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Personal Tax Plan

Prepared for:

Mr. & Mrs. Charles F. Client Jr.
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Tax Strategy Summary

Family, Home, & Job

Make the Most of Home Equity Interest

Borrowing against your home lets you convert nondeductible personal interest (credit cards, auto loans, etc.) into deductible home equity interest. However, there may be limits. ... page 2

Potential Savings: Up to \$250 in income tax for every \$1,000 of personal interest converted to home equity interest.

Your Business

Hire Your Family

Hiring your children lets you shift income that would otherwise be taxable to you (at your top rate) to them, to be taxed at their lower rate. This, in turn, lets you “deduct” the private or parochial school tuition, summer camps and activities, and college savings you fund with their income. ... page 3

Potential Savings: Up to \$403 in income and employment tax for every \$1,000 paid to a “zero-bracket” taxpayer.

Consider a Medical Expense Reimbursement Plan

A Medical Expense Reimbursement Plan lets your business reimburse you for your family’s uninsured medical expenses. This avoids the usual limit for deducting medical expenses (7.5% of Adjusted Gross Income) and may also save self-employment tax if your business is taxed as a sole proprietorship or partnership. ... page 4

Potential Savings: Up to \$403 in income and employment tax for every \$1,000 in qualifying expenses.

Your Investments

Depreciate Real Estate for Maximum Savings

“Cost segregation” strategies let you maximize depreciation deductions, even for properties you’ve owned for years. Review your properties to determine if you can use these strategies to boost your deductions. ... page 6

Potential Savings: Up to \$250 in income tax for every \$1,000 in increased depreciation.

Cashing Out

"Tax-Engineered Products" for Single-Stock Gains

Blocks of appreciated stock can be difficult to liquidate because selling outright triggers tax on your gain. “Tax-engineered products” may let you defer or even eliminate that tax. ... page 7

Potential Savings: Up to \$150 in income tax for every \$1,000 of long-term capital gain avoided.

Disclaimers

“Potential Savings” are based on your marginal federal income tax bracket, and where applicable, marginal employment tax bracket (FICA and Self-Employment tax), as calculated using the information you provided. These estimates do not include additional savings which may be available at the state and local tax levels.

Any tax advice contained in the body of this presentation was not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.

Introduction: How to Use This Plan

Filing Guide

These give you the lowdown on reporting income and deductions: where to report them and further IRS resources.

Deadlines

These highlight deadlines for acting to take advantage of strategies.

Tax Savers

These highlight special opportunities to cut your tax. They may be clever ways to use tax laws to your advantages, or bright financial choices that also bring tax relief.

Land Mines

These warn you of potential traps. They may be aggressive positions, IRS red flags, or financial mistakes that people make in the name of tax planning.

Internet Resources

These alert you to special Internet resources: articles, explanations, financial planning tools and calculators, and selected products and services to help you implement these strategies.

Sources

Here you'll find sources and citations to verify strategies discussed in the plan

IRC = Internal Revenue Code
Regs. = Treasury Regulations
Rev. Rul. = Revenue Ruling
Rev. Proc. = Revenue Procedure
PLR = Private Letter Ruling
IR = Internal Revenue Notice
TD = Treasury Decision

“The avoidance of taxes is the only intellectual pursuit that still carries any reward.”

- John Maynard Keynes

Congratulations! You've just taken a giant step towards beating the IRS. This plan gives you a personalized road map for the maximum tax savings allowed by law. But before we start with specific recommendations, let's review how this plan is organized and how you can use it to squeeze the biggest savings out of your return. You'll find five main sections:

1. **How the Tax System Works:** This section outlines how the tax system works to lay a foundation for understanding specific strategies to come.
2. **Family, Home, & Job:** This section covers day-to-day strategies for your family, your home, and your job. This section outlines tax strategies for financing college and elder care, buying and owning your home, and making the most of popular employee benefits.
3. **Your Business:** Owning your own business—a bona fide business with a legitimate profit intent—is the best tax shelter left in America. This section outlines strategies for organizing your business, deducting day-to-day expenses, buying and owning real estate and equipment, and choosing retirement and employee benefit plans.
4. **Your Investments:** Making money is hard. *Keeping* it is easier. That's because you have more control over tax-efficiency than any other aspect of your portfolio. This section outlines how to use IRAs and retirement accounts, how to buy and sell stocks, bonds, and mutual funds, and how to manage real estate for maximum after-tax return.
5. **Cashing Out:** This final section outlines strategies to defer or eliminate taxes when you sell personal, business, and investment assets. Just one of these ideas can avoid six- and seven-figure tax bills and help assure your financial legacy for generations.

Supreme Court Justice Oliver Wendell Holmes called taxes “the price we pay for civilization.” But he didn't say we had to pay retail. This plan is your guide to tax discounts throughout your return. Enjoy your savings. And don't spend it all in one place!

Family, Home, and Job: Make the Most of Home Equity Interest

Filing Guide

IRS Publication 936:
[Home Mortgage Interest Deduction](#)

Tax Savers

A reverse mortgage is a loan against your home's equity that lets you draw income without making repayments until your death. Reverse mortgages are available if the youngest resident is age 62 or older. The lender advances cash in a lump sum, series of payments, or line of credit for a term of years or your lifetime. At your death, the lender sells the house, collects as much of the proceeds as necessary to repay the loan, and returns any excess to your heirs. If the equity at death isn't enough to repay the loan, the lender eats the loss. Since the money comes in the form of a loan, you pay no tax on what you receive from the arrangement.

Internet Resources

www.reverse.org
reverse mortgage resources

You can deduct interest you pay on up to \$100,000 of loans or lines of credit secured by your primary residence and one additional residence. Using home equity debt to pay off cars, colleges, and any similar creditors converts nondeductible personal interest into deductible home equity interest.

Home equity debt doesn't have to consist of an actual second mortgage. A single mortgage can include both acquisition indebtedness and home equity indebtedness. If you refinance an existing mortgage and take out equity (cash exceeding the original loan balance), you can deduct the interest on the original balance, plus whatever you use to substantially improve your residence, as "acquisition indebtedness," and interest on up to \$100,000 more as home equity indebtedness.

- Make sure you compare after-tax rates before you refinance consumer debt with home equity debt. If you can buy a car with a special interest rate, your nondeductible personal interest may still cost less than deductible home equity interest. If you can transfer a credit card balance to a new card with a low introductory rate, you could save money and avoid the paperwork needed to refinance your home.
- You can use home equity interest to deduct otherwise nondeductible student loan interest. But avoid paying off loans while the student is still in college or qualifies for the student loan interest deduction. With many loan programs, the federal government pays or waives the interest while the student is still in school. It makes no sense to pay home equity interest when none is due to begin with.
- There's no deduction for home equity debt you use to buy life insurance or annuities.
- If you pay points on a home equity loan, deduct them over the term of the loan. If you sell the house or refinance the loan with a new lender, you can deduct any remaining balance when you sell or refinance.
- Home equity interest you don't use to buy or improve your home is an adjustment for the AMT.

You can still deduct the interest you pay on home equity balances over \$100,000 if you use those loan proceeds for a deductible purpose. If you use home equity debt to buy stocks, you can deduct it as investment interest; if you use it to finance your business, deduct it as a business expense. Deducting home equity interest as a business expense is especially valuable because it avoids the phaseout of itemized deductions for incomes above \$150,500, avoids AMT, and lowers business income subject to self-employment tax.

Your Business: Hire Your Family

Filing Guide

Pay your family employee's wages the same as you would pay any other employee on Schedule C, Form 1065, or Form 1120. They should complete Form W-4 for your records. File Form 941 quarterly, Form 940 annually, and any applicable state taxes. If you pay \$600 or more, prepare a Form W-2 and file it, along with Form W-3, annually. (If this sounds like a hassle, introduce your child to the joys of bureaucracy by having them manage their payroll!)

