

# Those who know, plan

With the passage of every new tax law, the tax code becomes more complex. So, while there are now more ways than ever to reduce your tax liability, taking full advantage of them is becoming increasingly difficult. Indeed, as savvy taxpayers know, without careful planning it's virtually impossible.

To help you keep current with changes in tax law, regulations and planning strategies — and save as much tax as possible — we are pleased to offer this tax guide. It highlights recent tax law changes, discusses various taxpayer scenarios, and points out steps — some proven and some new — you can take to lighten your tax burden.

The guide looks at ways to maximize deductions and take advantage of various tax breaks for you and your family. It explains how to minimize taxes on investment gains and lower your business taxes. And it shows how to build up the funds you'll need for retirement, protect your wealth and transfer it to loved ones in a tax-efficient manner.

Given the complexity of tax laws and tax planning, this guide simply cannot cover all strategies that apply to you. So, as you read through the chapters, note the sections that seem to pertain to your situation. Then, before implementing any of the ideas suggested here, consult a tax professional. He or she can advise you about whether these or other strategies may be best for reducing your taxes and achieving your financial goals.

## Contents

<b>Tax law changes</b>	<b>2</b>
<b>Deductions</b>	<b>3</b>
<b>Family and education</b>	<b>5</b>
<b>Investing</b>	<b>7</b>
<b>Business</b>	<b>9</b>
<b>Retirement</b>	<b>13</b>
<b>Wealth management</b>	<b>15</b>

## Charts

<b>Chart 1:</b> 2006 individual income tax rate schedules	<b>4</b>
<b>Chart 2:</b> 2006 family and education tax break AGI phaseouts	<b>6</b>
<b>Chart 3:</b> Capital gains tax rates	<b>7</b>
<b>Chart 4:</b> 2006 corporate tax rate schedule	<b>9</b>
<b>Chart 5:</b> Retirement plan contribution limits	<b>14</b>
<b>Chart 6:</b> Transfer tax exemptions and rates	<b>15</b>

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# 2006 is setting a rapid pace for tax law changes

*How much more will we see?*

Congress has passed and the President has signed two major tax-related bills in 2006 thus far: the Pension Protection Act of 2006 (PPA), which was passed only after years of debate and months of negotiation between House and Senate lawmakers, and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). These new laws affect a wide variety of tax planning areas, such as investing, college funding, retirement planning, charitable giving and the alternative minimum tax (AMT).

## PPA

In August 2006, Congress finally made good on its promise to create reforms that would help make secure traditional pension plans. Specifically, PPA takes measures to ensure full funding of these plans, including even stricter requirements on plans deemed “at risk.” On the other hand, PPA allows assets in excess of 120% of current liability to be used to fund retiree health benefits for both single-employer and collectively bargained plans. It also makes permanent the increases in the annual benefit limit that had been set to expire after 2010.

But PPA goes much further — it enhances retirement savings held in IRAs and defined contribution plans, such as 401(k)s, 403(b)s, 457s and SIMPLEs. For example, PPA makes permanent many provisions from the 2001 tax act that were to “sunset” after 2010, such as higher contribution limits, “catch-up” contributions for

those 50 and older, and Roth 401(k)s and 403(b)s. And, beginning in 2008, it simplifies the rules for automatic enrollment in employer-sponsored defined contribution plans.

PPA also brings changes related to charitable contributions (see page 3) and the way not-for-profits operate. For instance, to curtail charity-related abuses, PPA tightens federal oversight of the organizations themselves by doubling fines and penalties for certain activities by exempt organizations and extending present-law public disclosure requirements applicable to Form 990 to the Unrelated Business Income Tax (UBIT) returns of Section 501(c)(3) organizations.

Finally, in a nod to our men and women in the military, PPA waives the early withdrawal penalty from IRAs or 401(k)s for many National Guard members and reservists who are called to active duty through 2007, and it allows repayment

within two years of the distribution without regard to the annual contribution limit. This provision comes on the heels of a smaller act that was passed in May 2006. The Heroes Earned Retirement Opportunities Act of 2006, retroactive to 2004, allows tax-exempt combat pay to be included when determining eligibility to contribute to an IRA.

## TIPRA

This tax act, passed in May 2006, extends through 2010 the lower (15%) maximum rate on most long-term capital gains and qualified dividends. It also extends through 2009 the higher limit (\$100,000 indexed for inflation) on expensing of certain depreciable assets under Section 179. And the new legislation provides a temporary and limited fix for taxpayers caught in the AMT trap by increasing the AMT exemptions, but only through 2006.

In addition, TIPRA changes the “kiddie” tax rules. Previously, only children under the age of 14 were taxed on unearned income at their parents’ tax rate. Now the age threshold has been increased to 18 (with some exceptions). The new law also removes the income restriction (currently \$100,000) for Roth IRA conversions, but this change doesn’t begin until 2010. ♣

# The more, the merrier

*Tax-saving opportunities abound for those who seek them*

Finding a new deduction can turn even the most hardened taxpayer into a giddy school kid. Our tax code is filled with tax-saving opportunities just waiting for those who take the time to uncover them. Whether you're a philanthropist, homeowner or landlord, Uncle Sam has a deduction custom-made for you. Here are some for you to explore.

**Maximize charitable giving.** Charitable contributions are generally fully deductible. So the more you donate, the more tax benefit you receive this year, as long as your itemized deductions exceed the standard deduction and you don't surpass statutory limits — 50%, 30% or 20% of your adjusted gross income (AGI), depending on what you donate and whether the recipient is a public charity or an operating or nonoperating foundation. Contributions in excess of the limits may be carried forward — for future use — for up to five years. For larger donations, consider more sophisticated charitable vehicles such as private foundations or donor-advised funds.

