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TAX IMPACT

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WHAT CAN YOU DO AFTER MAXING OUT RETIREMENT PLAN CONTRIBUTION LIMITS?

Today, many investors deal with complexity and uncertainty. Some of the reasons are Social Security benefits possibly decreasing or running out, and many companies reducing or eliminating their pension plans. So even more pressure is put on people to ensure they have sufficient funds to continue their current lifestyles after they retire.

An important step in preparing your nest egg is making contributions to your retirement accounts, including your employer-sponsored plan and traditional or Roth IRA. But what can you do after you've contributed the maximum to these accounts? Consider both currently taxable and tax-advantaged vehicles. One plus of investments made outside retirement plans is that they are more accessible — although you may be able to borrow from your qualified retirement plan, there could be restrictions or penalties. More important, outside investments provide the opportunity to further grow your retirement savings.

RETIREMENT PLAN

CATCH-UP CONTRIBUTIONS

As you probably already know, your retirement accounts offer tremendous tax benefits — now and later. You may think you're maxing out your contributions, but are you aware of catch-up contributions that allow individuals age 50 or older to contribute more to some retirement plans, including 401(k) plans and IRAs?

So before you begin focusing on an investment portfolio for your retirement, make sure you are taking full advantage of retirement plans by contributing the maximum. (To see how much you can contribute, see the chart "Contribution limits for retirement plans" on page 3.)

CURRENTLY TAXABLE INVESTMENTS

After you've contributed the maximum to your retirement accounts, you may want to build a separate portfolio of stocks, mutual funds and index funds. Though taxed currently, such investments may be taxed at lower rates. The 2003 tax act decreased the long-term capital gains tax rates. On assets held more than 12 months — but sold before Jan. 1, 2009 — the



maximum tax rate dropped from 20% to 15% for those taxpayers in the 25% tax bracket or above. For assets held 12 months or less, the maximum tax rate is 35%.

Plus, you can benefit from the recent dividends tax rate changes under the 2003 act. Through 2008, most dividends will be taxed as net-long-term capital gains. The maximum rate will be 15% for both regular tax and alternative minimum tax (AMT) purposes.

TAX-ADVANTAGED INVESTMENTS

Another option is to consider tax-advantaged investments. Let's review the pros and cons of:

Municipal bonds. State, county and city governments issue municipal bonds to finance operations. The key benefit for investors: The interest earned on them is exempt from federal income tax and, in most cases,

CONTRIBUTION LIMITS FOR RETIREMENT PLANS

Year	401(k)s, 403(b)s and 457s	401(k), 403(b) and 457 catch up ¹	Traditional and Roth IRAs	Traditional and Roth IRA catch up ¹	SIMPLEs	SIMPLE catch up ¹
2004	\$13,000	\$3,000	\$3,000	\$500	\$9,000	\$1,500
2005	\$14,000	\$4,000	\$4,000	\$500	\$10,000	\$2,000
2006	\$15,000	\$5,000	\$4,000	\$1,000	adjusted	\$2,500
2007	adjusted	adjusted	\$4,000	\$1,000	adjusted	adjusted
2008	adjusted	adjusted	\$5,000	\$1,000	adjusted	adjusted

¹For taxpayers 50 and over.

Source: U.S. Internal Revenue Code

from income taxes in the states issuing them. But bond investments are sensitive to market changes. For instance, if interest rates rise, your municipal bond value will decrease.

To determine whether the income tax benefit outweighs the after-tax yield of taxable interest, calculate the yield of a municipal bond. You can figure out the taxable equivalent yield by dividing the tax-free yield by the reciprocal-of-tax bracket (1 – your tax bracket). For example, if you are in the 35% tax bracket and you are considering investing in a municipal bond with a 4% yield, the taxable equivalent yield is 6.15% [$4\% \div (1 - .35)$]. Keep in mind that some municipal bonds may make you subject to the AMT.

Inflation-indexed Series I-bonds. With I-bonds, available through the U.S. Treasury, you can defer federal tax on the interest earned until you redeem them. (Federal bonds aren't subject to state taxes.) And if the consumer price index exceeds a specified threshold, the I-bond's value increases.

