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Mid Year Tax Planning Letter
(Short Version – See Below for Long Version)

To Our Clients and Friends:

As you know, last year's legislation lowered individual income tax rates as well as the rates on qualified dividends and most long-term capital gains (from sales of investments owned for over a year). These reduced rates are still in effect for 2004, although one can't be absolutely certain they will last beyond the end of this year. So it's important to take advantage of all available tax benefits before the tax law takes a turn for the worse. (We are not predicting this, but it could happen!)

With that thought in mind, the summer is always a good time to start evaluating your tax planning options. To get you started, we've listed some ideas to consider.

Your Investments

As you review investments held in your taxable accounts, remember that qualified dividends (including most dividends paid by U.S. corporations and some from foreign companies) are now taxed at a maximum 15% federal rate. Therefore, you may want to allocate a larger portion of your portfolio to dividend-paying stocks—as opposed to securities that pay high-taxed interest income (such as bonds and money market funds) and growth stocks that pay little or nothing in dividends. In the last year or so, many corporations have increased their dividend payouts, partly in response to the favorable tax treatment dividends now receive.

As you evaluate rebalancing your investment portfolio, consider the impact of selling appreciated securities. Long-term capital gains from 2004 sales are generally taxed at a 15% maximum federal rate. Therefore, it makes more sense than ever to hold appreciated securities for at least a year and a day before selling. That said, now may be a great time to cash in some long-term winners to benefit from the historically low tax rate.

Selling some loser securities (currently worth less than you paid for them) can be a good idea too. The resulting capital losses will offset capital gains from other sales this year (including short-term gains from securities owned for one year or less). If capital losses exceed capital gains, the excess losses can be used to shelter up to $3,000 of high-taxed ordinary income from salaries, bonuses, self-employment income, and so forth ($1,500 if you're married and file separately). Depending on your exact situation, you could actually collect greater tax savings by triggering capital losses during a year in which you have minimal or no long-term gains. That could be next year rather than this year. Call us if you have questions about this.

Your Business

If you own a business, this is a very important year for tax planning. Here's why.

The Section 179 instant depreciation deduction was raised to $102,000 for new and used business equipment and software placed in service during tax years beginning in 2004. Under this favorable rule, you may be able to immediately deduct most or all of this year's 2004 equipment and software additions. Heavy sport utility vehicles, pickups, and vans used over 50% for business currently qualify for the ultra-generous Section 179 deduction. But that could change any day, because Congress is expected to enact a reduced $25,000 Section 179 deduction cap for these vehicles. The good news: the reduction probably won't apply to heavy vehicles purchased and put into business use before the change is signed into law. So, now could be a great time to buy a Durango, Tahoe, or Expedition for your business (many other models qualify too).

Above and beyond the generous Section 179 deduction, you can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software acquired and placed in service by December 31, 2004. The 50% bonus depreciation break will expire at year-end, unless Congress takes further action. So you may want to act before December 31 to lock in some extra tax savings for this year.

If you run your business as a C corporation (or if you own an S corporation with earnings and profits from earlier C corporation years), you could come out ahead by taking some qualified dividends this year instead of extra compensation. Thanks to the 15% maximum rate on dividends, this could actually reduce the combined tax bills paid by you and your corporation.

Your Estate

Although the federal estate tax is scheduled to be repealed in 2010, the repeal would just be for that one year. At least that's the way the law currently reads. It's crazy but true! Therefore, planning to avoid or minimize the federal estate tax should still be part of your overall financial game plan. Your estate plan could need an update right now, because the federal estate tax exemption for 2004 and 2005 is $1.5 million—up from the $1 million amount that applied last year. While the increased exemption is generally a good thing, it could also have an unintended (and possibly negative) impact on your estate plan. Contact us for more information on this important issue.

Conclusion

As we said at the beginning, this letter is intended to give you just a few ideas to get you thinking about tax planning for 2004. Please don't hesitate to call if you want more details or would like to schedule a tax planning strategy session. We are at your service!

