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STATE DEATH TAXES MAY HIT YOU WHERE YOU LIVE

The federal credit for state estate tax (also known as the state death tax credit) has been gradually decreasing and will be eliminated in 2005, and many states' death taxes will disappear with it. The increasing federal estate tax exemption also is affecting state death taxes. To replace lost revenue, many states whose taxes were linked to the federal tax are "decoupling" from the federal law — changing their laws to no longer be tied to it — and establishing their own estate or inheritance taxes.

Because of the disparity in state laws, estate planning is becoming even more complicated. To minimize estate taxes, look at where you live and own real estate.

HOW THE FEDERAL ESTATE TAX SYSTEM IS CHANGING

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the federal estate tax exemption gradually increases until it reaches \$3.5 million in 2009, and the tax is repealed in 2010. Meanwhile, the top estate tax rate decreases until the tax is eliminated. Unless Congress takes further action, the estate tax will return with gusto in 2011 when the estate tax exemption drops to \$1 million and the top estate tax rate jumps back up to 55%.

Before EGTRRA, estates received a dollar-for-dollar credit for estate or inheritance taxes paid to a state. Rather than create a standalone death tax, most states created "pick-up" or "sponge" taxes that soaked up the amount of the federal credit.

With the 2005 elimination of the state death tax credit, many states that rely on these sponge taxes will see their death tax revenues disappear. Starting next year, there will be a federal deduction to replace the federal credit for estate tax. The deduction provides only a reduced benefit to estates and no income for state treasuries.

In addition, many states' death tax exemptions have been equal to the federal estate tax exemption. So the rising exemption also is putting a damper on state death tax revenues.

HOW STATES ARE RESPONDING

States affected by the loss of the federal credit for state estate tax and increasing exemption amount have responded in different ways. Some are letting their estate or inheritance taxes die. These states may replace the lost revenue with other taxes.

Meanwhile, states that are changing their laws have varied approaches. Some are:

Decoupling only from the elimination of the state death tax credit. These states are imposing a tax equal

ESTABLISHING A NEW RESIDENCE

Changing your legal state of residence is simply a matter of spending the majority of your time in the new state with the intent to stay there permanently or indefinitely. But demonstrating your intent can be difficult. Here are steps you can take to show that you plan on living in the new state for an extended period of time:

- ⊙ File a declaration or affidavit of domicile.
- ⊙ Get a driver's license and license plates in the new state, and relinquish your license and plates in the old state.
- ⊙ Register to vote — and vote — there.
- ⊙ Pay property taxes.
- ⊙ File your federal tax returns with the IRS center closest to it.
- ⊙ File resident income tax returns in the new state (if applicable) and nonresident income tax returns in the old state.
- ⊙ File for a homestead exemption.
- ⊙ Open new bank accounts and a safety deposit box — and move the contents of your old box there.
- ⊙ Change your mailing address, such as on your passport and other important documents.
- ⊙ Join organizations in the new state and cancel memberships in organizations in the old state.

to the amount allowed as an estate tax deduction on the federal return. This deduction is equal to the amount that, pre-EGTRRA, was a dollar-for-dollar credit against the federal tax. For example, an estate valued at more than \$1.5 million in 2005 would be allowed a federal deduction — rather than a credit — for state estate tax paid. This will increase the total tax the estate must pay.

Decoupling from both the elimination of the credit and from the federal exemption. Some states have frozen the state exemption at the pre-EGTRRA federal exemption of \$675,000 or at some other set amount. Thus, there could be situations where an estate owes state estate tax but not federal estate tax.

HOW YOUR ESTATE PLAN MAY BE AFFECTED

Despite the phaseout of the federal estate tax, estate planning is as important as ever. Not only is the federal estate tax scheduled to return in full force in 2011, but if you live in a state that has established its own estate tax and your estate is large enough, you could owe considerably more estate tax than you would otherwise owe under EGTRRA.

Next, the divergence of state and federal law in certain states creates some thorny estate planning challenges. In states that have created a lower estate tax exemption, for example, estate planning techniques designed to take advantage of the federal exemption (such as credit shelter trusts) may produce unintended state tax consequences.

