AGI reaches \$55,000 for single filers and \$115,000 for joint filers, and it's completely phased out starting at AGIs of \$70,000 for single filers and \$145,000 for joint filers. ▲





## It's not how much you *gain*, but how much you *keep*

### INVESTING

With the market as volatile as it's been lately, you may be focusing as much attention on protecting your portfolio's value as on building it. But don't forget the tax implications of what you buy or sell, and when. Even losses can be to your advantage if you manage your portfolio to maximize after-tax gains.

#### Time gains and losses

While time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of your investment activities. The 15% long-term capital gains rate is 20 percentage points lower than the highest regular income tax rate of 35% — and it generally applies to investments held for more than 12 months. (See Chart 2 on page 12.)

Holding on to an investment until you've owned it for more than a year may help you substantially cut your tax on the gain. Keep in mind, though: You have only until 2010 to take advantage of the 15% rate (which also applies to qualified dividends), unless Congress extends it. Of course, be sure to consider overall performance and risk, not just taxes, when making investment decisions. Here are some other tax-saving strategies related to timing:

**Use unrealized losses to absorb gains.** If you've cashed in some big gains during the year, before year end look for unrealized losses in your portfolio and sell them off, thus offsetting the gains.

**Don't let tax reasons hold you back from selling at a loss.** If you're ready to divest your portfolio of a poorly performing

## Tax Law Change Alert

### No capital gains tax in 2008 — for some

From 2008 through 2010, the long-term capital gains rate drops to zero — but only for capital gain that would be taxed at 10% or 15% based on the taxpayer's regular income tax rate. If you have adult children in one of these brackets, there may be ways you can help them benefit from the lower capital gains rate, which also applies to qualified dividends.

For example, suppose you want to help out your 22-year-old daughter, who recently graduated from college and now is in a promising but low-paying job. You can give her qualified-dividend-producing stock that can provide her with tax-free income, at least through 2010.

Or perhaps you wish to give your 30-year-old son money toward a down payment to buy his first home. Instead of giving him cash, give long-term appreciated stock, which he can then sell without owing any tax on the gains.

But before implementing one of these strategies, make sure your child won't be subject to the kiddie tax. (See the Tax Law Change Alert on page 7.) Also, consider any gift tax consequences. (See page 26.)

security but don't have enough gains to absorb the loss you'll realize, remember that capital gains distributions from mutual funds can also be offset with losses. If you end up with a net capital loss, you can claim up to \$3,000 of the loss against ordinary income this year and carry forward any excess to future years.

**Identify which shares you've sold.** Investors usually want to sell high-tax-basis shares when possible to reduce gain or increase the loss and offset other gains. But if you bought the same security at different times and prices, you should specifically identify in writing which shares are to be sold by the broker to ensure you achieve the tax result you expect.

**Reduce turnover.** Selling stocks frequently or holding mutual funds with high turnover rates tends to repeatedly create short-term capital gains. Holding stocks long-term or choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

**Avoid wash sales.** The wash sale rule prevents you from taking a loss on a security if you buy a substantially identical security (or option to buy a security) within 30 days before or after you sell it — you can recognize a loss only when you sell the replacement security. Fortunately, there are ways to avoid the wash sale rule. For example, you may buy shares in a mutual fund that holds securities much like the ones you sold.

**2008 capital gains tax rates****Maximum tax rate for assets held:**12 months or less  
(short term)

35%

More than 12 months  
(long term)

15%

**Key exceptions to the 15% tax rate:**Gain on collectibles,  
such as artwork

28%

Gain attributable to certain prior  
depreciation on real property

25%

Gain that would be taxed at 10%  
or 15% based on the taxpayer's  
regular income tax rate

0%

*Source: U.S. Internal Revenue Code*

**Swap your bonds.** With a bond swap, you sell a bond, take a capital loss and then immediately buy another bond of similar quality from a different issuer. Generally, the wash sale rule (see page 11) doesn't apply because the bonds aren't considered substantially identical. Thus, you achieve a tax loss with virtually no change in economic position.

**Beware of special rules**

For some types of investments, special rules apply, so you have more tax consequences to think about than just capital gains and losses:

**Bonds.** The tax treatment of bond income varies:

- ▼ Interest on U.S. government bonds is taxable on your federal return, but it's generally exempt on your state and local returns.
- ▼ Interest on state and local government bonds is excludable on your federal return. If the state or local bonds were issued

in your home state, interest also may be excludible on your state return. **Warning:** Private activity municipal bonds may subject you to the alternative minimum tax (AMT).