Unlike other bonds that will decrease in value when interest rates rise, I-bonds become more valuable during times of rising interest rates. Plus, the federal government guarantees its bonds.

Annuities. Any money you invest in an annuity grows tax-deferred, no matter how tax inefficient the underlying portfolio might be. With a variable annuity, you may invest in any of the mutual funds (known as separate accounts) offered and even move assets among accounts with no tax on the gains. Meanwhile, fixed annuities provide investors with a stated interest rate that generally exceeds the interest rates available through bank savings accounts and certificates of



deposit. Most annuities offer options including a death benefit — when you die, your heirs will receive the full value of the money you invested, even if the investments have decreased in value.

Keep in mind that annuities have various fees and penalties for early withdrawals, and the income generated is ordinary, not capital gain.

In recent years, many people have invested in real estate and business interests for greater control as well as the ability to write off losses and depreciate the costs of assets purchased.

YOUR STRATEGY

Remember that in light of changes to the tax law and your own financial situation, you must continually review and update your retirement plan. Although you should consider taxes when making financial decisions, that shouldn't ever be the sole factor. 📖

THE FAMILY THAT WORKS TOGETHER SAVES TOGETHER

For many family businesses, familial bonds are strengthened because relatives spend more time together. Further, these companies are typically strongly rooted in their communities, often giving charitably to local organizations. And there may also be tax benefits for practices such as employing family members, which can help family businesses keep more profits.

REDUCE WITHHOLDING, PAYROLL AND UNEMPLOYMENT TAXES

If your business is a sole proprietorship, partnership or limited liability company (LLC), you can hire your family members and receive tax benefits. (Benefits are limited if your company is a C or S corporation; for example, you have to subject children to Social Security tax.) Consider the advantages of hiring these loved ones:

Minor children. You don't have to withhold income taxes from your children's paychecks. In addition, you owe no payroll taxes on their wages and you



By employing family members, you may have more incentive to create a retirement plan — or if you hire your spouse, you can both save more for your golden years.

pay no federal unemployment taxes if they are under age 18 (age 21 if not employed in a trade or business). Plus, there are tax benefits for your offspring — see “All in the family” on page 5.

Spouse and parents. If you hire your spouse or parents, you pay no federal unemployment taxes on them. But you must withhold federal income tax from their wages and pay Social Security and Medicare taxes.

In all cases, be sure family members do their jobs and the pay is reasonable for the work they do. Also keep good records (such as time sheets or other documentation of hours worked). Otherwise, the deduction could be disallowed and you may face an IRS penalty.

REAP RETIREMENT PLAN BENEFITS

Like many business owners, you may struggle with retirement issues — either planning for yourself or creating a retirement benefit for employees. For example, you may have wanted to offer a 401(k) plan but only a few workers would have participated, making it too costly a benefit. By employing family members, you may have more incentive to create a retirement plan — or if you hire your spouse, you can both save more for your golden years.

Under the current rules, your spouse (or any worker) can contribute to his or her employer-sponsored retirement plan all income earned up to the contribution limit. But there are additional limits if he or she contributes to another employer-sponsored retirement plan or the plan is subject to discrimination testing. So review how much money your spouse may be socking away through other plans to ensure you gain the maximum benefit.

SAVE ON HEALTH CARE AND CHILD CARE EXPENSES

The more people you employ and offer health care coverage to, the more you can cut costs in this area. For instance, you can qualify for expanded health insurance plans at better rates. Plus, like all companies, your business can deduct the total cost of coverage.

You can even reduce your child care costs, because the IRS allows individuals to claim a child and dependent care credit. Let's say you hired your spouse to work in the business and paid him or her a salary. You'll both have earned income and you can be eligible for the child care benefit.


BALANCE SAVINGS WITH OTHER FACTORS

There are myriad benefits to employing family members. You have loved ones to help you watch the business and you can cut costs, such as taxes.