Finally, techniques designed to minimize state taxes may cause you to lose out on federal exemptions and thus inadvertently result in higher federal taxes.

If you already split your time between two states, examine their death taxes and consider shifting your residence to the state with lower taxes.

HOW LOCATION PLAYS A ROLE

As you can see, your state residency will have a bigger impact on your estate tax liability.

One solution is to move to a state that's letting its death tax die along with the federal estate tax. If you already split your time between two states, examine their death taxes and consider shifting your residence to the state with lower taxes. (For tips on how to make this change, see "Establishing a new residence" on page 2.) Before you take action, consider state income taxes, which also can vary dramatically from state to state.

Remember that many states impose their death taxes on people who reside in the state or own property there. So even if you live in a state with no death tax, your estate may still be taxed on the value of homes or other property you own in other states.

HOW TO HANDLE A CHANGING LANDSCAPE

With the federal estate tax continuing to change over the next several years, many states' death tax strategies remain uncertain. This means that you need to monitor the changes and adjust your plans as needed. Otherwise, you may be leaving less to your loved ones. 📄



SAVING FOR RETIREMENT

Contribute early and often

With people living longer, their dollars must go further than ever before. Contributing the maximum to a traditional or Roth IRA or to a 401(k) or another employer-sponsored plan is one way you can help ensure you're saving enough for your golden years. Timing contributions can reap benefits, too. With the new year approaching, it's a good time to review your retirement plan to see that you're growing your savings and minimizing your tax bite.

THE POWER OF TIME

When it comes to building your nest egg, you can't begin too soon or contribute too often (as long as you stay within the limits of the law). That's because the sooner you begin contributing to retirement plans, the more you'll be able to benefit from compound, tax-deferred or tax-free growth. The timing of your contributions can also affect the size of your nest egg at retirement.

Suppose, for example, you're expecting to contribute \$15,000 to a Simplified Employee Pension (SEP) IRA next year. You can make contributions as late as the due date of your 2005 individual income tax return (including extensions) and receive a deduction in 2005. But if you contribute earlier, you'll have more time to grow your tax-deferred savings. Making the \$15,000 contribution one year earlier would add \$1,200 to your account (assuming an 8% return rate).

That may not sound like much now, but it can quickly add up. If you contributed \$15,000 to your SEP IRA annually for 20 years and did so earlier in the year, you would have about \$55,000 more when you retire (assuming an 8% return rate).

Besides, making retirement plan contributions right away helps you avoid current taxes on the funds' earnings during the year, and you can earn a higher rate of return than if you sock the money away in a savings or money market account. But the risks are greater because of the potential volatility of stocks, bonds and mutual funds.

REGULAR CONTRIBUTIONS

Despite the advantages of making early retirement plan contributions, it may be more beneficial for you to contribute your funds gradually throughout the year. For example, if you participate in an employer-



sponsored retirement plan — such as a 401(k), 401(b), 457 or Salary-Reduction SEP (SARSEP) — you're likely making contributions each pay period.

Investing a fixed amount regularly allows you to benefit from “dollar-cost averaging.” This strategy can optimize investment performance because you buy more shares when prices are low and fewer shares when prices are high.

AGI CONTRIBUTION PHASEOUT RANGES

Making contributions as soon as possible can set a potential trap for Roth IRA holders because allowable contributions are phased out above certain income levels. In 2004, Roth modified adjusted gross income (AGI) limits are \$95,000 to \$110,000 for singles and heads of household, \$150,000 to \$160,000 for married couples filing jointly and up to \$10,000 for married couples filing separately.

Let's say, for example, that you contributed the maximum amount (\$4,000) to a Roth IRA in early 2005.