Be aware that, under the Pension Protection Act of 2006 (PPA), every cash donation must be supported by a canceled check, credit card receipt or written communication from the charity. Moreover, to be deductible, clothing and household good donations must be in at least "good condition." On the plus side, if you're 70½ or older, PPA allows you to give up to \$100,000 each year (through 2007) to your favorite charity

directly from an IRA. You won't get a tax deduction if the IRA distribution would otherwise have been taxable, but you save the tax you would have otherwise owed.

**Donate 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. Beware: The deduction amount is subject to tighter limits (30% or 20% of AGI) than cash contributions.

**Create a charitable remainder trust (CRT).** A great way to benefit a charity while helping ensure your own financial future is to fund a trust that, for a given term, will pay income to you. At the

## *Tax Action Strategy*

### Look into tax-favored health care accounts

If your employer offers either a Flexible Spending Account (FSA) or a Health Savings Account (HSA), be sure to take advantage of these plans, because participation reduces your taxable income.

FSAs allow you to redirect pretax income to your account up to an employer-determined limit. The plan then pays or reimburses you for medical expenses incurred that were not 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.

HSAs permit you to contribute pretax income up to the lesser of your health plan deductible or \$5,450 annually for a family plan (\$2,700 for individual coverage) to interest-bearing accounts or mutual funds. Account holders age 55 and older may contribute an additional \$700 in 2006. HSAs require that you be covered by high-deductible health insurance. Withdrawals for medical expenses are tax free, and you can carry over a balance from year to year.

**Chart 1**  
2006 individual income tax rate schedules

Taxable income	Base tax	Marginal tax rate (tax on next dollar)	Taxable income	Base tax	Marginal tax rate (tax on next dollar)
<b>Married filing jointly or qualifying widow(er)</b>			<b>Single</b>		
\$ 0	\$ 0	10%	\$ 0	\$ 0	10%
\$ 15,100	\$ 1,510	15%	\$ 7,550	\$ 755	15%
\$ 61,300	\$ 8,440	25%	\$ 30,650	\$ 4,220	25%
\$ 123,700	\$ 24,040	28%	\$ 74,200	\$ 15,107.50	28%
\$ 188,450	\$ 42,170	33%	\$ 154,800	\$ 37,675.50	33%
\$ 336,550 and above	\$ 91,043	35%	\$ 336,550 and above	\$ 97,653	35%
<b>Married filing separately</b>			<b>Head of household</b>		
\$ 0	\$ 0	10%	\$ 0	\$ 0	10%
\$ 7,550	\$ 755	15%	\$ 10,750	\$ 1,075	15%
\$ 30,650	\$ 4,220	25%	\$ 41,050	\$ 5,620	25%
\$ 61,850	\$ 12,020	28%	\$ 106,000	\$ 21,857.50	28%
\$ 94,225	\$ 21,085	33%	\$ 171,650	\$ 40,239.50	33%
\$ 168,275 and above	\$ 45,521.50	35%	\$ 336,550 and above	\$ 94,656.50	35%

Source: U.S. Internal Revenue Code

end of the term, the trust's remaining assets pass to one or more charitable organizations. You receive an income tax deduction for the present value of the amount that will go to charity. And you can contribute appreciated assets and avoid paying capital gains tax while possibly increasing your annual cash flow.

**Maximize home deductions.** You can deduct interest on a second home as long as your combined home mortgage debt doesn't exceed \$1 million. Deduct related points in addition to interest if the loan is for purchasing or improving your principal residence. Refinancing points must be amortized over the loan's term.

**Pay off nondeductible interest with a home equity loan.** You may be able to maximize your interest deduction by paying off nondeductible interest — such as that on credit cards or auto loans — with money from a deductible class, such as a home equity loan. If you're paying off credit cards, you likely also will benefit by paying interest at a much

lower rate. Interest is deductible on home equity loan balances up to \$100,000.

**Make the most of moving.** You can exclude up to \$250,000 (\$500,000 if you're married filing a joint return) of the gain you realize on the sale or exchange of your principal residence, as long as you meet certain tests.

**Take advantage of rental rules.** If you rent a portion of your primary residence or vacation home for less than 15 days, you need not report the income. If you convert your residence from personal to rental use, you may reap other benefits. For example, you may be able to do a like-kind exchange after the conversion. And, if you used the home as your principal residence for at least two of the five years preceding the date of the exchange, you may be able to exclude up to \$250,000 (or \$500,000) of the gains as described above before applying the like-kind exchange rules, thus increasing the tax basis of the replacement property by the amount

of the excluded gain. Or, if you sell the property at a loss, you may be able to deduct the loss because the property is considered a business asset.

**Watch out for the AMT.** Originally aimed at those sheltering excessive amounts of income, the alternative minimum tax (AMT) continues to affect more and more middle-class taxpayers. AMT rates are 26% and 28%, but many deductions allowed in calculating regular tax liability aren't allowed for the AMT, such as state and local income taxes, property taxes, and some miscellaneous itemized deductions. If your AMT liability exceeds your regular tax liability, you must pay the AMT. For 2006, the AMT exemption is \$62,550 for joint filers, \$42,500 for single filers and those filing as heads of households, and \$31,275 for married persons filing separately. Project whether you'll fall under the AMT this year or next, and then time income and deductions as much as possible to either avoid the tax or protect your deductions. ♣

# Recess is over

*It's time to take a serious look at your tax breaks*

Many American families go through the year without giving much thought to their tax situation — until they're slammed with a huge tax liability on tax day. Don't be one of them! Our federal government offers many tax breaks for parents and students — and others who are supporting loved ones. But you can't take advantage of them until you learn how and when these breaks will help you and your family the most.