ALL IN THE FAMILY

Employing your children can create tax benefits for them. For example, the amount they earn up to the standard deduction amount is income-tax free to them. If they are minors and your wholly owned business isn't incorporated, their income won't be subject to Social Security or Medicare taxes.

And if you pay them more than the standard deduction amount, your offspring will still likely fall in a lower tax bracket. On the next \$7,150 of income they earn, the tax rate will be only 10%, and 15% on the next \$21,899.

But don't let financial savings be the deciding factor in deciding to hire a loved one. After all, he or she should be capable and interested in working in your company. 

ILITS CAN HELP YOU REDUCE YOUR TAXABLE ESTATE

 One goal of estate planning is to ensure as much of your assets as possible pass tax free to your loved ones. Just as you need hammers, screwdrivers and other tools to build a house, you also need a variety of tools to build your estate plan.

Consider including life insurance in your planning toolbox because it can provide your family with much-needed financial support and other benefits after your death. But without proper planning, it could create a larger estate tax bill for your family. Let's look at how an irrevocable life insurance trust (ILIT) can help.

KNOWING THE INS AND OUTS OF THE ESTATE TAX AND ILITS

In planning your estate, you must understand how the estate tax works and upcoming changes to it. Through 2009, the estate and generation-skipping transfer (GST) tax exemptions increase while the top gift, estate and GST tax rates decrease. In 2010, the estate and GST taxes vanish and the top gift tax rate drops to 35%. In 2011, unless Congress passes further legislation, the estate tax exemption returns to \$1 million (the same as the gift tax exemption),

the GST tax exemption is indexed for inflation, and the top gift, estate and GST tax rates return to 55% (not including the 5% surtax).

You may be surprised to learn that proceeds from life insurance are included in your taxable estate in normal circumstances, which might cause you to exceed your lifetime estate and GST tax exemptions of \$1.5 million in 2004. Fortunately, you can sidestep the problem of incurring an unexpected estate tax liability by creating an ILIT and having the trust own your life insurance. The ILIT will pay the premiums, receive the death benefits and distribute the money according to the terms of the trust. Because the ILIT is the policyholder — not you — the proceeds will be excluded from your taxable estate.

ILITs are also advantageous because they can help financially safeguard your family after you die. For example, the life insurance proceeds can remain in the trust to provide regular income and, to the extent needed, additional amounts to your surviving spouse (or a child unable to support him- or herself). Plus, the trust keeps these assets out of your spouse's estate and they can be used to pay estate taxes.



FOLLOWING THE REQUIREMENTS

To ensure all your insurance proceeds are excluded from your estate when transferring an existing policy, you must live for three years after transferring it to the trust. If you die within that period, the proceeds will be included in your estate. You may be able to defer estate taxes on that money until your spouse's death if your ILIT provides for a contingent marital trust.

Another requirement: You can't act as trustee or retain powers in trust administration. Instead, you must appoint someone to handle tasks such as changing or adding beneficiaries and making adjustments to the policy, including borrowing against it or paying premiums with policy loans. If you perform any of these duties, the IRS may view you as the owner and include the policy in your estate.

**ILITs are advantageous
because they can help
financially safeguard your
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BENEFITING FROM

THE ANNUAL EXCLUSION

Keep in mind that transferring an existing policy may be a taxable gift. To the extent the policy has a cash value component, the insurance company can provide you with the proper amount to report. As long as the

trust has been properly drafted, you'll be able to use your annual gift tax exclusion (\$11,000 per recipient in 2004), minimizing gift tax and reducing your taxable estate. If the gift exceeds the annual exclusion, you can use your lifetime exemption (if available) or pay the gift tax.

Alternatively, you can simply buy a new policy through the trust and make a gift to fund it. Make sure the trust is properly drafted or your gift may not qualify for the annual gift tax exclusion.

USING THE CRUMMEY POWER

To qualify for the annual gift tax exclusion, your gifts must be of present interest, which means that the trust beneficiaries — such as your children — must be able to access the assets right away. This is accomplished by drafting the trust to include a Crummey power (named after a court case), which gives beneficiaries the right to withdraw money contributed to the trust within a specified time period, typically 30 days.