IRS Publication 15:
[Circular E, Employer's Tax Guide](#)

IRS Publication 15-B:
[Employer's Tax Guide to Fringe Benefits](#)

Land Mines

Some planners suggest hiring your child under age 7 to model for your advertising. But this is untested—if you try, you'd better have a very cute kid!

Sources

¹Rev. Rul. 73-393.

²IRC §1(c).

³*Eller v. Comm'r*, 77 TC 934.

⁴*Denman v. Comm'r*, 48 TC 439 (1967).

⁵Regs §1.162-7(a).

⁶IRC §3121(b)(3).

⁷IRC §3306(c)(5).

“Allowance” and other financial aid you extend to your children, grandchildren, or even parents is a deductible business expense if you pay them to perform bona fide work for your business and pay them reasonable compensation for that work.¹ Of course, at that point, it isn't allowance. It's wages. If you're hiring your kids, they might even learn not to treat you like “The First National Bank of Mom and Dad”:

- Your child can earn up to the standard deduction for single taxpayers (\$5,150 for 2006) before they owe tax on their income. The next \$7,550 is taxed at just 10%. Earned income isn't subject to the “kiddie tax” for children under 14.² Other family employees pay tax at their regular rate.
- The Tax Court approves wages for children as young as 7.³
- Your family employee's work should be directly related to your business.⁴
- Pay your employee a reasonable wage for their age and the service they perform. Their wages should be similar to amounts paid for similar services by similar businesses under similar circumstances—with adjustments made for their age and experience.
- To verify your deduction and audit-proof your return, keep a timesheet showing the dates, hours, and services performed.⁵ Pay your child by check, and deposit the check in an account in the child's name. This can be a Roth IRA, Section 529 college savings plan, or custodial account. You can't use custodial assets for your obligations of parental support; however, parental support doesn't include “extras” like private or parochial school tuition, summer camps, and similar expenses.
- If your business is taxed as a proprietorship or partnership, you don't owe Social Security or Medicare taxes on your child's wages until they reach age 18.⁶ You don't owe unemployment tax until they reach age 21.⁷
- Hiring family members to help work in your business also lets you establish employee benefit programs such as a medical expense reimbursement plan, education assistance plan, and retirement plans.

Your Business: Consider a Medical Expense Reimbursement Plan

Filing Guide

You'll need a written plan document and summary plan description to establish the plan. No special filings are required until the plan covers 100 or more employees. Report MERP benefits as "employee benefits" on the appropriate business form or schedule.

Tax Savers

If you hire your spouse to qualify for a MERP, you can pay them in benefits only, rather than cash. This avoids managing payroll formalities and filing Form W-2. The key to making this work is to document your spouse's bona fide employment. Consider executing a written employment contract. Track their hours, weekly or monthly, to substantiate your deduction.¹¹

Tax Savers

If you and your spouse are eligible for both a Section 125 plan and a MERP, consider which saves more. If your spouse buys health insurance through a Section 125 plan, they split the FICA savings with their employer. If you reimburse them through a MERP, you'll keep all the self-employment tax savings yourself. If you're eligible for both, consider which strategy saves more.

Sources

¹IRC §105(b).

²IRC §105(g).

³Rev. Rul. 71-588; PLR 9409006.

⁴IRC §105(h)(2).

⁵IRC §105(h)(3)(A)(ii).

⁶IRC §105(h)(3)(B);

Regs. §1.105-11(c)(2)(iii).

⁷Rev. Rul. 2002-58.

⁸IRC §105(b).

⁹Rev. Rul. 2003-102.

¹⁰IRC §105(b) ("amounts are paid, directly or indirectly.").

¹¹UIL No. 162.35-02.