**Start your teen's retirement saving now with a Roth IRA.** Roth IRAs are perfect for teenagers because they're typically in low tax brackets and have many years to let their accounts grow tax free. The contribution limit for minors is the same as for adults under 50: the lesser of \$4,000 (in 2006) or 100% of earned income from a legitimate job reported on their tax returns. (For more on Roth IRAs, see "Consider a Roth IRA" on page 14.)

**Hire your kids for additional tax benefits.** If you own a business, you can hire your children and fully deduct their pay. And if your business is unincorporated, has no owners other than you and certain family members, and your children are under age 18, you won't owe any payroll or unemployment taxes on their wages. Your kids benefit too: They can earn as much as \$5,150 (the 2006 standard deduction amount for singles) and pay zero federal income

taxes. They can earn an additional \$4,000 tax-deferred if they contribute it to a traditional IRA, though that will make them ineligible for Roth IRA contributions. Keep in mind that the children must perform actual work for wages in line with what you would pay nonfamily employees.

**Take advantage of tax credits.** You may be able to claim the \$1,000 Child tax credit for each child under age 17 at the end of the calendar year. And you may be eligible for the Child and Dependent Care credit, which is worth at least 20% of qualifying expenses, subject to a cap. If you adopt, you may be able to take the maximum Adoption credit of \$10,960 in 2006 or the employer adoption assistance program income exclusion, also \$10,960 per eligible child. But note that these credits include restrictions, and some phase out if your income is above certain levels. (See Chart 2 on page 6.)

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extends to 2006 the provision that allows you to take nonrefundable personal credits (such as the Child credit and education credits) against the alternative minimum tax (AMT) as well as against the regular tax.



**Shift income to children.** For children ages 18 and older, all income (earned and unearned) will be taxed at their own, generally lower, marginal rates. So giving them income-producing assets can save your family tax dollars. In 2006, you and your spouse together can give up to \$24,000 of assets free of federal gift tax to each of your children (or grandchildren) without using any of your lifetime gift tax exemption. (For more on gift tax planning, see "Make lifetime gifts" on page 16.) Prior to TIPRA, the so-called kiddie tax applied to children

under age 14. Effective in 2006, the act expanded the rule to apply to children under age 18. As a result of this change in the law, unearned income of children under age 18 that is beyond \$1,700 in 2006 will be taxed at their parents' marginal rate — so, the income tax benefit of shifting income to them will be limited. Consider whether this increase in age alters your income tax and estate tax planning.

**Teach yourself — and your kids — about education credits.** When your kids hit college, you may be able to claim a Hope credit for the first two years of postsecondary education. For qualified tuition and related expenses required for enrollment on at least a half-time basis, the maximum credit, now adjusted annually for inflation, is \$1,650 per student for 2006. Similarly, you may be eligible for the Lifetime Learning credit of up to \$2,000 per taxpayer for an unlimited number of years of postsecondary, graduate and certain other education expenses. If your income is too high to qualify for either credit (see Chart 2 below), your child may be able to claim it.

An individual who attends an eligible educational institution located in the Gulf Opportunity Zone for 2006 is

**Tax Action Strategy**  
**Consider a 529 plan**

Section 529 plans enable parents (or grandparents) to either secure current tuition rates with a prepaid tuition program or create tax-free savings accounts to fund college expenses. And the Pension Protection Act of 2006 has made the Sec. 529 provisions permanent. Most 529 plans are state-sponsored, although private institutions can offer prepaid tuition plans. 529 plans typically offer much higher contribution limits than Education Savings Accounts (ESAs — see “Cover more education costs with Coverdell ESAs,” below) but fewer investment options. Distributions used to pay qualified higher education expenses are income-tax free. 529 plans provide estate planning benefits as well: Your contribution can qualify for the \$12,000 annual gift tax exclusion (\$24,000 for gifts by married couples). You even can elect to use annual exclusions for five years all at once (for example, a \$60,000 contribution or a \$120,000 joint gift). (For more on estate planning, see page 15.)

eligible for an increased Hope credit or Lifetime Learning credit: The maximum credits are potentially doubled. The definition of “qualified education expenses” for a Zone student has been expanded to include, for example, books, supplies, and qualified room and board expenses.

**Cover more education costs with Coverdell ESAs.** Coverdell Education Savings Accounts (ESAs) allow you more investment options than 529 plans. (See the Tax Action Strategy above.) Subject to income limitations (see Chart 2), you can contribute \$2,000

to such a plan to benefit a child under age 18 (unless the child has special needs, in which case special rules apply). The contribution isn't deductible, but distributions of earnings will be tax free if used to pay for the beneficiary's qualified education expenses. Another advantage over 529 plans is that the expenses can be for elementary (including kindergarten) and secondary school in addition to college.

You may claim the Hope or Lifetime Learning credit (see “Teach yourself — and your kids — about education credits” on this page) and take tax-free ESA distributions as long as you don't use the ESA funds to pay the same expenses for which you claim the credit. The deadline for contributions is the due date of the income tax return for the year of contributions — April 15 of the following year.

**Deduct student loan interest.** Taxpayers paying interest on student loans may be able to deduct up to \$2,500 of interest above the line. Income phaseout ranges are now adjusted annually for inflation. (See Chart 2.) ♣

**Chart 2**  
**2006 family and education tax break AGI phaseouts**

Tax break	Adjusted gross income phaseout ranges	
	Single filers	Joint filers
Child tax credit	\$ 75,000 – \$ 95,000	\$ 110,000 – \$ 130,000
Adoption credit	\$ 164,410 – \$ 204,410	\$ 164,410 – \$ 204,410
Hope credit	\$ 45,000 – \$ 55,000	\$ 90,000 – \$ 110,000
Lifetime Learning credit	\$ 45,000 – \$ 55,000	\$ 90,000 – \$ 110,000
ESA contribution	\$ 95,000 – \$ 110,000	\$ 190,000 – \$ 220,000
Student loan interest deduction	\$ 50,000 – \$ 65,000	\$ 105,000 – \$ 135,000

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

# Learn the secrets

*Smoothing out the highs and lows with smart tax planning*

Investing isn't for the fainthearted. But it's a must if you're one of the millions of Americans who are counting on a comfortable retirement, a college fund for their kids or luxury vacations. Along with regularly setting aside money to put in sound investments, you need to consider the tax consequences of each transaction. Although tax considerations shouldn't dictate your investment decisions, these strategies can help you enjoy investment highs and weather the gut-wrenching lows.

