PayTaxesLater E-Newsletter

ACCUMULATE WEALTH AND REDUCE TAXES

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2003 Year-End Tax Planning Strategies

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Last year President Bush signed the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (JGTRRA). Please see our email newsletter (http://www.rothira-advisor.com/jgtrra.htm) for more information. JGTRRA accelerated the tax cuts scheduled to take effect in future years into tax year 2003. This means, everything else being equal, you should pay less tax this year than last year.

A few year-end tax-planning action points could help reduce income taxes even further and add positive returns.

Reduced Tax Rates on "Qualifying Dividends"

Effective for tax years beginning after 2002 and before 2009, qualifying dividends are generally taxed at a maximum federal rate of 15%. The tax rates on interest bearing investments are at the higher ordinary tax rates.

Reduced Tax Rates on Individual Long-Term Capital Gains (Assets Held More Than One Year)

JGTRRA reduces the top adjusted net capital gain rate from 20% to 15% for long term capital gains taken after May 5, 2003 and before January 1, 2009. This rate applies to both regular and alternative minimum tax. The capital gains rate for lower income taxpayers is reduced from 15% to 5%. Make sure that you know how long you have held an appreciated security that you plan to sell. The difference of 35% for short-term gains versus 15% for long-term gains is substantial. For taxpayers heavily invested in highly appreciated securities now may be the time to realize these gains at the lower capital gains rates in order to better diversify your portfolio. Please be **AWARE** of the Alternative Minimum Tax (AMT) trap. Capital gains are a tax preference add-back in the AMT calculation. Run the numbers before you leap. You may discover that spreading a gain over two years may save you from a severe case of AMT indigestion!

When planning your investments, you may consider a reallocation based on taxes. The combination of the lowered income tax rate for qualifying dividends and capital gains creates an incentive to make changes. Please assume you have both taxable (after tax) and IRAs or other retirement plan funds. There is greater tax incentive now to invest more of your interest bearing investments into your IRAs and retirement plans. There is also an incentive to invest the individual securities that enjoy the preferential capital gains rate and dividend rate in your taxable accounts. Even maintaining the same overall asset allocation mix, you could significantly reduce your taxes. The tax advantage of having your income securities in your IRA and qualifying stocks outside your IRA must be weighed against the traditional advice of keeping your income assets in the after tax accounts and your individual securities in the IRA. The reasoning behind the traditional advice is that many investors count on the interest income to meet their short term expenses and want to make sure that money is there when they need it.

Maximize your savings by using the incremental changes in the tax rate schedules. If your income ordinarily fluctuates, or better yet, you have some control over the timing of income recognition, take full advantage of this situation. Please see our Tax Reference Card at www.rothira-advisor.com/articles/tax_card_2003.pdf.

This discussion of capital gains is limited in scope. In actuality, this year it is possible for a taxpayer to have capital gains (both long and short term) taxed at one of the following rates- 5%, 7.5%, 8%, 10%, 14%, 15%, 20%, 25%, 28%, 33%, or 35%.

Retirement Savings and Pension Contributions

Retirement savings incentives and pension plan reform did not undergo any sweeping changes in 2003. The 2003 limits for elective deferrals to 401(k)s, 403(b)s, and section 457 retirement plans increases to $12,000 ($14,000 for individuals age 50 and over). 2003 contribution limits to the popular Simplified Employee Pension Retirement plan (SEP) remains at the lesser of 25% of an eligible employee's compensation (maximum $200,000) or $40,000.

Now is your last chance to review with your plan administrator options for additional deductions from your December pay to maximize your tax deferred contributions for 2003. If your 2003 tax return refund is bigger than usual due to the changes from the JGTRRA of 2003, consider lowering your federal withholdings from your paycheck in 2004 and increasing your contributions to your retirement plan. This move will create a new deduction for yourself while saving a little extra for your retirement.

Keep in mind that contributions to elective deferral retirement plans and self-employed retirement plans will reduce your "adjusted gross income." Because certain limitations on deductions and tax credits are based on your "adjusted gross income," you have the chance to trim 2003 income taxes by hundreds or thousands of dollars.