If the beneficiary is a minor, your trustee must notify his or her parents or guardian. This strategy presumes that beneficiaries won't exercise the withdrawal right, so the trust will have funds to pay the premium.

TAKING CARE WITH YOUR ESTATE PLAN

Tools, such as saws and drill presses, require concentration when you use them. An ILIT also needs attention because it can be complicated to set up and maintain. But its invaluable estate planning benefits make the effort worthwhile. An ILIT can not only keep insurance proceeds out of your estate, but also allow you to transfer assets gift-tax free. ■

TAX TIPS

CAN YOUR BUSINESS REDUCE BENEFITS ONLY FOR YOUNGER WORKERS?

A company announced it would stop providing health coverage for future retired workers with an exception — workers at least 50 years old would still receive this benefit. Younger employees age 40 and older sued the company, alleging discrimination on the basis of age. The Supreme Court ruled in favor of the business, finding no age bias even though the change hurt younger employees. 📄

DEDUCTING ESTATE PLANNING COSTS

Although you can't deduct all expenses incurred in creating and implementing an estate plan, some costs qualify, including:

- ☉ Tax advice and tax planning,
- ☉ Income collection and production (such as administrative costs), and
- ☉ Property held for the production of income.

Keep in mind that miscellaneous itemized deductions are subject to a floor of 2% of your adjusted gross income.

When you pay fees related to estate planning, ask your attorney or other professional to itemize your fee statement. Specifically, ask him or her to break down the fees into tax advice and planning; advice and document preparation for property management, conservation and maintenance; and personal matters. 📄

THE TAX BENEFITS OF DISABILITY INSURANCE

In addition to providing income for your employees when they're unable to work, disability insurance offers tax advantages to you and, in some cases, your workers.

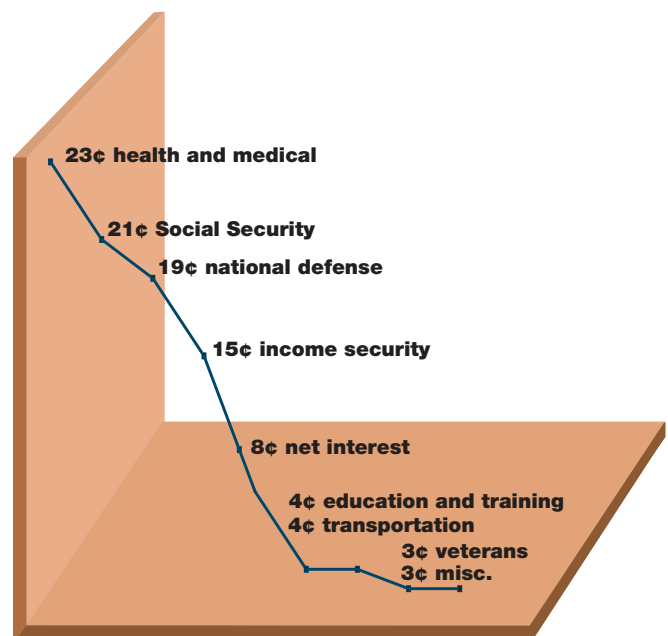
For instance, if your business pays the premiums and treats the expenses as taxable compensation, you can deduct them as compensation and they are included in your employees' W-2. When workers become disabled, the policy benefits will be tax free. The same is true if employees pay for premiums with after-tax dollars.

But if you don't treat premiums as taxable compensation or if employees pay the premiums with pretax dollars (such as from a cafeteria plan), workers pay tax on policy benefits when they receive them.

As with any tax-related matter, planning is critical. After all, if your workers become disabled and receive benefits, not only could they pay more tax on the benefits than they pay for the premiums, but they will have less cash when they will likely need it the most. 📄

HOW THE FEDERAL GOVERNMENT WILL SPEND YOUR TAX DOLLARS

Here's the breakdown of where funds from each tax dollar in 2005 will go:



Source: Tax Foundation

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