**Time capital gains and losses.** The 15% long-term capital gains rate — 20 percentage points lower than the highest regular income tax rate of 35% (see Chart 3 below) — applies only to investments held for more than 12 months. Remember this if you're considering purging your portfolio of an underperforming stock. Holding on

to it may help you cut your tax on the profit in half. Timing is also important 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. If you end up with a net loss, you can claim up to \$3,000 this year and carry forward any excess to future years.



The 15% rate on long-term capital gains and qualified dividends was to expire at the end of 2008. But the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extended the rate through 2010.

**Reduce turnover to save more tax dollars.** Selling stocks frequently or holding mutual funds with high turnover rates tends to repeatedly create capital gains. Holding stocks long-term or choosing funds that provide primarily long-term gains could save you more tax dollars because of the lower long-term rates. But be sure to consider overall performance, not just taxes, when selecting stocks or mutual funds.

**Avoid wash sales.** The wash sale rule prevents you from taking a loss on a security if you buy an identical or significantly similar 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

**Chart 3**  
Capital gains tax rates

Holding period	Maximum tax rate
12 months or less (short term)	35%
More than 12 months (long term)	15%
<b>Key long-term 15% rate exceptions:</b>	
Collectibles, such as artwork	28%
Gain attributable to depreciation on real property	25%
Gain that would be taxed at 10% or 15% based on the taxpayer's regular income tax rate	5%

*Source: U.S. Internal Revenue Code*

### Tax Action Strategy

#### 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 must identify which shares you've sold when you file your tax return or you'll be deemed to have sold the shares on a first-in, first-out (FIFO) basis. If you hold stock certificates, you must surrender the appropriate ones.

security. Fortunately, there are ways around the wash sale rule. For example, you may buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold. Alternatively, consider doubling up on your investment for a 31-day period before selling the original shares or selling and then waiting 31 days to repurchase.

**Consider dividend-paying stocks.** With the 2003 introduction of the lower 15% maximum federal tax rate on qualified dividends, dividend-paying stocks have become more desirable, especially after TIPRA extended the rate for another two years through 2010. But many saw price increases as a result, perhaps offsetting the tax advantage with an inflated price. Nevertheless, the lower rate serves as a reminder that dividend-paying stocks may have a place in your portfolio.

#### Weigh the tax impact of bonds.

Although interest on U.S. government obligations is taxable on your federal return, it's generally exempt on your state and local returns. In contrast, 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 excludable on your state return. But corporate bond interest is fully taxable for federal and state purposes.

**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. The wash sale rule (see the earlier paragraph, "Avoid wash sales") 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 OID income.** Bonds (except U.S. savings bonds) with original issue discount (OID) build up "interest" as they rise toward their maturity price. The IRS says you earn a portion of that interest annually — even though the bonds don't pay you this interest annually — and expects you to pay tax on it. So, these investments may be best suited for tax-deferred vehicles, such as IRAs, or for investors with sufficient cash flow to absorb this tax.

#### Exercise stock options with care.

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. At the same time, financial risks can be great if you focus solely on getting the best tax treatment.

**Be creative when selling assets.** An installment sale allows you to defer capital gains on most assets other than publicly traded securities. You can defer your overall tax burden by spreading the gain over several years as you receive the proceeds. Or, if you invest in rental real estate, consider a like-kind exchange. You may be able to defer gain over the time you hold the replacement property, though you will reduce your depreciation deductions on that property.

**Take the investment interest expense deduction.** You can deduct investment interest — up to your net investment income for the year — on any money you borrow to buy or carry taxable investments. But you can't include long-term capital gains or dividends in your net investment income for investment interest deduction purposes without waiving the favorable 15% rate and subjecting your gains or dividends to your higher ordinary income tax rate. ♣



# Staying at the top

*Tax law changes require additional planning strategies*

There's nothing more satisfying than nurturing a business to success. But success doesn't come overnight, and it's never easy. You must be in tune not only with technological, economic and marketplace changes, but also with the nuances of tax law changes. For example, recent legislation and IRS guidance have upended the laws for exporters, introduced a new deduction for "manufacturers," provided incentives to aid the recovery of areas affected by Hurricanes Katrina, Wilma and Rita, and created headaches for sponsors of nonqualified deferred compensation plans. Count on your tax advisor and the following tried-and-true strategies for keeping your tax bill under control.

**Consider business structure.**

Businesses may operate under a variety of structures, ranging from sole proprietorship to C corporation. Income taxation and owner liability are the main factors that differentiate one from another.

Many new businesses lean toward the flow-through taxation of a sole proprietorship, partnership, limited liability company (LLC) or S corporation. Maximum federal tax rates for corporations (see Chart 4) and individuals are now identical at 35%, taking away one of the old advantages of the C corporation. At the same time, double taxation of C corporation income is less of a factor because of the current lower dividend and long-term gains rates — which have been extended through 2010 — though still not an issue to ignore.

**Defer income and accelerate deductions.** In potentially high-income years, consider deferring some income to later

years. For example, if your business uses the cash method of accounting, you may be able to delay billing invoices as you approach year end and pay as many expenses as possible. Or, if you use the accrual method, you can delay shipping products or delivering services until the new tax year. If you want to accelerate deductions and don't have ready cash, consider charging expenses on your bank charge card.