- ▼ Corporate bond interest is fully taxable for federal and state purposes.
- ▼ Bonds (except U.S. savings bonds) with original issue discount (OID) build up “interest” as they rise toward maturity. You’re generally considered to earn a portion of that interest annually — even though the bonds don’t pay you this interest annually — and you must pay tax on it. So, these bonds may be best suited for tax-deferred vehicles, such as IRAs, or for investors with sufficient cash flow to absorb the tax.

**Stock options.** Before exercising (or postponing exercise of) options or selling stock purchased via an exercise, consider the complicated tax rules that may substantially add to your tax liability if you act hastily — or minimize it if you plan properly. Talk with your tax and financial advisors for the best course of action.

## Defer taxes when appropriate

Would you like to divest yourself of an appreciated asset but defer the tax liability? With proper planning, it’s possible. Here are two strategies to consider:

**1. Installment sale.** An installment sale allows you to defer capital gains on most assets other than publicly traded securities by spreading the gain over several years as you receive the proceeds. **Warning:** Ordinary gain, including certain depreciation recapture, is recognized in the year of sale, even if no cash is received.

**2. Like-kind exchange.** If you’re thinking of selling rental property or investment real estate, consider a like-kind exchange (also known as a Section 1031 exchange). You may be able to defer paying tax on the gain until you sell the replacement property.

Keep in mind, however, that tax deferral may be somewhat risky because of the scheduled return of the long-term capital gains rate to 20% in 2011. ▲





## For a buzz-worthy financial statement, brew a robust tax plan

### BUSINESS

Running a profitable business these days isn't easy. You have to operate efficiently, market aggressively and respond swiftly to competitive and financial challenges. But even when you do all of that well, taxes may drag down your bottom line more than they should. Don't let that happen. Take steps like these — and work with your tax advisor — to make your tax bill as small as possible.

### **Project your income**

Projecting your business's income for this year and next allows you to time income and deductions to your advantage. For example, in potentially high income years, consider:

**Deferring some income to later years.** If your business uses the cash method of accounting, you may be able to defer billing for your products or services. Or, if you use the accrual method, you can delay shipping products or delivering services (provided that's acceptable to the client).

**Accelerating deductions into the current year.** If you're a cash-basis taxpayer, consider making an estimated state tax payment before Dec. 31, so you can deduct it this year rather than next year. But be sure to consider the alternative minimum tax (AMT) consequences. For accrual taxpayers, accelerating deductions is possible, but more complicated.

On the other hand, if you expect to be in a higher income tax bracket *next* year, you may be better off accelerating income into the current year and deferring deductions to next year.

## Accelerate depreciation

Careful planning during the year can help you maximize depreciation deductions in the year of purchase:

- ▼ Determine whether your purchase may be eligible for Section 179 expensing or 50% bonus depreciation. (See the Tax Law Change Alert on page 18.)
- ▼ For purchases that don't qualify for those breaks, you'll generally want to use the Modified Accelerated Cost Recovery System (MACRS), instead of the straight-line method, to get a larger deduction in the early years of an asset's life.
- ▼ The IRS generally treats all newly acquired tangible assets other than real estate as being placed in service at the midpoint of the year. This gives you six months of depreciation in the first year.
- ▼ If you make more than 40% of the year's asset purchases during the last three months of the year, you must use the generally less favorable midquarter convention.

If you've recently purchased or built a building or are remodeling existing space, consider a cost segregation study:

- ▼ It identifies property components, and their related costs, that can be depreciated over five or seven years using 200% of the straight-line rate, or over 15 years using 150% of the straight-line rate.
- ▼ This allows you to depreciate the property much faster and may dramatically increase your current deductions.
- ▼ Typical assets that qualify for this faster depreciation include decorative fixtures, cabinets, security equipment, parking lots, landscaping, and architectural fees allocated to qualifying property.

The benefit of a cost segregation study may be limited in certain circumstances — for example, if the business is subject to the AMT or located in a state that doesn't follow federal depreciation rules.