One-Person 401(k) Plan or a SIMPLE

Small business owners have been waiting for a plan that would allow them to set more money aside for retirement, with tax-favored treatment. The biggest potential benefit is realized by one-person businesses earning between $50,000 and $160,000. An unincorporated business owner earning $50,000 could shelter roughly $21,200 in 2003 or 42% of earnings! This plan must be established no later than December 31, 2003 in order to make a contribution based on 2003 earnings.

Individuals already participating in 401(k) or 403(b) elective deferral plans at work while earning additional income from a side business are not the best suited to take advantage of this type of plan because of limitations on the combined retirement contributions.

Sole proprietors earning less money may consider a SIMPLE in you could deduct up to $8,000 for 2003 (or $9,000 if 50 or older) even though your income was only $8,000.

Tax Loss Harvesting

We will shortly send out a more detailed discussion of tax loss harvesting. Many readers will have capital loss carry-forwards to use in 2003 and possibly beyond. Using losses to reduce taxable gains by offsetting the losses against the gains is referred to as "tax-loss harvesting or tax-loss selling." Now is the time to review your investment portfolio and make some decisions that will generate tax savings.

The best losses to have are short-term capital losses. This is because the IRS forces you to match short-term gains against short-term losses and long-term gains against long-term losses first. Only then can you use your excess short-term losses to offset long-term gains. If all your losses are long-term losses, and you have no short-term losses to soak up your short-term capital gains, you will be taxed on your short-term capital gains at ordinary income rates. This rate might be twice as high as you pay on your long-term capital gains.

Many investors fail to maximize the benefits by specific lot selling. Keeping track of your stock purchases at lot levels (instead of the First-In, First-Out default method) allows for greater control when instructing your broker to sell shares.

If your losses exceed your profits, you can deduct up to $3,000 of losses against ordinary income. That adds up to $840 tax savings for an individual who is in a 28% tax bracket. Be careful to avoid a wash sale, i.e., buying the same security within 30 days of the time you sell the shares- the tax rules will disallow the loss.

Harvesting your investment losses can reduce your capital gain income to zero. It's a great way to increase the after-tax rate of return on your portfolio without the risks of active trading. In combination with a good asset allocation and reallocation strategy, you can add value to your investment portfolio without increasing your investment risk.

ALERT-Special Allowance Depreciation and Increased Section 179 Expense Limits

The Jobs and Growth Tax Relief Reconciliation Act of 2003 provides for an additional first-year depreciation deduction equal to 50% of the adjusted basis of the qualified property placed into service after May 5, 2003. The Job Creation and Worker Assistance Act of 2002, introduced the 30% additional depreciation allowance. Taxpayers can make an election to use the percentage that allows for the maximum tax savings.

JGTRRA increase the maximum dollar amount that may be deducted under Section 179 to $100,000. This allows taxpayers to reduce income taxes by fully expensing qualifying assets in the year of purchase. Again, it is very important to look forward before deciding how much to expense immediately. Deferring some of the deduction for a year or two down the road when you project your marginal tax rate to be higher than your current tax rate will undoubtedly save tax dollars in excess of the time value of money lost due to accelerating income taxes.

More Bonus Depreciation for Business Autos

If you use a car for business purposes, you are no doubt aware of the incredibly unfavorable depreciation rules. Until now, the maximum first-year depreciation write-off for a new (not used) vehicle placed in service this year was a paltry $7,660. Thanks to the new 50% bonus depreciation break, you can deduct up to $10,710 worth of first-year depreciation for new (not used) vehicles acquired after May 5th of this year. For new autos acquired this year but before May 6th, the maximum first-year depreciation deduction is still only $7,660 (under the 30% bonus depreciation rule). For *used vehicles* placed in service at any time this year, the maximum first-year depreciation deduction remains at only $3,060.

Alternative Minimum Tax

Very few people including the IRS understand the Alternative Minimum Tax. Unfortunately more people, and not necessarily the wealthy, are falling victim to its prey. The JGTRRA of 2003 provided some limited AMT relief by increasing the exemption deduction. In general, you compute your tax liability using both regular tax rates and the AMT tax rates and pay the higher of the two. If you determine that you may be a victim of the AMT in 2003, holding off paying certain deductible expenses such as state and local taxes, medical expenses, real estate taxes, etc. until next year may prove to be advantageous. Alternatively, a 2004 AMT candidate may want to accelerate deductions before year-end in order to avoid throwing away valuable tax deductions.