Other ways to defer income to next year include investing in short-term Treasury instruments. Interest income earned on certain Treasury securities and bank certificates of deposit with maturities of one year or less isn't includible in income until received. To

**Chart 4**  
**2006 corporate tax rate schedule**

Taxable income	Base tax	Marginal tax rate (tax on next dollar) <sup>1</sup>
\$ 0	\$ 0	15%
\$ 50,000	\$ 7,500	25%
\$ 75,000	\$ 13,750	34%
\$ 100,000	\$ 22,250	39%
\$ 335,000	\$ 113,900	34%
\$ 10,000,000	\$ 3,400,000	35%
\$ 15,000,000	\$ 5,150,000	38%
\$ 18,333,333	\$ 6,416,667	35%

<sup>1</sup> Personal service corporations taxed at flat 35% rate.  
**Source:** U.S. Internal Revenue Code

defer interest income, consider buying short-term obligations that won't mature until next year.

A simple example of a deduction that you can accelerate or defer is your state tax deduction for a cash-basis taxpayer. If you make an estimated state tax payment before Dec. 31, you can deduct it in that year. If you wait until the due date of the return, it will be deductible the following year.

You may be able to shift some items of income or deduction, but you can't alter your accounting method. Of course, you should also consider the business risks of these strategies. Consult with your tax advisor to see what is possible.

**Expense when you can.** Generally, equipment with a useful life well beyond the taxable year must be capitalized. An exception is the Section 179 expensing election. It allows a current deduction for

assets that otherwise would be subject to normal depreciation rules. The maximum Sec. 179 deduction for 2006 is \$108,000, and it will be indexed for inflation from 2007 through 2009. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extended through 2009 both the increased deduction limit and the indexing for the limit. But for tax years beginning after 2009 this amount is scheduled to drop back to \$25,000 per year.

#### **Tax Action Strategy**

#### **Take advantage of the manufacturers' deduction**

Effective in 2005, the new deduction for domestic production activities, often called the manufacturers' deduction or the Section 199 deduction, presents businesses with a wide range of planning and computational challenges and opportunities. When fully phased in, the deduction will be equal to 9% of the lesser of qualified production activities income or taxable income (adjusted gross income for individuals). The deduction is 3% in 2006, 6% in 2007 through 2009, and 9% in 2010 and thereafter.

The deduction is further limited to 50% of 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). Effective for taxable years beginning after May 17, 2006, the Tax Increase Prevention and Reconciliation Act of 2005 provides that, when the deduction for domestic production is determined, W-2 wages include only wages attributable to domestic production. Because the deduction is limited by wages, businesses that use few employees or rely heavily on independent contractors probably won't benefit much from it.

A qualified production activity is much broader than the traditional meaning of manufacturing. The deduction is available to businesses engaged in activities such as construction, engineering, architectural services, computer software production and agricultural processing. It applies to several categories of qualifying activities, including any lease, rental, license or sale of qualifying production property that is manufactured, produced, grown or extracted in whole or in significant part in the United States. Qualifying production property includes tangible personal property, any computer software and sound recordings.

The deduction isn't allowed in determining net earnings from self-employment and, generally, can't create or increase a net operating loss (NOL). But it can be used against the alternative minimum tax (AMT).

Plan now to maximize your benefit from this deduction. Determine whether your business qualifies, if there are ways to increase your deduction, and how to capture the necessary information in your accounting system.

Given that, it may be appropriate to schedule major capital asset purchases in the next few years when the greatest tax benefits may be available. And if you have more than the maximum \$108,000 limit in 2006, choose those assets for expensing that would have had the longest life under the regular depreciation rules. If total asset acquisitions in 2006 exceed \$430,000, the expensing election begins to phase out.

The Gulf Opportunity Zone Act of 2005 provides a special depreciation allowance and expanded Sec. 179 expensing election for qualified Zone property.

**Maximize depreciation with a cost segregation study.** If you have recently purchased or built a building or are remodeling existing space, make sure you maximize your depreciation deductions. Although real property generally must be depreciated over 27½ or 39 years using the straight-line method, certain parts of the "building" can qualify for a shorter depreciable life.

A cost segregation study 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, shelves, 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 alternative minimum tax (AMT) or is located in a state that doesn't follow federal depreciation rules.

**Take into account other depreciation rules.** Careful planning during the year can help you maximize depreciation deductions in the year of purchase. You generally will 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. But if you made 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.

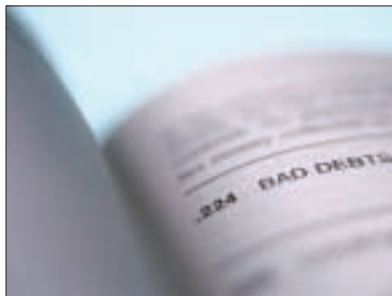
**Claim all business losses.** Generally, a net operating loss (NOL) may be carried back two years to obtain a current tax refund, which can provide a cash infusion in times of loss. Any loss not absorbed in the prior two-year period is then carried forward for up to 20 years. If you prefer, you may choose to waive the carryback 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. The portion of an NOL that qualifies as a Gulf Opportunity Zone loss can be carried back five years. Other losses that may generate a deduction include casualty and theft losses (to the extent they aren't covered

**Tax Action Strategy**  
**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. You can also deduct above the line half of the self-employment tax you pay on your self-employment income. And you may be able to deduct home office expenses against your self-employment income.

by insurance) and losses from the sale or abandonment of business assets.

**Write off bad debts.** Business bad debts are treated as ordinary losses and can be deducted when they become either partially or wholly worthless. For individuals and certain other entities, the IRS may consider loans made to closely held corporations as not business related and, if not repaid, reclassify them as nonbusiness bad debts, which must be wholly worthless to be deductible and are treated as short-term capital losses.