## Check out the manufacturers' deduction

The manufacturers' deduction, or the Section 199 deduction, presents many businesses with a wide range of planning opportunities:

- ▼ The deduction for 2008 and 2009 is 6% of the lesser of qualified production activities income or taxable income (adjusted gross income for individuals). In 2010, when it's fully phased in, the deduction will be 9%.

Chart 3

**2008 corporate income tax rate schedule**

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

*Note: Personal service corporations are taxed at a flat 35% rate.*

*Source: U.S. Internal Revenue Code*



- ▼ The deduction is further limited by W-2 wages paid by the taxpayer during the calendar year (or, for fiscal year taxpayers, during the calendar year that ends in the fiscal tax year). Moreover, wages not properly allocable to domestic production gross receipts are excluded from W-2 wages for the purposes of the deduction.
- ▼ The deduction is available not just to traditional manufacturers but also to businesses engaged in activities such as construction, engineering, computer software production and agricultural processing.
- ▼ The deduction applies to several categories of qualifying activities, including any lease, rental, license or sale of qualifying production property that's manufactured, produced, grown or extracted in whole or in significant part in the United States.
- ▼ The deduction isn't allowed in determining net earnings from self-employment and generally can't reduce net income below zero. But it can be used against the AMT.

Work with your tax advisor to determine whether your business qualifies, if there are ways to increase your deduction, and how to capture the necessary information in your accounting system.

### Deduct auto expenses when you can

Your business vehicle can save you taxes, especially when surges in fuel costs are affecting every business. However, you must abide by strict recordkeeping rules and keep a contemporaneous log of business vs. personal miles. Vehicle expenses can be deducted using the mileage method (50.5 cents per business mile driven from Jan. 1

through June 30, 2008, and 58.5 cents per business mile driven from July 1 through Dec. 31, 2008) or the actual method (total out-of-pocket expenses for fuel, insurance and repairs, plus depreciation). Choosing whether to use the mileage or actual method is complicated, so be sure to consult your tax advisor to maximize your tax benefit.

Also take advantage of increased depreciation opportunities available under the Economic Stimulus Act of 2008. (See the Tax Law Change Alert on page 18.)

## **Make the best of a bad situation**

While losses are usually undesirable, they can offer tax benefits:

- ▼ Generally, a net operating loss (NOL) may be carried back two years to generate a current tax refund, which can provide a cash infusion in times of loss. Any loss not absorbed in the prior two-year period is then carried forward for up to 20 years. (When this guide went to press, Congress was considering extending the carryback period; check with your tax advisor for the latest information.)

### **Tax Law Change Alert**

#### **Nonqualified deferred compensation plan compliance date looms**

Employers have until Dec. 31, 2008, to bring their nonqualified deferred compensation (NQDC) plans into compliance with the final regulations under Section 409A of the Internal Revenue Code. NQDC plans generally aren't subject to nondiscrimination rules, so they can be used to provide substantial benefits to only your key employees.

In exchange for this flexibility, an employer generally doesn't get a deduction for NQDC plan contributions until the employee recognizes the income. This is unlike a qualified plan, such as a 401(k), in which the employer normally deducts the contribution in the year it's made, even though the employee doesn't generally recognize income until he or she withdraws the funds.

Employers should identify all plans that may be subject to Sec. 409A and have them reviewed to determine whether they're operationally and administratively Sec. 409A compliant. If a plan isn't compliant, the employer must bring the plan and plan documents into conformity by Dec. 31, 2008. The penalties for noncompliance can be severe: Plan participants will be taxed on plan benefits at the time of vesting, and a 20% penalty tax and potential interest charges also will apply.

## Tax Law Change Alert

### 2008 legislation provides incentives for asset purchases

The Economic Stimulus Act of 2008 includes two provisions that can provide you with large 2008 deductions if you make major asset purchases this year. First, the act increases the Section 179 expensing limit to \$250,000 (from \$128,000):

- ▼ The Sec. 179 election allows a current deduction for newly acquired assets that otherwise would have to be depreciated over a number of years.
- ▼ A business can claim the election only to offset its net income, not to reduce net income below zero.
- ▼ Because this tax break is designed to benefit primarily smaller businesses, it begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$800,000 (up from \$510,000 before the act).

The new higher limits apply only for calendar year 2008 or your business's fiscal year that begins in 2008.

