

Tax Planning for 2004 (not 2003!)

The sooner you start, the better prepared you will be.

BY MICHAEL P. HATCH, CFP, JD

By now, you are probably well on your way to assembling the documents necessary to prepare your 2003 tax return. In fact, I find most people spend a great deal of time looking back at what happened during the past tax year (in order to get their tax return filed) but place precious little effort into reducing their taxes for the coming year. Following are strategies to help encourage you to look at how your affairs are structured now, while there are still nearly 9 months left in this tax year. Most of these items will not amount to a tax windfall, but, taken together, they could materially impact your tax bill.

qualify for the 5% capital gains rate. For example, suppose you are helping your child or grandchild with college expenses. That bill may total \$20,000 per year. If, at the same time, you have a stock (or a stock mutual fund) with \$20,000 in appreciation, you could transfer that stock to the child, and he would only pay a 5% capital gains tax as opposed to your 15%. For each \$10,000 transferred, the savings is \$1,000 in capital gains tax, plus any reduced state taxes that may apply. (You may need to split large transfers over a few years to avoid gift taxes, but forward planning can reap rewards.)

STRATEGIES FOR 2004

Reviewing Federal Capital Gains Rules

IDEA 1 Review the new federal capital gains rules to make sure that your investments are taking the best possible advantage of the new lower capital gains rate. The maximum federal capital gains rate is now 15% for those taxpayers in a 25% or higher tax bracket. Likewise, the maximum capital gains rate is only 5% for taxpayers in lower tax brackets. This information should help investors to focus more on the underlying merit of holding an appreciated investment rather than on the tax issues related to gains. In addition, there are favorable tax benefits to gifting appreciated assets to other family members that may



IDEA 2 Maximum Tax Rate on Stock Dividends

The maximum tax rate on most stock dividends is now 15%. You should make sure your portfolio is adequately diversified and structured to take advantage of this favorable rate. If you have income-oriented stocks or funds, consider having a portion of those assets in a fully taxable account. These lower tax rates are not available in tax-deferred accounts such as your pension or IRA. This way, dividends will be taxed at a 15% maximum, as will any gains, and keep in mind that those gains are deferred until you decide to sell. The 15% maximum stock dividend rate does not apply to Real Estate Investment Trusts—either individual securities or funds

in this category. Don't be lured to a Real Estate Investment Trusts stock based solely on the assumption that the high dividend will enjoy favorable tax treatment.

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529 Savings Plans

Look into the benefits of investing in a 529 Savings Plan, either for yourself, your children, or your grandchildren. These plans have loads of flexibility and allow great tax benefits.

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Roth IRAs

Investigate Roth IRAs. Many taxpayers are not taking advantage of this opportunity. For example, if your income is less than \$150,000 for married individuals (or \$95,000 for single taxpayers), you may want to consider a Contributory Roth IRA for both you and your spouse (there is a phase-out of your ability to make a Contributory Roth IRA contribution, which tops out at \$160,000 for married tax filers and at \$110,000 for single filers). Although there is no tax break for putting the money in today, the funds grow tax-free as long as the account is held for 5 years. Moreover, contribution limits to all IRAs are increasing. For 2004, the contribution limits are \$3,000 per person, and there is an additional \$500 catch-up (thus, \$3,500 in total) for those over age 50 by the end of 2004. Thus, a married couple could contribute \$7,000 if both spouses are over age 50, and these amounts are increasing to \$6,000 per individual and \$12,000 per couple by 2008. Finally, Roth IRA assets are not subject to the age 70.5 Required Minimum Distributions, as are other IRA assets.

If your income is under \$100,000, in addition to a contributory Roth IRA, you should also consider switching some of your traditional IRA assets to a Roth IRA Conversion. This means paying a tax now on money that was in a traditional IRA, but it allows you to avoid all future taxes on those Roth IRA assets. Many studies analyzing this topic have been completed; this could potentially be a great strategy for some taxpayers, but you need to consult your tax accountant to see how this would work in your situation. Remember the bottom line with these Roth IRA Conversions: the reason Congress added an income limitation is because they be-

lieved this strategy would be appealing to a large number of high-income taxpayers.