Mid Year Tax Planning Letter
(Long Version)

Thanks to taxpayer-friendly legislation enacted during the last few years, the current tax environment is probably about as good as it's going to get. That said, things don't usually stay the same for very long in today's world. We want to help you collect all your rightful tax savings before it's too late. Of course, that requires some advance planning. While the end of 2004 still seems far over the horizon right now, it's a good idea to begin planning sooner rather than later in order to reduce your taxes for this year and beyond. With that thought in mind, here are a few strategies to consider.

Your Investments

Most long-term capital gains from 2004 sales are now taxed at a maximum federal rate of only 15%. Even better, long-term gains that fall within the 10% and 15% brackets are taxed at only 5%. Qualified dividends from most domestic corporations and many foreign firms are taxed at these same low rates. For this year, a married joint filer can have taxable income as high as $58,100 (after reductions for personal exemptions and deductible items) and still be eligible for the ultra-low 5% rate on long-term gains and dividends. These favorable rules have several implications for you.

Holding on Longer Can Lower Your Taxes

If you hold appreciated securities in taxable accounts, owning them for at least one year and a day is necessary to qualify for the preferential long-term capital gains tax rates. In contrast, short-term gains are taxed at your regular rate, which can be as high as 35%. Make sure you consider this important distinction when evaluating your investment portfolio. Whenever possible, try to meet the more-than-one-year ownership rule for appreciated securities held in your taxable accounts. (Of course, while the tax consequences are important, they should not be the only consideration for making a buy or sell decision.)

Generally, when you sell stock or mutual fund shares, the shares you purchased first are considered sold first, which is good news if you are trying to qualify for the long-term capital gain rate. But, there may be situations where you're better off selling shares that have been held a year or less rather than those held longer. Selling recently purchased shares at little or no gain (because you purchased them at a higher price) may be better than selling shares held for more than one year if that sale would produce a significant gain. Whenever you want to sell shares other than those you purchased first, you must properly notify your broker as to the specific shares you want sold.

Sell Losers with Tax Savings in Mind

It's also important to consider the best time to trigger capital losses by selling losers held in your taxable investment accounts. Capital losses are used to offset any capital gains for the year. Specifically, short-term losses first offset short-term gains; then long-term gains. Long-term losses first offset long-term gains; then short-term gains. If total losses exceed total gains, the excess can be used to offset up to $3,000 ($1,500 if married filing separately) of ordinary income.

Bottom Line

To the extent you have long-term gains for this year, triggering capital losses before year-end may produce a tax benefit of only 15% (or possibly only 5%). Depending on your exact situation, you could actually collect greater tax savings by triggering capital losses during a year in which you have minimal or no long-term gains. That could be next year. On the other hand, triggering capital losses this year to offset short-term capital gains is almost always a good idea. Call us if you have questions.

Warning

Beware of the wash-sale rule when considering sales to trigger tax losses. You cannot deduct the loss if you purchase substantially identical securities within the period beginning 30 days before and ending 30 days after the date of the loss sale.

Consider Giving Appreciated Securities to Your Children

A great way to reduce the tax hit on an appreciated security is to give it your child (or grandchild). The child (grandchild) can hold the security until the year she turns 14 and then sell without being subject to the "kiddie tax." The resulting capital gain will probably be taxed at only 5% (assuming the current tax rate structure is left in place). Remember that giving the security to your child is considered a gift. However, you can use your annual $11,000 gift tax exclusion to shelter the transaction from any gift tax. For larger gifts, you can use part of your $1 million lifetime gift tax exemption to avoid any gift tax hit. However, dipping into your $1 million exemption could result in a higher estate tax bill after you die.