Second, the act offers a special allowance for certain property, generally only if acquired and put into service this year. For eligible property, the special depreciation amount is equal to 50% of its adjusted basis. Property eligible for this "bonus" depreciation includes:

- ▼ Tangible property with a recovery period of 20 years or less,
- ▼ Computer software purchased by the business,
- ▼ Water utility property, and
- ▼ Qualified leasehold improvement property.

For passenger automobiles that are eligible property under the 50% bonus depreciation rules, the first-year limit on depreciation is increased by \$8,000.

Under the Housing and Economic Recovery Act of 2008, corporate taxpayers can take advantage of a provision that allows them to accelerate their alternative minimum tax and Research and Development credits in lieu of taking bonus depreciation for which they are otherwise eligible. This provision is generally effective for property placed in service after March 31, 2008, and before Jan. 1, 2009.

The Housing act also extends the deadline for a special 50% bonus depreciation allowance available for certain qualified Gulf Opportunity (GO) Zone property, generally to Dec. 31, 2010. The GO Zone includes certain areas affected by Hurricanes Katrina, Rita or Wilma.

Not part of either the Stimulus act or the Housing act but also of note: An expanded Sec. 179 expensing election effective through 2008 for selected portions of the GO Zone. Certain property located in specified portions of the GO Zone enjoys a later deadline of Dec. 31, 2010.



- ▼ You may choose to waive the carryback period and carry the entire loss forward, which may be beneficial if your marginal tax rate in the carryback years is unusually low, or if the AMT in prior years makes the carryback less beneficial. **Warning:** The election to waive the carryback period must be made by the due date of the tax return (plus extensions) for the year in which the NOL arose.

## Provide employee benefits

Including a variety of benefits in your compensation package can help you not only attract and retain the best employees, but also manage your tax liability. In particular, consider:

### Qualified deferred compensation plans.

These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. You can enjoy a tax deduction for your contributions to employees' accounts, and the plans offer tax-deferred savings benefits for employees. (For more on the benefits to employees, see page 22.)



**HSAs and FSAs.** If you provide employees with qualified high-deductible health insurance (which can help you control your business's health care costs), you can also offer them Health Savings Accounts (HSAs). Regardless of the type of health insurance you provide, you also can offer health care Flexible Spending Accounts (FSAs) and child and dependent care FSAs. These plans can help you attract and keep employees. (See pages 4 and 7 for details.)

**Fringe benefits.** Some fringes, referred to as "statutorily excluded" benefits, aren't included in employee income. Both the employer and the employee come out ahead: The employer receives a deduction, but the value of the benefit is tax free to the employee. Plus, the business usually avoids payroll taxes on these amounts. Examples of benefits treated in this manner include group-term life insurance (up to \$50,000), health insurance, parking and employee discounts.

## Look at business structure

Structures range from sole proprietorships to C corporations. Income taxation and owner liability are the main factors that differentiate one from another. Many businesses choose entities that combine flow-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations. Sometimes it makes sense to change business structures, but

there may be unwelcome tax consequences, so be sure to consult your tax advisor.

Some tax differences between structures may provide planning opportunities, such as those related to salary vs. distributions:

**S corporations.** To reduce their employment tax, shareholder-employees may want to keep their salaries relatively low and increase their distributions of company income (which generally isn't taxed at the corporate level). **Warning:** The IRS expects shareholder-employees to take a reasonable wage each year. What is considered "reasonable" is determined by the specific facts and circumstances.

**C corporations.** Shareholder-employees may prefer to take more income as salary (which is deductible at the corporate level) because the overall tax paid by both the corporation and the shareholder-employee may be less.

## Be tax-smart when exiting your business

All business owners should create an exit strategy to sell their companies or to pass them on to their children, other family members or key employees. Potential tax consequences are one of the many important factors to consider if you're selling the business:

**Asset vs. stock sale.** With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. Buyers generally want an asset sale to maximize future depreciation write-offs.

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

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

## Tax Law Change Alert

### Many tax credits in limbo

Tax credits reduce your business's tax liability dollar-for-dollar, so they're particularly valuable. Unfortunately, many tax credits for businesses aren't permanent, and thus require Congress to extend them.

Among the credits that expired in 2007 and hadn't yet been extended (or made permanent) when this publication went to press are:

- ▼ The Empowerment Zone credit, and
- ▼ The Research and Development credit.