**Manage your inventory for tax savings.** You must calculate the dollar amount of inventory you have on hand at year end. If your ending inventory value is low and the cost of merchandise sold is higher, your taxable income will be lower — so the inventory method you choose can significantly affect your taxable income.

**Maximize tax credits.** Tax credits reduce your business's tax liability dollar-for-dollar. Credits that may be available include Empowerment Zone, Research and Experimentation, Work

Opportunity, and Welfare-to-Work. Extensions through 2006 for some credits are still pending.

**Follow the rules for nonqualified deferred compensation.** Nonqualified deferred compensation arrangements are a promise to pay executives and key employees sometime in the future for services to be currently performed. The plans are often geared to the individual and based on his or her performance or on the company's performance. Under the Pension Protection Act of 2006, employers with underfunded or terminated single-employer pension plans cannot fund nonqualified deferred compensation plans.

The rules generally affect the timing of initial deferral elections, changes to elections, timing of distributions and how benefits are funded. Distributions are allowed only for specific events — such as separation from service or disability — and payment of benefits generally can't be accelerated. If a plan fails to meet the requirements, it will result in loss of tax deferral. In addition, all amounts previously deferred will be taxed, plus charged interest and a penalty of 20%.

These rules apply to a wide range of plans and arrangements, but they specifically exclude 401(k)s and other qualified employer plans, qualified governmental plans, and any bona fide plan covering vacation leave, sick

leave, compensatory time, disability pay or death benefits. Nonqualified deferred compensation can still be an effective way to compensate employees. If you haven't already done so, you need to amend your plan documents by Dec. 31, 2007.

**Look into qualified deferred compensation plans.** To attract and retain the best employees and manage your tax liability, qualified deferred compensation plans can be useful. They include pension, profit-sharing and 401(k) plans, as well as Savings Incentive Match Plans for Employees (SIMPLEs), Simplified Employee Pensions (SEPs), 403(b)s and 457s. You can enjoy a tax deduction for your contributions to employees' accounts under the plan, and they offer tax-deferred savings benefits for employees. (For more on the benefits to employees, see "Maximize contributions to employer-sponsored plans" on page 13.) PPA includes many provisions affecting traditional pension plans, so it's critical to ensure you're in compliance with the new rules if you provide such a plan.

**Provide fringe benefits.** Fringe benefits are a crucial part of any compensation package. Some fringes, referred to as "statutorily excluded" benefits, aren't included in employee income. With these fringes, 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.

This favored tax treatment gives both parties incentive to "shift" some compensation from salary to fringe benefits. Examples of benefits treated in this manner include group-term life insurance (up to \$50,000), health insurance, parking and employee



discounts. Other types of fringe benefit offerings — subject to various rules and limitations — range from the more commonplace, such as Flexible Spending Accounts (see the Tax Action Strategy on page 3), to the more elaborate, such as an athletic facility or on-site day care.

**Develop a comprehensive succession plan.** All business owners should create a strategy to sell their companies or pass them on to their children or other family members. Your strategy should include choosing the best and appropriate amount of insurance, maximizing valuation discounts, developing a buy-sell agreement and determining whether an employee stock ownership plan (ESOP) could work for you. You will want to have a comfortable retirement while the business continues under the leadership and direction of your children or key employees — or in the hands of a new owner. A business succession plan will require consulting with family members, developing an effective management structure, and working with legal and financial advisors to set up and implement the plan.

**Make the most of selling your business.** The first tax consideration may be whether to sell assets or your equity interest, such as stock. With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. Buyers, on the other hand, generally want an asset sale to maximize future depreciation write-offs.

The transaction of transferring your business can be either taxable or tax-deferred, depending on whether the seller is receiving immediate cash or stock. Although it's generally best to avoid — or postpone — tax, there are some advantages to a taxable sale. For example, the seller doesn't have to worry about the quality of buyer stock or other business risks that might come with a tax-deferred acquisition. Also, the buyer receives a stepped-up basis in the assets and doesn't have to deal with the seller as a continuing equity owner, as would happen in a merger transaction. The parties also don't have to meet the technical requirements of a tax-deferred transaction.

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. Watch out, though: An installment sale can backfire because depreciation recapture must be reported as gain in the year of sale. Also, if tax rates increase in the future, the overall tax could wind up being more on an installment sale than on a cash sale. As a result, TIPRA's extension of the 15% rate on long-term capital gains through 2010 is good news for anyone considering an installment sale. Be sure to calculate the potential tax effect before you finish negotiations. ♣

# Don't gamble with your future

*A comfortable retirement requires a lot of planning — and a little luck*

Whether it's at a poker table or in the lottery, a lot of people don't seem to mind losing something to potentially gain a bigger reward. Gambling with loose change may be fine, but don't gamble with your retirement. It's important to have a plan in place that will help you accumulate enough assets so you live out your retirement in relative comfort. Along with hard work and a little luck, provisions of the Pension Protection Act of 2006 (PPA) may help you reach your goals.

**Anticipate inflation's effect.** If your retirement is many years in the future, considering how inflation will affect your retirement living expenses is especially important. For best results, take into account two periods of inflation: the time you will be accumulating retirement funds and the estimated length of your retirement. Knowing exactly how much the cost of living will increase is impossi-

ble, but past inflation rates can help you generate a likely estimate. Equally important, life expectancies are increasing, and a longer retirement period means you'll need more assets built up so your money can survive as long as you do.

