

# TAXOLUTIONS



►► *ideas on taxes*

## TEN COMMON ESTATE PLANNING MISTAKES

Whether your estate plan is simple or complex, there are many details, often overlooked, that can undermine your plan's effectiveness. Below we've listed ten common estate planning mistakes. Although these are numbered, this is not an indication of severity or prevalence.

### 1) Titling property jointly with your children as a substitute for a will.

Unlike a will, a transfer of an interest in your property is irrevocable, which may prevent you from changing the disposition if circumstances change before your death. Also, titling your personal residence jointly can result in partial loss of the capital gain exclusion if it is sold before your death.

### 2) Failing to plan for the possibility of children getting divorced or having problems with creditors.

Parents often have cause to regret having made outright gifts to their child when the child subsequently divorces and the ex-son- or daughter-in-law is awarded an interest in the gifted property by a court. Or, when the property is taken pursuant to a legal judgment against the child. Such problems can be minimized through proper use of trusts or a business entity, such as an LLC.

### 3) Failing to make sure that all your assets pass in accordance with your

wishes upon your death. Many types of assets can pass to your heirs or others based upon beneficiary designations (life insurance, IRAs, brokerage accounts). The provisions of your will cannot change a beneficiary designation. Remember to account for things you've already designated. You should review your will, as well as all other beneficiary designations when formulating your estate plan.

### 4) Underestimating the true value of your estate for federal estate tax purposes.

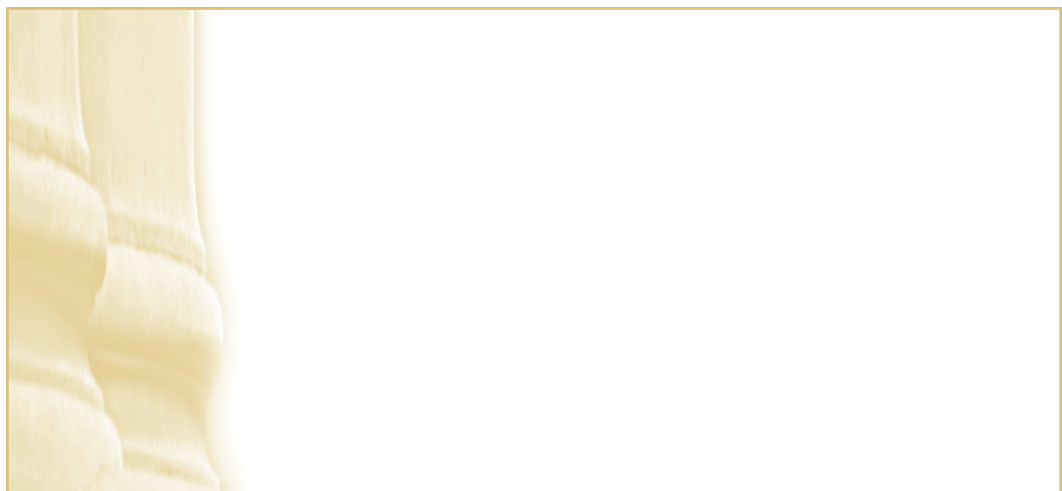
For instance, many people are unaware that the proceeds of life insurance on their lives are includable in their taxable estates if they own the policy. This could bring their total estates to more than the amount

sheltered from estate tax by the unified credit (currently \$1.5 million).

### 5) Failing to consider state death taxes in light of recent changes in the law.

Many states have "decoupled" their death tax from the federal estate tax, which means your estate could be subject to death tax in a state even if no federal estate tax is due. This could result in an unpleasant surprise upon your death, one that might be avoidable with proper planning. The laws of each state where you own property should be carefully reviewed to determine the potential exposure to state death taxes, and how to minimize them.

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## SPRING CLEANING... DUST OFF THOSE TAX, FINANCIAL, & LEGAL DOCUMENTS

This time of year, you are probably sorting through records for your tax return or preparing to store them. While you have those records out, start the process of putting your tax, financial, and legal affairs in order.

With organization and preparation, you can improve your chances of meeting your personal and financial goals, now and throughout 2004. The lists below, although by no means all-inclusive, can help you get started. Remember that you will also need competent tax, financial, and legal advice.