The Work Opportunity credit, however, has been extended through Aug. 31, 2011. It benefits businesses hiring employees from certain economically disadvantaged groups, such as ex-felons, food stamp recipients and disabled veterans.

Be sure to check with your tax advisor for the latest information on the credits your business may qualify for.

**Installment sale.** If a taxable sale is chosen, the transaction may be structured as an installment sale, due to the buyer's lack of sufficient cash or the seller's desire to spread the gain over a number of years. Installment sales are also useful when the buyer pays a contingent amount based on the business's performance. But an installment sale can backfire in some situations. For example:

- ▼ Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- ▼ If tax rates increase in the future, the overall tax could wind up being more on an installment sale than on a cash sale. (Remember, the favorable 15% rate on long-term capital gains is scheduled to end Dec. 31, 2010.)

## Benefit from tax breaks for the self-employed

If you're self-employed, you can deduct 100% of health insurance costs for yourself, your spouse and your dependents. This above-the-line deduction is limited to the net income you've earned from your trade or business. Half of the self-employment tax you pay on your self-employment income and all contributions you make to a retirement plan and HSA for yourself are also deducted above-the-line. And you may be able to deduct home office expenses against your self-employment income. ▲



# Reap more in your golden years: Tend to your retirement plans

## RETIREMENT

While growing older just happens, building and preserving funds for retirement takes careful planning, disciplined saving and wise investing. Fortunately, many tax-advantaged retirement savings tools are available. But there are also tax traps you'll need to sidestep if you want to fully enjoy the fruits of your labor.

### Save tax-deferred first

Because of the tax advantages, contributing to an employer-sponsored retirement plan, such as a 401(k), 403(b), 457, SIMPLE or SARSEP, is usually the best first step in retirement planning:

- ▼ Contributions are generally pretax, so they reduce your taxable income.
- ▼ Plan assets can grow tax-deferred — meaning that you pay no income tax until you take distributions.
- ▼ Your employer may match some or all of your contributions, also on a pretax basis. At minimum, contribute the amount necessary to get the maximum employer match.

See Chart 4 for the 2008 contribution limits. Note that, if you're age 50 or older, you're eligible to make a "catch-up" contribution.

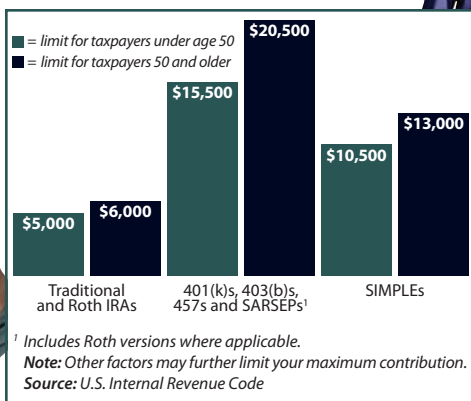
In certain situations, other tax-deferred savings options may be available:

**If you're a business owner or self-employed.** You may be eligible for a plan that would allow you to make much larger contributions. Depending on the plan, you might not have to make 2008 contributions, or even set up the plan, until after year end.

Chart 4

## 2008 retirement plan contribution limits

“Catch-up” contributions mean higher retirement plan contribution limits for workers age 50 or older.



**If your employer doesn't offer a retirement plan.** Consider contributing to a traditional IRA:

- ▼ You can generally deduct your contributions, though your deduction may be limited based on your adjusted gross income (AGI) if your spouse participates in an employer-sponsored plan.
- ▼ Contribution limits, including for catch-up contributions, are lower than those for employee contributions to employer-sponsored plans. (See Chart 4.)

You can make 2008 IRA contributions as late as April 15, 2009.

### Consider tax-free opportunities

A potential downside of tax-deferred saving is that you'll have to pay taxes when you make withdrawals at retirement. Two retirement plan options allow tax-free distributions; the tradeoff is that contributions to these plans don't reduce your current-year taxable income:

**1. Roth IRAs.** In addition to tax-free distributions, an important benefit is that, unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime. This can provide income tax and estate planning advantages. But Roth IRAs are subject to the same relatively low annual contribution limit as traditional IRAs. (This limit applies to your total combined Roth and traditional IRA contributions — see Chart 4.) Your Roth IRA contribution may be further limited based on your AGI.