RETIREMENT PLAN CONTRIBUTION LIMITS

Retirement plan type	2004 limit	2004 limit (age 50 or older)	2005 limit	2005 limit (age 50 or older)
Traditional and Roth IRAs	\$3,000	\$3,500	\$4,000	\$4,500
401(k)s, 403(b)s, 457s ¹	\$13,000	\$16,000	\$14,000	\$18,000
SIMPLEs ¹	\$9,000	\$10,500	\$10,000	\$12,000
SEP IRAs	25% ² of eligible compensation, up to \$41,000	n/a	25% ² of eligible compensation, ³ up to \$41,000	n/a
Keoghs (profit-sharing)	25% ² of eligible compensation, up to \$41,000	n/a	25% ² of eligible compensation, ³ up to \$41,000	n/a

¹ Not including employer contributions.

² For a sole proprietor, 20% of self-employment income.

³ Adjusted annually for inflation in \$1,000 increments.

But as the year end looms, you realize your 2005 income will exceed the Roth AGI limit, which means you've made an unqualified IRA contribution and will face a 6% excess contribution penalty for each year the amount remains in the account.

Fortunately, because you caught it before you had to file your tax return, you can avoid the penalty by withdrawing the contribution and any income it earned before you file your 2005 return. You'll have to pay tax on the earnings, though.

Making retirement plan contributions right away helps you avoid current taxes on the funds' earnings during the year.

Another option is to use a trustee-to-trustee transfer to move the excess Roth IRA contribution and earnings to a traditional IRA before you file your return. Even if you're not eligible to make deductible contributions, there's no income limit for nondeductible contributions to traditional IRAs — therefore no excess contribution penalty. Plus, you avoid paying current taxes on the earnings.


INCREASED CONTRIBUTION LIMITS

It's also important to know the maximum contribution limits for your retirement plans because even if you maxed out an account or plan this year, you may be able to contribute more next year. Contribution limits are frequently increasing and additional catch-up contributions are allowed for individuals age 50 or older. (For the annual limits, see "Retirement plan contribution limits" above.)

Although Congress has enhanced certain retirement plan benefits, they aren't available under every plan. Catch-up contributions to an employer-sponsored plan, for instance, are available only if the plan allows them. And some employers impose percentage-of-compensation caps that may be lower than statutory limits.

IT'S NEVER TOO LATE

Even if you can't contribute to your retirement plan at the earliest possible date, doing so late is still better than never. For traditional and Roth IRAs, you have until the income tax filing deadline (April 15, 2005, for 2004 contributions) to open an account and make contributions. For traditional IRAs, you can still receive the deduction for 2004. Self-employed and business owners also have time to create certain retirement plans and make contributions to them.

Don't continue to put off retirement planning, because you could miss tax-saving strategies or other opportunities to grow your nest egg. 

WHEN SHOULD YOUR BUSINESS DEDUCT VS. CAPITALIZE ADVERTISING COSTS?

If you're advertising to promote a product or service or even to enhance your company's reputation or goodwill, you can generally treat these costs as deductible business expenses. But there are some instances when you have to capitalize and depreciate these costs.

WHAT'S AT ISSUE?

For years, businesses and the IRS have disputed when companies should deduct advertising costs as current expenses vs. capitalize and depreciate them. Businesses thought they had to capitalize these costs only when they created a new asset. But the U.S. Supreme Court's landmark *INDOPCO Inc. v. Commissioner* decision in 1992 changed the landscape.

The Court held that creation of a new asset was a sufficient, but not necessary, condition for classifying a cost as a capital expenditure. Costs must also be capitalized, the Court said, if they produce "significant long-term benefits" — for example, benefits that extend well beyond the tax year in which they're incurred. In this case, the target of a friendly takeover had to capitalize more than \$2 million in investment banking fees, legal fees and other costs related to the transaction.

After the *INDOPCO* decision, many businesses worried that the IRS would extend the court's holding to advertising costs under the theory that advertising expenses produce benefits beyond the current year. The IRS alleviated those concerns with Revenue Ruling 92-80, which stated that advertising costs "are generally deductible (as ordinary and necessary business expenses) even though the advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising."

WHAT ARE THE EXCEPTIONS?

The IRS ruling provides an exception for certain unusual circumstances. The IRS cited *Cleveland Electric Illuminating Co.*, a U.S. Claims Court case involving an electric company that conducted an advertising campaign to allay public fears about nuclear power. The court required the company to capitalize these expenses because the advertising was

"directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising."