**Maximize contributions to employer-sponsored plans.** You may be able to make pretax contributions to your

401(k), 403(b), 457 or Salary-Reduction Simplified Employee Pension (SARSEP) plan up to the legal limit — \$15,000 for 2006 (\$1,000 more than in 2005). Plus, your employer may match some of your contributions — also on a pretax basis. And plan assets grow tax-deferred. Similarly, under a Savings Incentive Match Plan for Employees (SIMPLE), you may elect to contribute up to \$10,000 of your salary pretax, and your employer is required to make contributions as well. Again, assets grow tax-deferred. Contribution limits are scheduled to rise, and taxpayers age 50 and older can make additional “catch-up” contributions to these plans. (See Chart 5 on page 14.)

**Take advantage of the Roth 401(k).** Starting in 2006, you may have another way to save for retirement — the Roth 401(k). Participants in an employer's 401(k) or 403(b) plan may designate some or all of their elective contributions as a Roth contribution, if the plan has been amended to allow it — and now that PPA has made permanent the Roth contributions provision, more employers are likely to amend their plans to allow them. Unlike regular 401(k) contributions, Roth 401(k) contributions will be taxed, but plan assets grow tax free. And, in contrast to a Roth IRA, there is no phaseout of eligibility as your adjusted gross income (AGI) increases.

## *Tax Action Strategy*

### Plan for required minimum distributions

For employer-sponsored plans and traditional IRAs, once you reach age 70<sup>1</sup>/<sub>2</sub> you're subject to the required minimum distribution rules. There is a narrow exception to this rule for an employee: If your plan allows, you don't own more than 5% of the company and you continue to work after age 70<sup>1</sup>/<sub>2</sub>, you won't be subject to the rules until you retire.

Whether you should take distributions before age 70<sup>1</sup>/<sub>2</sub> or more than the minimum after that age depends on how much you'll receive from other income sources, your life expectancy and other factors. Generally, maximizing tax-deferred growth provides more savings if you can afford to leave the funds in the plan — even if it means depleting other investment accounts.

**Chart 5**  
**Retirement plan contribution limits**

Year	401(k)s, 403(b)s, 457s and SARSEPs <sup>1</sup>	401(k)s, 403(b)s, 457s and SARSEPs for taxpayers 50 and over <sup>1</sup>	Traditional and Roth IRAs	Traditional and Roth IRAs for taxpayers 50 and over	SIMPLEs	SIMPLEs for taxpayers 50 and over	SEPs <sup>2</sup>
2006	\$ 15,000	\$ 20,000	\$ 4,000	\$ 5,000	\$ 10,000	\$ 12,500	\$ 44,000

<sup>1</sup> Includes Roth versions where applicable.

<sup>2</sup> Not subject to "catch-up" provisions.

Source: U.S. Internal Revenue Code

**Avoid early withdrawal penalties with a lump-sum rollover.** With a few exceptions, retirement plan distributions made before age 59½ are subject to a 10% penalty. But when you change jobs, you may receive a lump-sum distribution from your employer's retirement plan. To avoid being penalized, consider rolling it over to the plan sponsored by your new employer within 60 days. Or, roll it over into a traditional IRA, which may give you more investment choices. Either way, a rollover will avoid current income tax and early withdrawal penalties while allowing the assets to continue to grow tax-deferred. If possible, transfer by direct rollover to avoid any income tax withholding issues.

**Save more with a Keogh, single-employee SEP or solo 401(k).** If you're a business owner or self-employed, you may be able to deduct contributions to a Keogh, single-employee SEP or solo 401(k). This year, the annual contribution limit for defined contribution Keogh plans goes up \$2,000 to \$44,000, as does the limit on single-employee SEP contributions. The maximum compensation that can be considered under any retirement plan increases \$10,000 to \$220,000. Solo 401(k)s allow for added flexibility because if you're age 50 or over you can augment your savings with the catch-up contribution, which for 2006

is \$5,000. Limits for all three plans are indexed for inflation each year, and their earnings accumulate tax-deferred.

**Contribute to a traditional IRA.** You may be able to take an above-the-line deduction for traditional IRA contributions up to \$4,000 or 100% of earned income, whichever is less. Taxpayers age 50 and older can also make "catch-up" contributions of up to \$1,000. The contribution limits will increase in future years. But if you or your spouse participates in an employer-sponsored plan, your deduction may be limited based on your AGI.



**Consider a Roth IRA.** Like a traditional IRA, a Roth IRA may allow you to make annual contributions of the lesser of your compensation for the year or \$4,000 (reduced by annual contributions to all your other IRAs), plus a catch-up contribution of \$1,000 if you're age 50 or over. The contribution limits also

will increase in future years. You can't deduct contributions, but you can take qualified distributions tax free. Your contribution may also be limited based on your AGI.

If eligible, you should also consider converting your traditional IRA or other retirement plan to a Roth IRA. This option will be available to more taxpayers starting in 2010, when the income restriction (currently \$100,000) for eligibility is waived under the rules of the Tax Increase Prevention and Reconciliation Act of 2005.

**Be aware of your retirement portfolio.** Consider which investments you should hold inside and outside your retirement accounts. For instance, if you hold taxable bonds to generate income and diversify your overall portfolio, consider holding them in an IRA or qualified retirement plan where there won't be a current tax cost. But try to own dividend-paying stocks that qualify for the 15% tax rate outside of retirement plans so you'll benefit from the lower rate. Keep in mind that, unless Congress extends it, the 15% dividend rate is available only through 2010. Also, periodically reallocate your retirement plan assets. For example, the allocation you set up for your 401(k) plan 10 years ago may be too aggressive now that you're closer to retirement. ♣

# Plan ahead so your wealth is there when it's needed most

*Preserving what you've worked so hard for*

Whether you've already amassed your millions or it's a goal you're working toward daily, preserving your wealth should be a top priority. Smart tax planning is only one aspect of successfully managing your finances. You must also consider how estate planning, insurance and asset protection fit into the overall picture. Here are some ideas to launch you toward financial freedom.