If you have a traditional IRA, consider whether you might benefit from converting it to a Roth IRA:

- ▼ You must generally pay tax on the conversion, but you can enjoy tax-free distributions in the future.
- ▼ You can make the conversion only if your AGI for the year of the conversion is \$100,000 or less. (This limit is scheduled to be eliminated beginning in 2010.)

**2. Roth 401(k)s and Roth 403(b)s.** If you participate in a 401(k) or 403(b) plan and the plan allows it, you may designate some or all of your contributions as Roth contributions. (Employer matches, however, aren't eligible to be treated as Roth contributions.) There are no AGI limits on designating Roth 401(k) contributions, so these plans may be especially beneficial for taxpayers who are ineligible to contribute to Roth IRAs because their AGIs are too high.

### Take care when changing jobs

With a few exceptions, retirement plan distributions made before age 59½ are subject to a 10% penalty. When you change jobs, you may receive a lump-sum distribution from your employer's retirement plan. To avoid the early-withdrawal penalty and other negative income tax consequences, request a direct rollover of your retirement plan assets to either your IRA or your new employer's retirement plan.

If the funds from the old plan are instead paid to you, you'll need to make an indirect rollover to your IRA or new plan within 60 days to avoid the tax and potential penalty on those funds. Be careful, though, to roll over the *gross* amount of the distribution. The check you receive from your old plan may be net of federal income tax withholding. If you don't roll over the gross amount, you'll likely be subject to income tax and the 10% penalty on the difference.

For instance, if you had a \$100,000 gross distribution from your 401(k) but received a check for only \$80,000 due to \$20,000 of federal tax withholding, you'll need to come up with the \$20,000 difference when you make the rollover to your IRA or new 401(k). Otherwise, the \$20,000 will be subject to income tax and, if you're under age 59½, the 10% penalty. You'll be able to claim the \$20,000 withheld when you file your income tax return, but that may be of little help during the 60-day rollover period.

### Follow the distribution rules

For employer-sponsored plans and traditional IRAs, once you reach age 70½ you're subject to the required minimum

## Make withdrawals wisely

Suppose you've got a \$250,000 traditional IRA and are trying to decide whether it's smarter to:

1. Take 5% withdrawals starting the year you turn age 65½ and then take the greater of 5% of the balance or your required minimum distribution (RMD) starting the year you turn 70½, or
2. Wait to take distributions until the year you turn 70½ and then take the greater of 5% or your RMD.

Assuming a 7% return on your IRA funds, here's what you could expect under the two scenarios:

Age at year end	Scenario 1: Starting at age 65½	
	Total received	Year end IRA balance
Age 70½	\$ 59,139	\$ 281,541
Age 80½	\$ 175,929	\$ 341,597
Age 90½	\$ 361,199	\$ 340,356

Age at year end	Scenario 2: Starting at age 70½	
	Total received	Year end IRA balance
Age 70½	\$ 13,149	\$ 357,651
Age 80½	\$ 161,501	\$ 433,942
Age 90½	\$ 396,867	\$ 432,366

By waiting until age 70½ you'd not only maintain a much larger balance in the account, but, if you lived long enough, you'd also receive more total distributions. So if you could afford to leave the funds in the plan until that age, you might want to do so — even if it means depleting other investment accounts. Of course, additional factors may impact your specific situation, so consult your tax and financial advisors to determine the best strategy for you.

*This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume a balance of \$250,000 at the beginning of the year you turn 65½, withdrawals at the end of the year in which you reach the stated age, and your birthday falling in the first half of the year. The amounts presume federal income taxes of 25% that would be due on the distributions, but don't reflect any other potential tax consequences that would be unique to your circumstances.*

distribution (RMD) rules. If you don't comply, you may owe a penalty equal to 50% of the amount you should have withdrawn but didn't. There's an exception for employer-sponsored plans that may allow you to delay taking RMDs until you retire. For you to use this exception, the plan must specifically allow it, and you can't own more than 5% of the company.

Whether you should take distributions before age 70½ or take more than your RMDs after that age depends on how much income you'll receive from other sources, whether your tax bracket is likely to change, your life expectancy and other factors. Generally, maximizing tax-deferred growth provides more savings. (See Case Study 1.) ▲



# Plan now to leave the legacy you desire

## ESTATE PLANNING

As difficult as it is, accumulating wealth is only the first step to providing a financially secure future for your family. You also need to develop a comprehensive estate plan. The earlier you begin, the more options you'll have to grow and transfer your wealth in a way that minimizes taxes and leaves the legacy you desire.