Investments in Retirement Accounts Get Less-favored Treatment

Remember that nothing has changed for investments held in tax-deferred retirement accounts (traditional IRAs, 401(k) accounts, SEPs, Keogh accounts, and the like). All the accumulated income and gains from investments held in these accounts will eventually be taxed at higher ordinary income rates when you start taking withdrawals. For this reason, it may make sense to keep investments that throw off high-taxed interest income in your tax-deferred accounts, while holding stocks and mutual funds expected to generate long-term gains and qualified dividends in your taxable accounts. On the other hand, equity investments you expect to hold for one year or less should probably be kept in your tax-deferred accounts or in a tax-free Roth IRA. Also, if the dividend/capital gain producing investments are likely to have significantly higher returns than the interest-producing investments, the benefit of the tax deferral may make holding those higher return assets in the tax-deferred account the way to go. If in doubt, we can help you figure out the optimal mix of investments to hold in your taxable and tax-favored accounts.

If You Own a Business . . .

For business owners, 2004 is a very important year for tax planning for a number of reasons.

Claim Big Section 179 Deduction

The Section 179 depreciation deduction is $102,000 for both new and used business equipment and software placed in service during tax years beginning in 2004. This means

you may be able to immediately deduct the cost of most or all of this year's equipment and software additions. A key point is that heavy sport utility vehicles, pickups, and vans used over 50% for business currently qualify for the ultra-generous Section 179 deduction. But this could change any day, because Congress is expected to enact a reduced $25,000 Section 179 deduction cap for these vehicles. The good news: the reduction probably won't apply to heavy vehicles purchased and put into business use before the change is signed into law. So, now could be a great time to buy a Durango, Tahoe, or Expedition for your business (many other models qualify as well).

Claim First-year Bonus Depreciation Too

Above and beyond the generous Section 179 deduction, you can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software acquired and placed in service by December 31, 2004. However, the bonus depreciation break will expire at year-end, unless Congress takes further action. So you may want to take action before December 31 to lock in some extra tax savings for this year.

Consider New C Corporation Strategy

If you own a profitable C corporation (or an S corporation with earnings and profits from earlier C corporation years), the time-honored tax planning strategy has been to drain as much cash as possible from the corporation in the form of compensation, rents, or any other payments that are not double-taxed dividends. However, the new 15% maximum federal tax rate on qualified dividends makes the idea of intentionally paying some double-taxed dividends worth considering.

Assume the sole owner of a C corporation is in the 35% federal income tax bracket and collects a salary in excess of the $87,900 Social Security tax ceiling for 2004. Any additional compensation collected this year would be hit with a 35% income tax rate plus a 2.9% Medicare tax rate, for a combined rate of 37.9%. If the corporation instead pays out its last $50,000 of taxable income as a dividend to the owner, the company would owe corporate federal income tax on the $50,000 at the rate of 15%. The owner would also owe 15% tax, for a combined 30% corporate and shareholder rate. There would be no Medicare tax. As you can see, a 30% tax rate is better than a 37.9% rate. And the tax savings would be even greater if the owner's 2004 compensation is subject to the combined 15.3% rate for Social Security and Medicare taxes (this higher rate applies to 2004 compensation of up to $87,900).

Bottom Line

Paying a limited amount of double-taxed dividends can now be a tax-smart move in certain circumstances. However, there are other factors to consider including the state income tax impact. Please contact us if you are interested in this idea.

Bunch Expenditures for Deductible Items

If your 2004 itemized deductions are likely to be just under (or just over) the standard deduction amount, it may pay for you to adopt the strategy of bunching together expenditures for itemized deductions every other year, while claiming the standard deduction amount in intervening years. This year's standard deduction for married joint

filers is $9,700. The magic number for single filers is $4,850, while the figure for heads of households is $7,150.

For example, say you're a joint filer whose only itemized deductions are $3,000 of annual property taxes and $7,000 of annual home mortgage interest. If you prepay your 2005 property taxes before December 31 of this year, you could claim $13,000 of itemized deductions on your 2004 return ($3,000 of property taxes for this year, plus another $3,000 for the 2005 bill, plus $7,000 of mortgage interest). In 2005, you would only have the $7,000 worth of mortgage interest, but you can claim the standard deduction amount, which will be $9,700 plus an inflation adjustment.