**Consider transfer tax exemptions and rates.** During your life or at death, you can transfer up to the exemption amount (\$1 million during life and whatever is left of that \$1 million plus an additional \$1 million at death) free of federal gift and estate taxes. If your taxable estate is equal to or less than the remaining exemption, no federal estate tax will be due when you die. But if your estate exceeds this amount, it will be subject to estate tax. With the gradual phaseout of the estate tax and then its scheduled return in 2011 (see Chart 6), gift and estate planning is especially important.

**Take advantage of the unlimited marital deduction and each spouse's exemption.** Your estate generally can deduct the value of all assets that pass in a qualified manner — either outright or in trust — from you to your spouse at your death, provided your spouse is a U.S. citizen. (If your spouse isn't a U.S. citizen, you can still take advantage of the unlimited marital deduction, but you must use a Qualified Domestic Trust, or QDOT.) But if your combined estates

are greater than the exemption amount, simply using the full marital deduction to avoid taxes on the first spouse's death could result in needless tax liability on the surviving spouse's death. A credit shelter trust can help minimize the estate tax by taking advantage of both spouses' exemptions.

**Keep an eye on the GST tax.** The generation-skipping transfer (GST) tax was designed to limit an individual's ability to transfer wealth to successive generations without incurring a gift or estate tax at each generation. It is now, and scheduled to remain, equal to the top estate tax rate, and the GST tax exemption is also equal to the estate tax exemption. (See Chart 6 below.) You can make the most of this exemption by setting up a GST or dynasty trust. And you can preserve your GST tax exemption for future transfers by making annual exclusion gifts to grandchildren or following generations. Such gifts generally are exempt from the GST tax.

**Chart 6**  
Transfer tax exemptions and rates

Year	Estate and GST tax exemptions <sup>1</sup>	Gift tax exemption	Highest estate, GST and gift tax rate
2006	\$ 2 million	\$ 1 million	46%
2007	\$ 2 million	\$ 1 million	45%
2008	\$ 2 million	\$ 1 million	45%
2009	\$ 3.5 million	\$ 1 million	45%
2010	(repealed)	\$ 1 million	35% <sup>3</sup>
2011	\$ 1 million <sup>2</sup>	\$ 1 million	55% <sup>4</sup>

<sup>1</sup> Less any gift tax and GST tax exemptions used during life.

<sup>2</sup> The GST tax exemption is adjusted for inflation.

<sup>3</sup> Gift tax only. Equal to highest marginal income tax rate, which is currently 35%.

<sup>4</sup> Reverts to 2001 rules. The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates and gifts over \$10 million.

Source: U.S. Internal Revenue Code

**Make lifetime gifts.** Gifts you make during your lifetime are subject to federal gift tax. Fortunately, 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) without using up any of your lifetime exemption. To use the annual exclusion, you must give recipients a “present interest” in the property. In other words, the recipient must have access to the funds.

You may also pay — on behalf of someone else — eligible expenses for educational and medical purposes without having such payments treated as taxable gifts, so long as the payment is made directly to the provider. If you want to retain more control, consider a Crummey trust, where, because of a temporary withdrawal right, the gift will qualify for the annual exclusion — even though the recipient doesn’t have access to the gifted assets after the withdrawal right expires.

**Set up trusts to preserve assets and control.** Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. They serve a variety of purposes. For example, a qualified terminable interest property (QTIP) trust is good



for benefiting first a surviving spouse and then children from a prior marriage. An irrevocable life insurance trust (ILIT) can keep insurance proceeds out of your taxable estate. 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 gift tax value (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 for other investments, except instead of retaining the right to live in your home over the trust’s term, you receive payments from the trust for a specified period.

**Plan for family business interests.** If you’re a family business owner, transferring business ownership can preserve your business and accumulated wealth — if planned properly. For

instance, consider tax breaks such as the family business estate tax deferral and valuation discounts. And protect yourself with a well-structured buy-sell agreement. Gifting family business stock also can be an effective estate-tax-saving strategy. But keep in mind that the gift’s value determines the gift and estate tax ramifications. And the IRS may challenge the value you place on a gift. A valuation by a professional valuator can help the value stand up to such scrutiny.

**Evaluate insurance needs.** 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 succeeding generations free of estate tax. Long-term disability insurance is also important. For many, future earning power is their biggest asset, and employer-provided coverage is often insufficient. Long-term care insurance also is worth considering, because savings can disappear fast if you or a loved one requires years of such care.

**Split up assets carefully in a divorce.** Divorce is never easy, and it becomes even more difficult when marital property is significant. Talk with your advisors about how to handle the taxes, “innocent spouse” tax law provisions, and Qualified Domestic Relations Orders (QDROs) for retirement funds and property transfers. Discussing these items thoroughly will help you make the best of a bad situation.

**Protect assets.** In our litigious society, asset protection planning is more important than ever. Ask your financial professional about strategies such as transferring assets to your spouse; family limited partnerships; liability insurance; Delaware, Alaska or offshore trusts; and even your retirement plan. ♣

#### **Tax Action Strategy**

#### **Determine which property to gift**

Take into account both estate and income tax consequences and the economic aspects of any gifts you’d like to make. To minimize *estate taxes*, gift property with the greatest future appreciation potential. To minimize *income taxes*, gift property that hasn’t appreciated significantly since you’ve owned it. That’s because your basis in the property generally carries over to the recipient, who will owe taxes on any gain when he or she sells it. While the estate tax is in effect, it may make sense to wait to transfer highly appreciated assets until your death, because the basis will be stepped up and the capital gains tax can be avoided. For property that has declined in value, your best bet is to sell the property to take advantage of the tax loss. You may then gift the sale proceeds.