You also must capitalize some advertising costs incurred to create a tangible asset expected to last more than one year, such as a billboard or other permanent signage, Web site content, and catalogs.

WHAT ABOUT COSTS RELATED TO NEW OR EXISTING BUSINESSES?

You can deduct expenses only when they're related to an existing trade or business. If the company is new, you must capitalize all startup costs, including advertising. These expenses may be amortized and deducted, if elected, once the business is active.

Unfortunately, the distinction between a new and existing business isn't always clear. In one case, a bank was able to deduct advertising costs related to the development of a new branch because these expenses were used to expand an existing business.

But in another case, when a clothing and cosmetics manufacturer opened a retail store, it had to capitalize the costs associated with the first location, including advertising. Additional retail outlets were then considered expansions of the existing retail business.

WATCH OUT FOR GRAY AREAS

The tax treatment of advertising expenses is complex. A seemingly simple distinction, such as whether a business is considered new or existing, isn't clear cut. Be sure to properly document these costs and consult your tax advisor. 📄



FSAs BENEFIT YOUR STAFF AND BUSINESS

A flexible spending account (FSA) is a terrific benefit for workers because it allows them to pay for a range of health care expenses with pretax dollars. (FSA funds are exempt from federal income, Social Security and Medicare taxes.) Plus, you receive the same income tax deduction for gross wages paid while reducing your portion of Social Security and Medicare taxes. And FSAs are a great tool to help attract and retain employees.

There are some drawbacks for employees: Expenses must be incurred and paid before the plan year end (typically Dec. 31) or they lose the money. (Now is a good time to remind participating workers about this deadline.) Also, reimbursements are limited to certain expenses including:

- ⊙ Over-the-counter drugs, such as pain relievers and allergy medications,
- ⊙ Eyeglasses and contacts,
- ⊙ Hearing aids,
- ⊙ Deductibles and copayments,
- ⊙ Acupuncture and hydrotherapy, and
- ⊙ Dental and orthodontia.

Insurance premiums, cosmetic surgery, and expenses covered by medical or dental insurance plans aren't eligible for reimbursement.

Remember, the IRS doesn't allow taxpayers to deduct FSA-paid expenses as itemized medical expenses. 📖

SELF-EMPLOYMENT TAX BREAKS

If you're self-employed, you may be able to deduct:

Health insurance costs. This above-the-line deduction allows you to deduct 100% of health care insurance costs for you, your spouse and your dependents. (Partners and shareholders who own more than 2% of an

S corporation also can deduct these expenses.) The tax break is limited to income earned from your trade or business.

Home office expenses. You may be able to claim expenses related to a home office if it's your principal place of business, you regularly see clients there or you use it for administrative and management duties. Eligible costs include prorated shares of:

- ⊙ Mortgage interest or rent,
- ⊙ Property taxes,
- ⊙ Homeowner's insurance,
- ⊙ Repairs,
- ⊙ Cleaning,
- ⊙ Utilities, and
- ⊙ Refuse removal.

If you sell your home at a gain, you'll have to pay a maximum 25% rate on any depreciation you claimed as part of your home office expenses.

Self-employment tax. You can take a deduction against your adjusted gross income for 50% of the self-employment tax you pay. 📖

TIME FOR YOU TO RECEIVE IRA DISTRIBUTIONS?

If you turned age 70½ this year, you must start taking distributions from your traditional IRA. You can do so by Dec. 31 so that the distribution will be included in your 2004 income or wait until April 1, 2005, so that it will be included in your 2005 income. If you fail to take the distribution, you'll have to pay a 50% penalty on the minimum required distribution. (After the first year of withdrawals, the deadline is Dec. 31.)

When you should take the initial required distribution depends on your financial situation. If you wait until April 1, you'll have to make two withdrawals in 2005 (the initial withdrawal plus a 2005 withdrawal), which could put you in a higher tax bracket. Meanwhile, delaying your first withdrawal is beneficial if you'll be in a lower tax bracket in 2005. 📖

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