### Keep taxes to a minimum

The top gift and estate tax rates and the generation-skipping transfer (GST) tax rate are currently 45%. The estate and GST taxes are scheduled to be repealed for only one year, 2010, and the gift tax will remain in place that year, albeit at a lower rate (equal to the top income tax rate at the time, scheduled to be 35%). So taking steps to minimize these taxes is as important as ever. Fortunately, some exemptions, exclusions and deductions are available to help you do just that:

**Gift and estate tax exemptions.** During your lifetime, the gift tax exemption allows you to transfer up to \$1 million without paying gift tax. At death, transfers up to the estate tax exemption amount minus any gift tax exemption used can be made free of estate tax. For 2008, the estate tax exemption amount is \$2 million.

**Annual gift tax exclusion.** You can exclude most gifts of up to \$12,000 per recipient each year (\$24,000 per recipient if your spouse elects to split the gift with you, or you're giving community property) without using up any of your gift tax exemption. If you gift more than \$12,000

## Be careful when giving to grandchildren

With the exception of most annual exclusion gifts, for a generation-skipping transfer (GST) to be completely tax free, you must apply not only your GST tax exemption but also either your gift or estate tax exemption. So, for example, if you already made an annual exclusion gift to your granddaughter for the year and you want to give her an additional \$20,000 to help her pay for her dream wedding, you'll have to use \$20,000 of your GST tax exemption plus \$20,000 of your gift tax exemption to avoid any tax on the transfer.

during the year to one person, you must file a gift tax return, even if no tax is due. (The exclusion is adjusted for inflation, but only in \$1,000 increments. So it doesn't increase annually.)

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

**GST tax exemption.** The GST tax applies to transfers (both during life and at death) made to people two generations or more below you, such as grandchildren. For 2008, the GST tax exemption is \$2 million.

**Charitable deduction.** There's no limit on this deduction. If you bequeath your entire estate to charity, no estate tax will be due. (For more on charitable giving, see page 5.)

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





## Start giving now

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

**Choose gifts wisely.** Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

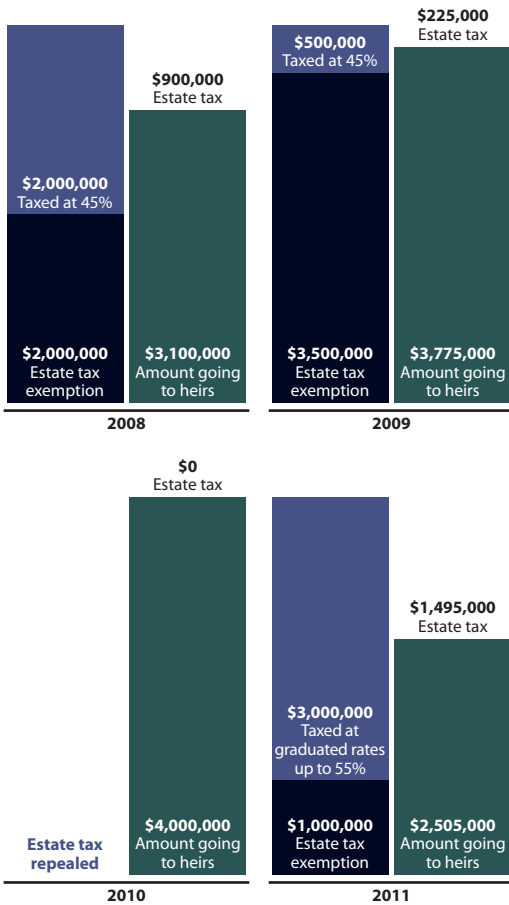
- ▼ To minimize *your estate tax*, gift property with the greatest future appreciation potential.
- ▼ To minimize *your beneficiary's income tax*, gift property that hasn't already appreciated significantly since you've owned it.
- ▼ To minimize *your own income tax*, don't gift property that has declined in value; instead sell the property so you can take the tax loss and then gift the sale proceeds.

**Make annual exclusion gifts to grandchildren.** Such gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers.

**Gift interests in your business.** If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the discounts total 30%, you can gift an ownership interest equal to as much as \$17,143 tax free because the discounted value doesn't exceed the \$12,000 annual exclusion. But the IRS may challenge the value; a professional appraisal is required to substantiate it.

