

August 2009 Issue

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Develop a Tax-Planning Mentality

Many people confuse tax planning with tax preparation and only think about the subject when preparing their annual tax return. However, there is little you can do to actually lower your bill when preparing your return. If your goal is to reduce income taxes, you need to be aware of tax-planning opportunities throughout the year.

Take time early in the year, perhaps as part of the tax preparation process, to assess your tax situation, looking for ways to reduce your tax bill. Consider a host of items, such as the types of debt you owe, how you're saving for retirement and college, which investments you own, and what tax-deductible expenses you incur. It often helps to discuss these items with a professional who can review strategies you might not have considered.

During the year, consider the tax consequences before making important financial decisions. This will prevent you from finding out later that there was a better way to handle the transaction for tax purposes.

Look at your tax situation again in the fall, which gives you plenty of time before year-end to implement any additional tax-planning strategies. At that point, you'll also have a better idea of your expected income and expenses for the year.

There are basically three strategies that can help reduce your income tax bill:

- **Reduce or eliminate taxes.** The objective is to receive income in a nontaxable form or to find additional tax deductions, exemptions, or credits. For instance, you might want to consider municipal bonds, whose interest income is generally not subject to federal, and sometimes state and local, income taxes. Or investigate investments that generate capital gains, such as growth stocks. Gains are not taxed until you actually sell the investment, and if held for over one year, capital gains are subject to the 15% capital gains tax (0% for individuals in the 10% or 15% tax bracket). If you have realized capital gains, you might want to offset those gains by selling investments with losses.
- **Postpone the payment of income taxes until sometime in the future.** By postponing tax payment, your earnings compound on the entire balance, including the portion that will eventually be paid in taxes. You may also be in a lower tax bracket when taxes are paid. As an example, contribute as much as possible to retirement accounts, including employer plans and individual retirement accounts (IRAs).
- **Shift the tax burden to another individual.** The objective of this technique is to transfer assets to other individuals so that any income on those assets becomes taxable to those individuals. Typically, however, you have to give up control of the asset. For instance, annually you can give tax-free gifts, up to \$13,000 in 2009 (\$26,000 if the gift is split with your spouse), to any number of individuals. Any future income generated on those gifts then becomes taxable to those individuals. You may also want to use your lifetime gift tax exclusion of up to \$1,000,000 to make larger gifts.

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Reduced Planning Opportunities for Vacation Homes

In the past, it was possible to turn a vacation home or rental home into your principal residence so that you could later sell it and exclude gains on the sale from income. If you were planning on such a strategy, be aware that the tax rules recently changed.

Prior to the tax law change, you could purchase a vacation home or rental property years before you retired. Once you retired, you could sell your principal residence. As long as you lived in that home for two of the last five years before

selling, you could then sell the home and exclude up to \$250,000 of gain if you are single and up to \$500,000 of gain if you are married filing jointly. After that, you could move into your vacation home and use it as your principal residence. Then, as long as you had lived in the vacation home at least two of the last five years before selling, you could sell that home and exclude the gain up to the limits noted above.

The new law now separates holding periods into qualified and nonqualified use. When a home is sold, the gain must be allocated between qualified and nonqualified use, with the portion of the gain related to nonqualified use included in taxable income.

The law is effective after December 31, 2008. Qualified holding periods include:

- Holding periods prior to January 1, 2009;
- Holding periods after January 1, 2009, where the taxpayer uses the residence as his/her principal residence; and
- Any portion of the five-year period after the taxpayer's use of the property as a principal residence, provided the home is sold within that five-year period.

To count as qualified use, the home must be used as the principal residence by the taxpayer, the taxpayer's spouse, or the taxpayer's former spouse. A temporary absence from the home for reasons of employment, health, or unforeseen circumstances not exceeding two years does not count as nonqualified use. Any period up to 10 years that the taxpayer or the taxpayer's spouse is serving on extended military duty also does not count as nonqualified use.

Now, when a principal residence with nonqualified use is sold, even if the home has served as the principal residence for two of the last five years preceding the sale, any gain must be allocated between qualified and nonqualified use. Gains related to nonqualified use must be included in income, taxable at capital gains rates as long as the home was held over one year.

Thus, starting in 2009, there is no tax benefit to taxpayers to purchase a vacation home that will later be converted to a principal residence. For those who already own vacation homes, the longer the pre-2009 holding period and the sooner the vacation home is converted to a principal residence, the better for the taxpayer.