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Income-Shifting Opportunities

Along the lines of gifting capital gains to family members, you may wish to investigate income-shifting opportunities to family members who may be working in your practice. For example, if your daughter is already keeping your expense reports up to date or doing your filing, why not pay her a reasonable wage to do so, as opposed to paying her an allowance out of your after-tax income? You could put her on the payroll so that she can start accruing some income. This will help in a number of ways. First, if it is a modest amount and she is only taxed at 10% versus your tax rate (most likely as high as 35%), there is a potential 25% tax savings involved. Although the savings are somewhat offset by the potential additional payroll tax, it could still be very substantial. Next, you may wish to include your child or other lower-taxed family members in your company's qualified retirement plan. The inclusion of this type of part-time employee may help meet some of the IRS and Department of Labor testing requirements in most qualified plans, and it may help offset the financial obstacles many small practices have, because more of the contribution is going to one of your direct family members. Your child will benefit immensely by receiving a real check from the company instead of just getting handouts from mom or dad. You can help increase his knowledge and awareness of benefits, payroll issues, and general financial topics related to wages and so forth. These are all issues he will have to address once he is out in the work force anyway.

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Traditional IRAs

Help fund your children's traditional (deductible) IRAs. For low-income individuals, there is now a tax credit that matches 50% of an IRA deposit with a tax credit. By making a gift to fund the IRA deposit, college-aged students with the right level of earned income can not only shield some of their earnings from income taxes, but they also get an immediate 50% credit against their other tax bill.

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Tax Brackets

Know and manage income tax brackets. A portion of your net income is taxed at 10%, followed by a portion at 15%, then 25%, etc. Knowing how much of your income has fallen into your top tax rate and how close you are to the next higher tax bracket can help you decide how to manage income or deductions in this year versus next year. Timing on partic-

ularly large one-time itemized deductions (eg, medical cost payments or gifting) is often very controllable. If deductions are resulting in net income's being taxed at only 25%, when timing can shift the deduction to a year with a 35% bracket income, you could save 10% of the deduction amount.

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Real Estate Assets or Other Substantial Business Equipment

Investigate the benefits with your accountant and legal counsel of owning any real estate assets or other substantial business equipment outside of the practice and then leasing the real estate or other equipment directly to the business. This could be a big-ticket item, and it is too often overlooked. Let us say the practice needs a piece of equipment that costs \$100,000. There is no reason why you couldn't form a limited liability company or some other liability-reducing entity and lease that equipment to the business. Lease payments from the business to your own corporation are not subject to self-employment tax, potentially saving you and the practice money right off the top. If it is real property, you may be able to depreciate the property or have other write-offs that reduce the taxable income, right on your tax return, not your practice's tax return. With real property or any asset likely to appreciate, you do not want that asset to sit in your corporation and potentially be subject to double taxation in the future. You will certainly want to talk to your accountant and legal counsel about all of this, as these are general guidelines.

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Charitable Donations

Many people give money to charity by writing a personal check, but there are numerous other ways to benefit your intended charities and help ease your tax burden at the same time. One item to consider is a donor-advised fund. This is a special fund that allows you to set aside assets and receive a charitable deduction now but not dole out the money to the specific charity that you are intending to benefit until a later point in time. This strategy makes it very easy to transfer appreciated stock to the donor-advised fund, sell it at no capital gains, and invest those funds until you are ready to distribute the assets to charity. Some people do this in years during which they may have an income windfall, or to receive several years' charitable tax deductions in one year, or to help offset the tax burden of the windfall. Most people understand the concept of giving appreciated securities to their charities but have little idea of how to accomplish this task. The donor-advised fund is in itself a tax-qualified Exempt

Organization, under IRC § 501(c)(3), and merely acts as a conduit to give your cash or appreciated securities to the ultimate charity of your choice. There are many types of donor-advised funds from Fidelity Investments and many other mutual fund companies. Alternatively, you can investigate your local community foundation, which undoubtedly has a donor-advised fund for this purpose. Keep in mind, however, that, even if you like the stock you are gifting, you can always buy it back at the current basis with your cash and still hold the security—just at a higher tax basis (but remember that the IRS wash sale rules might apply if this is not done properly). Again, consult your tax advisor.

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Tax-Exempt Securities

The last item to consider is investing in tax-exempt securities. All too often, people fail to look at the taxable equivalent yields offered by tax-exempts. Top-quality tax-exempt bonds maturing in 4 years are currently yielding approximately 2.5% tax-free. This is equivalent to earning 4.2% on a taxable bond if you are in the top tax bracket; most investors are getting nowhere near the taxable-equivalent yield on their short-term investments. This is not to imply that AAA municipal bonds are just as safe as cash or CDs, but they could be an excellent parking place for your 1- to 4-year investment assets.

CONCLUSION

There are more sophisticated and potentially more lucrative ways to reduce, eliminate, or defer taxes, such as Non-Qualified Deferred Compensation Plans, ESOP Plans, Charitable Remainder Trusts, and Irrevocable Trusts, domiciled in a state other than your state of residence. The strategies listed herein are a good review of fundamental concepts, which have changed substantially in recent years. Proactive planning and attention to these fundamental concepts could help you reduce your tax bill now and into the future. □

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