



EXTRA

The Informative Dispatch

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Tax Planning Opportunities

As the year ends, there is still time to take advantage of tax saving opportunities and to make certain business and investment transactions are efficiently completed. Tax planning is particularly important in our current environment because the tax rules are changing.

*The 2001 Tax Act received much publicity when enacted but the impact was not felt immediately. The rules were phased in over a time and others will come and go. Not only that, **Congress slipped in a 2002 Tax Act earlier this year.** This Act contains several tax saving opportunities, particularly for businesses. In this newsletter, we focus on tax and financial planning strategies that should be considered now and through the rest of the year. Some strategies are the result of the 2001 and 2002 Tax Acts, while others are traditional tax saving techniques.*

Securities Transactions: It is always a good idea to periodically check stock and bond portfolios for investment allocation rebalancing, to identify gains to recognize, or to identify losers. Decide to sell securities after considering tax consequences. For example:

- ✓ Selling **appreciated securities** held for more than a year will generally cost less than 20% in federal income taxes. Locking in those gains by selling before that time can cost almost twice as much in taxes.
- ✓ Selling shares of **stocks or mutual funds**, generally, the shares purchased first, are deemed sold first. This is definitely not advantageous if there are newer shares with a higher basis (because more was paid for them). Fortunately, if the broker is properly notified as to the specific shares to sell, those identified shares are treated as sold instead. Given the right circumstances, reducing a tax gain (or increasing a tax loss) can be as simple as selecting shares with a higher tax basis.

Like-kind Exchanges of Real Property: An often overlooked but potentially significant tax saving strategy is the like-kind exchange where investment real estate is exchanged for another investment property and in so doing, gains is deferred in the property. When certain circumstances are met, the exchange of properties need not be simultaneous and can involve multiple properties.

To qualify as a tax deferred like-kind exchange, certain requirements must be met. Some gain is generally recognized if cash is received as part of the deal.

Nevertheless, a like-kind exchange can be a particularly valuable tax planning technique when real estate investments are involved.

What about Education Expenses? Many tax and financial planning strategies should be considered when saving for a college education for children or grandchildren. Proper planning includes the ages of the children or grandchildren, available tax incentives and the impact of possible financial aid. Let us look at a few of the key strategies.

Savings Accounts: Coverdell Education Savings Accounts (ESA) and state-sponsored Section 529 plans are particularly attractive tax advantaged ways to save for college, especially, after the changes that the 2001 Tax Act made. While neither provides a federal tax deduction for contributions, the earnings in the accounts are tax-free to the extent the funds are used for qualified education expenses.

Funds in the revamped ESAs account (formerly called Education IRAs and used for higher education costs), can now be applied to K-12th grade expenses or a family's home computer. **Beginning in 2002, up to \$2,000 can be contributed to each child's ESA each year.**

Funds in Section 529 plans, on the other hand, can only be used for college costs but the annual contribution limit, determined by each particular state plan, is generally much higher. Many states allow a state income tax deduction for residents who contribute to their own state 529 plan. When considering 529 plans, choose to invest in any state's plans as the funds can normally be used at any college or university in the country.

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College Tuition Deduction: In 2002, joint filers with adjusted gross income (AGI) of \$130,000 (\$65,000 for singles and heads of households) or less, can begin claiming a deduction for qualified college tuition and related expenses of up to \$3,000 whether they itemize deductions or not. However, this above-the-line tax deduction is only available through 2005.

Planning for Business: *Employ Teenagers.* The self-employed can lower the family's overall tax bill by employing their children or grandchildren. By paying one's own child wages, effectively, income will shift from a higher bracket taxpayer (employer) to a lower bracket (the child). The income earned by the child is considered earned income (as opposed to unearned income like dividends and interest); however, the child's standard deduction (\$4,700 for 2002) can offset the income. To the extent the income is taxed, a low 10% rate will generally apply. Some income normally taxed at the employer's rate, might escape taxes entirely or be taxed at the child's low rate. Thus, the family's income tax savings can be significant.

In addition, there may be payroll tax savings when employing one's child. Wages paid to a child under the age of 18 from a parent's sole proprietorship are exempt from social security and unemployment taxes. Depending on the total self-employment earnings, the tax savings can also include up to an additional 15.3% of the amount of wages paid to the child since paying self-employment tax on that amount is avoided and no payroll taxes are due on the wages.

Employing one's own teenager has the side benefit of enabling him or her to make an IRA contribution. With earned income (received from the business or elsewhere), the teenager is eligible to make a 2002 contribution to a traditional or Roth IRA, up to the lesser of \$3,000 or earned income. Generally, the Roth IRA is the better choice because although no deduction is allowed for the contribution, the earnings will never be taxed if the teenager does not withdraw them until at least age 59½. That's a long time for funds to grow. The employer-parent can choose to give their child enough money as a gift to make the allowable contribution.

Before leaving this subject, let us point out two important things:

- ✓ **First**, the employer must make sure the child's age and work done were the basis for the wages paid.
- ✓ **Second**, shifting income to a child in college or one who will be attending soon can have a detrimental impact on the family's eligibility for need-based financial aid. A child's income and assets are assessed at higher rates than the employer or parent's own when computing a family's financial aid eligibility.

New Assets: Many businesses, hoping that better economic days are around the corner, are looking for ways to cut their tax liabilities. Thanks to the 2002 Tax Act Congress snuck in this past March, businesses now get additional tax writeoffs when they purchase new assets. Under the new rules, an additional "bonus" depreciation deduction of 30% of the cost of most new business assets acquired this year can be claimed. That is 30% of the cost of the assets right off the top! Regular depreciation and if eligible, the Section 179 deduction can be claimed for the property. The 2002 Act also loosened the so-called luxury auto depreciation limits. Thus, higher first-year depreciation deductions are available for new autos placed in service in 2002.

Retirement Plans: If an individual's business does not offer a retirement plan, now might be the time to take the plunge. New retirement plan rules allow for higher deductible contributions. Even if the business is only part-time or something done on the side, contributing to an SEP-IRA or SIMPLE-IRA can enable reduction of current tax loads while increasing retirement savings. With an SEP-IRA, contributions can generally be up to 20% of the self-employment earnings, with a maximum contribution of \$40,000. An SIMPLE-IRA, on the other hand, allows up to \$7,000 to be set aside plus an employer match that could potentially be the same amount. In addition, if age fifty or older by year-end, an additional contribution of \$500 can be made to an SIMPLE-IRA.

Alternative Minimum Tax Planning: Any planning for the rest of this year and beyond should include a thorough assessment of exposure to the alternative minimum tax (AMT). Although the AMT originally was designed to limit the ability of higher-income individuals to benefit too much from certain tax loopholes, it now also affects many unsuspecting middle-income and upper middle-income taxpayers. The AMT puts a completely different spin on tax planning strategies. Some sensible strategies in a non-AMT situation are not beneficial when AMT applies.

Conclusion: This letter highlights selected tax and financial planning strategies **that should be considered**, based on each individual's particular situation. There are likely many others as well. Careful planning and periodic review can keep tax and financial situations in tip-top shape.

The complexities of governmental regulations are always difficult to follow. Please call us with any questions. We can help! (203) 929-3535