Education credits, dependent care credit and other credits that could be used to reduce both regular tax and AMT are set to expire at the end of 2003 unless extended.

Qualifying Taxpayers Should Plan to Convert a Portion of their Traditional IRA to a Roth IRA

The benefits of converting a traditional IRA to a Roth IRA are discussed at length in our peer-reviewed article, *Roth IRAs: Accumulating Tax Free Wealth*, in the recommended reading section of our web site, www.rothira-advisor.com/articles/roth.pdf. The conversion must be completed before year-end and many brokerage houses recommend getting the Roth IRA conversion form to their offices by December 15 to qualify for a year 2003 conversion.

The JGTRRA of 2003 has accelerated the drop in tax rates that were to be phased in over time from the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). There hasn't been a better time to consider a Roth conversion.

Consider Recharacterizing your Roth IRA

A complete discussion of Roth IRA converting and unconverting is found in a separate article on our web site, *Roth IRA Conversions: An Aggressive Strategy*, www.rothira-advisor.com/articles/roth30.pdf. The techniques discussed in this article can help taxpayers get the most bang for their conversion buck by jump starting the growth of the converted Roth IRA.

Transfer Appreciated Stock to Children 14 Years Old or Older

Consider transferring stock to your child. For example, assume you are in a 25% tax bracket and are planning to sell some appreciated long-term stock to pay for your child's education. Your child is in a 10% tax bracket. Consider making a gift and transferring the stock to your child who subsequently sells the stock. You have effectively shifted long-term capital gains from a 15% taxation rate to your child's long-term capital gains tax rate of 5%.

Revenue Ruling 2003-12 Adds Over-the-Counter Drugs as Excludable in Flexible Spending Accounts (FSA)

The IRS has recently issued guidance regarding over-the-counter drugs such as antacid, allergy medicine, pain reliever and cold medicine can be paid for with pre-tax dollars through Flexible Spending Accounts and other employer health plans. So be sure to include an estimated amount for these annual costs in addition to the ones that you normally include during the enrollment period for the upcoming year.

Consider Married Filing Separate Status

The new tax rate schedules under JGTRRA for married taxpayers filing jointly are exactly twice the amount as married taxpayers filing separately. This change may create new opportunities for married taxpayers who choose to file separately. Some deductions are limited by a percent of your AGI. For example, your medical deductions are allowed only to the extent they exceed 7.5% of your AGI. Miscellaneous itemized deductions must exceed 2% of your AGI before they're allowed. In the right situation, one spouse may have substantial deductions that are erased by the income of the other spouse.

S Corporations with Prior C Corporation Retained Earnings

Former C Corporations that converted to Subchapter S Corporations have an opportunity and should consider making an election to distribute dividends from prior C Corporations accumulated retained earnings. These qualifying dividends will be taxed at 15% to the shareholder. This window is set to close at the end of 2008.

Oldies, But Goodies

Make or Increase Retirement Plan Contributions: Business owners can reduce AGI by increasing contributions to pre-existing retirement plans or establishing a new plan such as 401(k) plans, SIMPLE pension plans, SEPs, Keogh plans, or regular (deductible) IRAs. Most self-employed retirement plans allow for deductions in tax year 2003, although payment can be postponed until the extended due date for filing the return. In other words, payment of 2003 deductible retirement plan contributions can be postponed until October 15, 2004 in certain cases.

Maximize Loss Situations: If you are experiencing an unusual tax year where you may be in a much lower tax bracket than usual or even in jeopardy if wasting itemized deductions and personal exemptions, careful tax planning can be more crucial than ever. Make sure you project your taxable income before the year-end has passed and examine all your alternatives.