Medical expense reimbursement plans ("MERPs") let you reimburse your employees, their spouses, and their dependents for uninsured medical costs.¹ Plan benefits are deductible by the business, and nontaxable to the employee. Here's how they work:

- You have to establish the plan for employees. If you run your business as a proprietorship, partnership, LLC, or "S" corporation, you're considered "self-employed," and not eligible.² If you're single, you can establish a C corporation and pay benefits to yourself as an employee. If you're married, you can hire your spouse and pay the benefits through him or her.³ If you operate as an S corporation, you and your spouse are both considered self-employed. (In that case, segregate part of your income through a proprietorship or C corporation and pay benefits through that entity.)
- You can't discriminate in favor of highly compensated employees.⁴ However, you can use a classification test (such as "all participants in Employer's group health plan") to qualify participants.⁵ You can also exclude those under age 25; those who regularly work less than 35 hours per week; those who work less than nine months out of the year; and those who have worked for you for less than three years.⁶
- You can't reimburse employees for costs they incur before the plan effective date.⁷

Paying medical expenses through a MERP offers several advantages:

- You can deduct 100% of your employees' health insurance. Deductible health insurance costs include major medical and supplemental premiums, Medicare premiums, qualified long-term care premiums, and Medicare supplemental ("Medigap") policies.
- Out-of-pocket medical costs include routine expenses such as co-pays, deductibles, and prescriptions; occasional expenses such as eyeglasses and dentistry; big-ticket items like orthodontics, fertility treatments, and schools for learning-disabled children.⁸ It also includes nonprescription medicines and health-care supplies.⁹ You can reimburse employees or pay health-care providers directly.¹⁰
- The plan lets you deduct 100% of your out-of-pocket costs, bypassing the usual 7.5% floor for itemized deductions. You'll also avoid any self-employment tax you would otherwise pay on amounts you deduct as plan benefits.

Your Investments: Tax-Efficient Funds for Taxable Portfolios

Filing Guide

IRS Publication 564:
[Mutual Fund Distributions](#)

Tax Savers

If you trade indexes and hold them for less than a year, rather than buying and holding for the long term, consider buying broad-based index options instead to qualify for preferential “Section 1256” treatment. Gains and losses from these contracts are taxed 60% as short-term and 40% as long-term, regardless of how long you hold them. This cuts your effective rate to no more than 23% for gains that would otherwise be taxed at 35%.

Land Mines

Some index funds, including smaller funds and “enhanced” and “leveraged” funds, don’t actually buy the securities that make up their underlying index. Instead, they use options or futures to track the index or beat it by specific percentages. These generate high short-term gains, costing you much of the tax advantages of true index funds. So watch out when you index. Hold true index funds in taxable accounts. Buy proxy index funds, enhanced index funds, and leveraged funds in tax-advantaged accounts.

Internet Resources

www.indexfundsonline.com
www.exchangetradedfunds.com
www.morningstar.com
mutual fund ratings and commentary

Mutual funds you hold in taxable accounts distribute all sorts of taxable dividends—and taxes drag down total returns. Here are eight ways to choose tax-efficient funds in taxable accounts:

1. Consider index funds to passively track indexes such as the S&P 500 or Russell 2000. These funds avoid the frequent sales that rack up taxes with actively managed funds. That’s because they sell only when they need to redeem shares or the underlying index itself changes.
2. Consider exchange-traded funds (“ETFs”), closed-end index funds that trade on an established exchange. They offer similar advantages as open-ended index funds. And they trade just like stocks, which lets you buy and sell throughout the day, use stop orders and limit orders, and short sales. (Downside: you’ll pay commissions to trade ETFs, and you can’t automatically reinvest shares like with open-end funds.)
3. Consider tax-managed funds, which focus on after-tax returns by avoiding turnover, harvesting tax losses, and selling specific shares to minimize taxable gains. Some also impose early-redemption fees to discourage withdrawals that might force managers to sell shares and realize gains.
4. Consider “basket portfolios” of up to 50 stocks, packaged in “baskets” of shares you own individually, rather than as a piece of a fund. Baskets let you manage taxes by timing sales, harvesting losses, and offsetting gains.
5. Look for funds with high “return after taxes.” This figure, calculated by *Morningstar Mutual Funds*, reports each fund’s annualized after-tax return. Morningstar calculates this figure twice, once for “return after taxes on distributions” and again for “return after taxes on distributions and sales.”
6. Look for funds with low “tax cost ratios.” This *Morningstar* figure represents the percentage-point reduction in an annualized return that you lose to income taxes.
7. Look for funds with low “Potential Capital Gains Exposure.” This *Morningstar* figure reports what percentage of a fund’s total assets represents undistributed capital appreciation. If the fund were liquidated today, this embedded capital gain would be taxable to shareholders. Embedded capital gains can be real ticking tax time bombs. In fact, some funds have deliberately distributed capital gains to existing shareholders in order to cut embedded gains to attract new shareholders!
8. Avoid funds with high turnover. This isn’t a perfect measure of tax efficiency, but it’s a useful indicator once you’ve narrowed your fund choices down to a few finalists.

Your Investments: Depreciate Real Estate for Maximum Savings

Filing Guide

IRS Publication 527:
[Residential Rental Property](#)

IRS Publication 946:
[How to Depreciate Property](#)

Tax Savers

Basis includes closing costs such as title insurance and fees, surveys and recording fees, transfer taxes, and the like.⁵ It also includes amounts payable on any mortgage you assume or buy “subject to.”⁶ Amortize costs of financing property (bank fees, points, and appraisals, etc.) over the term of the loan.⁷ Deduct any remaining costs when you refinance the loan.⁸

Tax Savers

If you’ve missed depreciation deductions, you can use Form 3115 to “catch up” and claim them retroactively as far back as the date you place the property in service. File Form 3115 with the IRS national office within the first 180 days of the year for which you claim the election then attach a copy to that year’s return. Many firms offer “cost segregation studies” to recover these lost deductions, and the IRS has issued an audit techniques guide examining the process.⁹

Sources

¹Regs. §1.167(a)-5.

²IRS Pub. 527 (2003).

³*Meiers v. Comm’r*, TC Memo 1982-51.

⁴Regs. §1.167(a)-8(a)(4).

⁵IRS Pub. 551, Page 2 (2002).

⁶IRS Pub. 551, Page 3 (2002).

⁷IRS Pub. 551, Page 3 (2002).

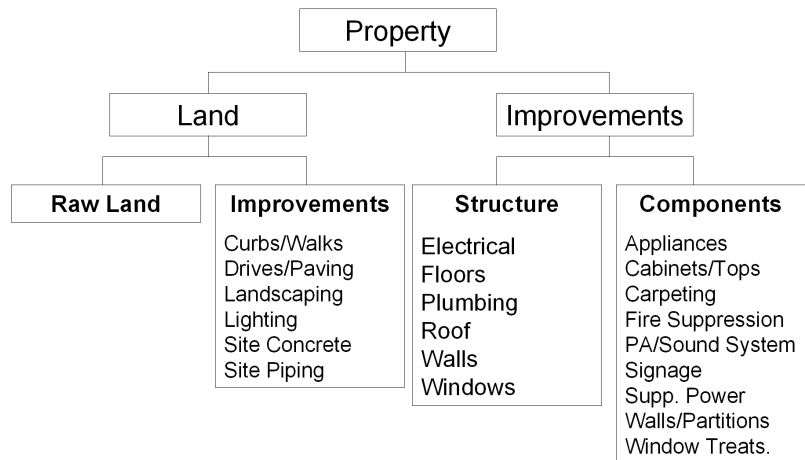
⁸IRS Pub. 527, Page 4 (2003).