This strategy allows you to cut your taxable income by a meaningful amount over the two-year period. You can then repeat the drill all over again in 2006 and 2007. You get the idea. You probably have other deductible items that can be bunched together every other year to lower your taxes in this fashion. Examples include the interest from your January home mortgage payment, charitable contributions, and state income tax payments.

Consider Deferring Income

In addition to bunching deductions, it may also pay to defer taxable income from this year to next—especially if you expect to be in a lower tax bracket in 2005. You can postpone taxable income by entering into a deferred compensation agreement with your employer, by putting off client billings until late in the year so you don't receive payment until 2005 (assuming you are a cash-method taxpayer), by prepaying deductible business expenses near year-end, and by selling appreciated assets on the installment method. Deferring income may also be helpful if you are subject to phase-out rules that reduce or eliminate various tax breaks (such as itemized deductions, the child tax credit, the education tax credits, and so forth). By deferring income every other year, you may be able to substantially increase your eligibility for these tax breaks every other year (which is much better than never being eligible or being eligible for only negligible breaks).

Watch Out for the Alternative Minimum Tax

While recent tax law changes have done a lot to reduce your regular federal income tax bill, they didn't do nearly as much to reduce the odds that you'll owe the alternative minimum tax (AMT). Therefore, it's critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are so complicated, you may want our assistance here. We stand ready to help!

Estate Tax Planning Is Still Important

Although the federal estate tax is scheduled to be repealed in 2010, the repeal would just be for that one year. At least that's the way the law currently reads. It's crazy but true! So, unless you can manage to time your death to occur during 2010 (no sooner and no later), planning to avoid or minimize the federal estate tax should still be part of your overall financial plan.

New $1.5 Million Exemption for This Year and Next

Your estate plan could need an update right now, because the federal estate tax exemption for 2004 and 2005 is $1.5 million—up from the $1 million amount that applied last year.

While the increased exemption is generally a good thing, it could also have an unintended (and possibly negative) impact on your estate plan. Contact us for more information on this important issue. (According to current law, the federal estate tax exemption will increase to $2 million for 2006–2008 before increasing again to $3.5 million for 2009.)

Making Annual Gifts Still a Tax-smart Idea

Most estate tax experts doubt the federal estate tax will actually be repealed, even for one year. Therefore, if you have a healthy-sized estate, whittling it down by making annual gifts continues to be a tax-smart strategy. If you have some favorite relatives or unrelated persons, you can give each of them up to $11,000 each year. So can your spouse. These gifts will reduce your estate tax exposure without any adverse gift tax effects. Making multiple gifts over multiple years can dramatically reduce your exposure. So the sooner you start an annual gifting program, the better. Annual gifts can also be a good way to gradually transfer ownership in a family business to the younger generation. The same goes for real estate investments. Contact us for more information on the best ways to make gifts for someone in your situation.

Consider Selling Assets to Intentionally Defective Trust

Another way to reduce your exposure to the federal estate tax is by selling appreciating assets to an intentionally defective grantor trust. This type of trust is ignored for federal income tax purposes. In other words, selling assets to the trust is treated the same as selling them to yourself! So there’s no taxable gain. However, for federal estate tax purposes, assets sold to the trust are removed from your estate. When you die, assets owned by the trust go to the individuals you’ve designated as the trust beneficiaries. As payment for the assets you sell to the trust, you’ll receive an installment note, which should pay interest at least equal to the applicable federal rate. Since current interest rates are still quite low, you avoid estate tax on the difference between the rate of appreciation in the value of the assets sold to the trust and the interest rate paid on the installment note. This is a fairly sophisticated tax planning technique. Call us if you want to hear more about it.

Conclusion

As we said at the beginning, this letter is intended to give you just a few ideas to get you thinking about tax planning for 2004. Please don’t hesitate to call if you want more details or would like to schedule a tax planning strategy session. We are at your service!

Very Truly Yours,

Krebs & Co., CPA’s, Inc.
dba **Krebs Advisory Group**