Calculate Medical Expenses: If this year's out-of-pocket medical expenses are larger than usual and your company doesn't offer a flexible spending account, it makes sense to compute if you're eligible to write-off your medical expenses. The total medical expenses must exceed 7.5% of your adjusted gross income to qualify. Because very few people normally beat the 7.5% test, be sure to pay as much as you can before the year-end in a year that you qualify for medical itemized deductions.

Take Advantage of Pre-Tax Parking Breaks: If your employer offers pre-tax dollars to be used for parking, mass transit or van pools, take advantage of the tax savings. Many individuals are not afforded the luxury of being able to deduct personal parking costs.

Make a Roth IRA Contribution: If you qualify, making an annual $3, 000 Roth IRA contribution (up to $3,500 if over the age of 50 by the end of 2003) both for you and your spouse will help you accumulate tax-free wealth. ***You have until April 15, 2004 to fund a 2003 Roth IRA.***

Make your Non-Cash Charitable Deductions before December 31: The IRS allows a deduction for the lower of cost or fair market value for your non-cash contributions. Please remember to ask for a receipt. You must provide a schedule if your non-cash contributions exceed $500.

Donate Appreciated Stock Instead of Cash to your Favorite Charity: If you hold appreciated publicly traded stock for more than one-year, you can donate the stock and get a charitable deduction for the full market value of the stock *and* avoid paying any capital gains tax. You must give the stock directly to the charity. The opposite is true for stocks that have gone down in value. Never donate stocks that have declined in value, but rather sell the stock at a loss and donate the cash to charity.

Avoid Doubling Up on First Year Minimum Distributions: It's possible to receive two minimum distributions in the year after you reach age 70½ . This may push you into a higher tax bracket, or even worse, cause some of your social security benefits to become taxable. Analyze your situation to see what strategy benefits you the most. Please see details in our Minimum Distribution Calculator on our web site, www.rothira-advisor.com/calculator/index.htm by entering 1930 or 1931 in the year of birth column.

Self-Employed Individuals Should Consider Employing their Child(ren)**:** Employing your child (age permitting) offers great tax-saving opportunities. Assuming your child has no unearned income, the parent could pay the child wages up to $4,750 in 2003, and the child would not have to pay any federal income taxes. The next $7,000 would be subject to a 10% tax rate. If the parents' marginal income tax bracket were 25%, the $11,750 wage deduction would generate $2,934 in federal income tax savings. Furthermore, when you employ a child under 18-years-old, neither the employer nor the employee is subject to social security tax on the child's wages. The wages your child earns will qualify as earned income for the purpose of establishing a Roth IRA. A Roth IRA will provide your child with an exceptional opportunity to accumulate money with tax-free growth.

Self-Employed Individuals with No Employees Should Consider Employing Their Spouse: A self-employed individual may be able to deduct all of their health insurance premiums and medical expenses by setting up a medical reimbursement plan with his/her spouse as the only employee of his/her business. Your spouse must become a bona fide employee of your business. Theoretically, that means your spouse will be working under your control. Good luck.

Last, But Not Least

Always know the tax consequences of separating or divorcing from your spouse.

Middle- or low-income taxpayers should consider selling tax-exempt investments and aim for greater appreciation or income.

Be sure that you meet the requirements for excluding gain on the sale of your principal residence. The exclusion amounts are up to $250,000 for single filers and $500,000 for married taxpayers filing jointly.

Conclusion

We hope this year-end planning letter has been helpful. These strategies are aimed at reducing both your short-term and long-term tax burden. Please take a moment to review your personal game plan to be sure you are not missing any opportunities.

If you are in need of tax planning and/or income tax preparation, the CPA side of our business stands prepared to help you. Client satisfaction was at an all time high last tax season. This year, we happily report that all eleven members of our tax staff are returning, and we expect an even better year.

We wish you and your family a happy, healthy and profitable holiday season and New Year!

P.S. On a different note, we received glowing praise for our teleseminars given in November. The seminar answered the most important questions readers have about IRAs and retirement plans. We will be making tapes, CDs and transcripts available after year end. If you are interested in this material at the lowest possible price, please send a blank email to admin@rothira-advisor.com and write "best price" in the subject line. This doesn't commit you to anything, but will insure you will get a substantial discount if you later decide to purchase.

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