Chart 5

## The changing impact of the federal estate tax on a \$4 million taxable estate



*Note: The chart assumes no gift tax exemption was used during life, and it doesn't include state estate tax, which could reduce the amount going to heirs.*

**Gift FLP interests.** If you don't own a business but you'd like to benefit from valuation discounts, you can set up a family limited partnership (FLP). You fund the FLP and then gift limited partnership interests. But the IRS is scrutinizing FLPs, so make sure you set up and operate yours properly.

**Pay tuition and medical expenses.** You may pay these expenses for a loved one without the payment being treated as a taxable gift, as long as the payment is made directly to the provider.

## Take advantage of trusts

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

- ▼ A credit shelter (or bypass) trust can help minimize estate tax by taking advantage of both spouses' estate tax exemptions.
- ▼ A qualified domestic trust (QDOT) can allow you and your non-U.S.-citizen spouse to take advantage of the unlimited marital deduction.
- ▼ A qualified terminable interest property (QTIP) trust is good for benefiting first a surviving spouse and then children from a prior marriage.
- ▼ A qualified personal residence trust (QPRT) allows you to give your home to your children today — removing it from your taxable estate at a reduced tax cost (provided you survive the trust's term) — while you retain the right to live in it for the trust's term.
- ▼ A grantor-retained annuity trust (GRAT) works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period.
- ▼ A GST or dynasty trust can help you leverage your GST tax exemption.

## Reap the benefits of insurance

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax.

Life insurance offers many tax advantages. For one, proceeds are generally income tax free to the beneficiary. And with proper planning, you can ensure proceeds are not included in your taxable estate. Also, policies that build cash value do so on a tax-deferred basis. But think twice before transferring an existing policy to someone else; in certain circumstances you could suffer negative tax consequences.

Long-term care (LTC) insurance also is worth considering, because the legacy you want to leave for your family can disappear if you or a loved one requires years of such care. And LTC insurance premiums may be deductible, provided your total medical expenses for the year exceed 7.5% of your adjusted gross income (AGI). Some states allow a deduction for or credit based on LTC insurance premiums even if you don't have enough medical bills to qualify for a federal deduction. ▲

Chart 6

**2008 individual income tax rate schedules**

Tax rate	Regular tax brackets	
	Married filing jointly or surviving spouse	Married filing separately
10%	\$ 0 – \$ 16,050	\$ 0 – \$ 8,025
15%	\$ 16,051 – \$ 65,100	\$ 8,026 – \$ 32,550
25%	\$ 65,101 – \$ 131,450	\$ 32,551 – \$ 65,725
28%	\$ 131,451 – \$ 200,300	\$ 65,726 – \$ 100,150
33%	\$ 200,301 – \$ 357,700	\$ 100,151 – \$ 178,850
35%	Over \$ 357,700	Over \$ 178,850



Tax rate	Single	Head of household
10%	\$ 0 – \$ 8,025	\$ 0 – \$ 11,450
15%	\$ 8,026 – \$ 32,550	\$ 11,451 – \$ 43,650
25%	\$ 32,551 – \$ 78,850	\$ 43,651 – \$ 112,650
28%	\$ 78,851 – \$ 164,550	\$ 112,651 – \$ 182,400
33%	\$ 164,551 – \$ 357,700	\$ 182,401 – \$ 357,700
35%	Over \$ 357,700	Over \$ 357,700



Source: U.S. Internal Revenue Code

Chart 7

## 2008 individual AMT rate schedules

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

AMT exemption <sup>1</sup>			
	Married filing jointly or surviving spouse	Married filing separately	
Exemption	\$ 45,000	\$ 22,500	
Phaseout <sup>2</sup>	\$ 150,000 – \$ 330,000	\$ 75,000 – \$ 165,000	
	Single	Head of household	
Exemption	\$ 33,750	\$ 33,750	
Phaseout <sup>2</sup>	\$ 112,500 – \$ 247,500	\$ 112,500 – \$ 247,500	

<sup>1</sup> These amounts were accurate at the time this guide went to press, but Congress was discussing increasing them. Consult your tax advisor for the latest information.

<sup>2</sup> The alternative minimum tax (AMT) income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

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

**Source:** U.S. Internal Revenue Code

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