⁹Misc-Doc, IRPO 203, 301

Depreciation cuts taxable income from rental real estate by deducting your investment in everything but raw land over a period of time intended to reflect its useful life. Your “basis” includes structures, components such as carpeting and appliances, and land improvements such as driveways, sidewalks, and landscaping. Unless your losses are limited by passive activity rules, it pays to maximize depreciation by allocating as much as possible to the fastest-depreciating pieces:

1. Divide basis between “land” and “improvements.”¹ Assign as much as possible to improvements. The IRS suggests you use local property tax assessments.² But you can use your own appraisal or your insurer’s estimate of replacement costs so long as you show a “reasonable basis” for your allocation.³
2. Divide land between “raw land” and “land improvements.” Assign as much as possible to land improvements, which generally depreciate over 15 years.
3. Divide improvements between “structure” and “personal property” such as appliances, cabinets and countertops, and carpeting. Assign as much as possible to personal property, which generally depreciates over 5 years.
4. Allocate your basis in “structure” to components such as roofs, windows, plumbing, and the like. These depreciate over 27.5 (residential) or 39 (nonresidential) years.
5. Some advisors suggest that when you replace structural components such as roofs and windows, you deduct any remaining basis in the replaced components as “abandoned property.”⁴

Maximize Depreciation



Cashing Out: "Tax-Engineered Products" for Single-Stock Gains

Filing Guide

IRS Publication 550:
[Investment Income and Expenses](#)

Tax Savers

Publicly-traded securities don't qualify for installment sale treatment. However, you can create similar savings by selling securities through a private annuity trust.

Land Mines

If you collar an appreciated stock position *too* closely, you'll be treated as having sold it and taxed on your gains.¹ The Joint Committee on Taxation indicates a 15% spread between put and call strike prices passes muster.

Sources

¹IRC §1259.

"Tax-engineered products" let you protect your stock gains and monetize stock while deferring or eliminating taxes you'd pay to sell outright. Consider these advanced investment-banking strategies for six- and seven-figure gains:

- **Stock loan** programs use custom derivatives to let you borrow against your stock. These are similar to traditional margin loans, but generally let you borrow up to 90% of your equity (as opposed to the traditional 50% for margin loans).
- **Collars** use special put and call options to hedge your stock position so that you can borrow more against it. First, sell a "call" option requiring you to sell the stock at a certain price. Then use the proceeds from that call to buy a "put" option letting you sell if the stock falls below a certain price and protecting you from a fall in the price. The bank writing the contracts uses "over-the-counter" options, exercisable under "European" rules only at the expiration of the option. With the stock safely collared, you can borrow up to 90% of the position's value. You can choose a zero-cost collar, where the sale of the call generates just enough to buy the put. Or you can choose an income-producing collar to help pay the interest on the loan. While the collar is in place, you'll retain voting rights and keep some, but not necessarily all of your dividends. Your ultimate gain or loss at the collar's expiration depends on the stock's price at that time.
- **Variable prepaid forwards** are agreements to sell shares at a future date in exchange for a specified payment today. The investment bank writing the contract specifies a minimum "floor price" and maximum "cap price," writes options to hedge its risk, then prepays you the purchase price on the trade date. When the position expires, you'll deliver as much stock as it takes to fulfill your obligation, depending on its price at that time. If the price doubles, for example, you'll deliver just half of your shares to satisfy your obligation. Or you can renew the arrangement to defer the tax even further.
- **Swap funds** let you exchange your low-basis stock or other assets into a partnership made up of other investors. There's no tax due on the exchange, and you wind up owning shares in a more diversified portfolio consisting of all the investors' partnership contributions. (The partnership itself can sell those assets to further diversify its portfolio.) Your main concern is to make sure the fund gives you the diversification you need. If you're a dot-com millionaire, a fund full of other dot-com stocks isn't likely to give you the diversification you want and need.

About Your Tax Planner



Internet Resources

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