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Get the Details First

Before purchasing a stock, you should understand the basics about the company you are investing in. Make sure you can answer these questions first:

- **What business is the company in?** Understand the products the company sells and the growth prospects of that industry. Is it in a high growth business or a business that is likely to have slow growth in the years ahead? For some companies, this may be basic information that can be understood without much research. For other companies, you may have to read quite a bit before you understand exactly what they do.
- **How much product is the company selling?** Most publicly traded companies have sales figures in the hundreds of millions of dollars. If you're interested in a company with sales significantly below that, realize that it is probably a growth company with more risk than a mature, established company. Also review the trend in sales to make sure the company has steadily increasing sales.
- **Is the company profitable?** You're not just looking to make sure the company has positive net income for the year. You want to determine whether the amount of profit is reasonable for that industry. To get a feel for that, take a look at return on equity, which equals the company's net income divided by shareholder's equity, and return on assets, which equals net income divided by total assets.
- **Does the company have positive cash flow?** The company's cash flow statement will indicate whether cash increased or decreased during the period. A company can adjust its accounting policies to affect net earnings, but cash is more difficult to manipulate. Thus, it's a good second check on a company's profitability.
- **How much debt does the company have?** While most companies need some debt, too much debt can be burdensome. With interest rates currently at such low levels, increasing interest rates in the future could cause problems for companies carrying too much debt.
- **Has there been any negative news about the company?** News like lower than expected earnings, management shakeups, problems with a new product, and accounting restatements can have a detrimental effect on the stock's price. If the event is just a temporary problem, it could be a good time to purchase the stock. However, often one negative news item leads to another. Make sure there is no more bad news before you purchase the stock.

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The Case for GRATs

The lifetime gift tax exclusion is \$1,000,000, but is not scheduled to increase in the future. If you'd like to pass on more than \$1,000,000 to your heirs before your death but don't want to pay gift taxes, you may want to take a look at grantor retained annuity trusts (GRATs).

With a GRAT, you transfer an asset to the trust, retaining an annuity interest for a specified term, typically two to five years, but sometimes longer. During that period, the trust pays you a specified amount every year. When the trust terminates, the property goes to the named beneficiary. The gift is valued based on the present value of the remainder interest, which is the property's value less the retained annuity interest's value. Any appreciation in the asset after transfer to the trust escapes gift and estate taxes. However, if you die before the trust ends, the trust property will be included in your taxable estate.

Recent declines in interest rates have made GRATs a more valuable estate planning strategy for a couple of reasons. When you initially place the asset in the trust, the lower interest rates will result in a lower value for your retained interest, thus reducing the gift's value. When your annuity payments are calculated, lower interest rates will result in a lower required annuity, leaving more assets in the trust for your beneficiaries. The interest rates that must be used for these calculations is 120% of the midterm applicable federal rate, which was 2.87% as of April 2009 (Source: *Federal Taxes Weekly Alert*, March 26, 2009).

Assets that are typically good candidates for a GRAT are those whose value is expected to increase significantly during the trust's term. GRATs are sophisticated estate planning tools that may only be appropriate in certain situations.

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No RMDs for 2009

Individuals age 70 1/2 and older do not have to take a required minimum distribution (RMD) from their company retirement plans or traditional individual retirement accounts (IRAs) in 2009. RMDs for 2009 were suspended as part of the Worker, Retiree, and Employer Recovery Act of 2008. The suspension

applies only to defined-contribution plans such as IRAs, 401(k)s, 403(b)s, and 457 plans, but not to defined-benefit plans or other traditional pension plans.

RMDs are calculated by taking the account balance as of the preceding year divided by the life expectancy factor from a uniform table. Thus, RMDs for 2009 would have been based on account values as of December 31, 2008.

Unfortunately, no relief was provided for 2008 RMDs, so many retirees found themselves taking large RMDs that were based on account values as of December 31, 2007. After December 31, 2007, their account balances had declined significantly, so they were forced to sell at depressed prices and remove a significantly larger percentage of their current account balance from their account.

This suspension is only for 2009, so unless further legislation is passed, RMDs will be required again in 2010. Even though you do not take an RMD in 2009, your life expectancy factor will decline by one year when calculating the 2010 RMD.