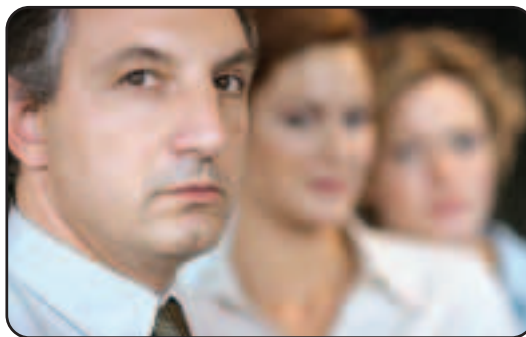
### *Personal Tax Planning & Legal Matters*

- ▶ Analyze your 2003 tax return and note how to improve your tax situation for 2004.
- ▶ File all tax returns on time (even if you don't have the money to pay the tax due). Penalties for failure to file are more severe than for late payment. If you have any unfiled tax returns, contact us immediately.
- ▶ Get tax advice on any transactions planned for 2004.
- ▶ Plan to take advantage of tax benefits that expire over the next few years.
- ▶ Pay particular attention to capital gains and losses. With the recent lowering of the long-term capital gains rate, there is more money to be saved through careful transaction planning.
- ▶ Transactions between family members can have adverse tax effects; get advice before finalizing.
- ▶ Have you made gifts during the year (more than \$11,000 per person) that may require filing a gift tax return?
- ▶ Keep all pertinent records. We can help you decipher what's important to keep and what isn't.
- ▶ Are you maximizing your retirement savings?

- ▶ Are you taking advantage of flexible spending accounts, health savings accounts, and any employer fringe benefits?
- ▶ Is your property titled the best way for tax, and other, reasons?
- ▶ Do you need to consider asset protection from creditors?
- ▶ Plan for tax-advantaged college saving.
- ▶ Consider shifting income to children or other relatives.
- ▶ Do you need to consider tax-wise support of elderly relatives?
- ▶ What about potential guardianship for elderly relatives?
- ▶ Do you have a durable power of attorney and medical directive?
- ▶ Make sure you have a will, and have it reviewed periodically.
- ▶ Have an estate plan and avoid probate.

### *Investors (Stocks & Bonds)*

- ▶ Are you up-to-date on the recent tax changes regarding capital gains and dividends? If not, contact us to learn the basics. These new rules can greatly enhance your after-tax investment earnings.



- ▶ Are you maximizing tax-advantaged investments such as tax-exempt or tax-deferred investments, dividend-

paying stock, and certain small business stock?

- ▶ Should you adjust your asset allocation to spread risk or get the investment mix you want?
- ▶ Do your records accurately reflect basis, account for reinvested earnings, and allow you to identify specific stocks to minimize sale gain?
- ▶ Are you deducting all allowable investment expenses?
- ▶ Are you coordinating investment and retirement goals?

### *Real Estate Investors & Owners*

- ▶ Get tax advice in planning any future acquisitions.
- ▶ For tax purposes, is the real estate held in the right entity?
- ▶ How should the title be held?
- ▶ Is your insurance coverage adequate?
- ▶ Should you consider refinancing?
- ▶ Consider a cost segregation study for recent acquisitions.
- ▶ When looking to sell, use a tax-wise structure, possibly a like-kind exchange.

If you are a business owner or are getting ready to launch a start-up, you have additional tax concerns. For example, do you know what type of business entity best serves your purposes? Are you taking advantage of the increased bonus depreciation and 179 expense amounts?

Proper planning and professional advice can help you achieve the best tax results. For specific guidance regarding your financial goals, call us today. ■

## IRS UPDATE: EXPANDED ENFORCEMENT ON THE HORIZON

The IRS is closing a return processing center, consolidating a number of functions, and reducing overhead. Savings from these initiatives will allow for more hiring. The IRS plans for these new hires to be in front-line and tax enforcement positions. They expect to fill about 2,200 new positions in the enforcement area.

Here are some of their plans for expanding enforcement.

### *Employment Tax Enforcement to Increase*

Increased scrutiny of employment taxes will come from both the civil and criminal side. The IRS has always taken a hard line with employers who use payroll deposit money for their own purposes, rather than submitting it to the government in a timely manner. But, now they're more likely to consider criminal sanctions. The IRS criminal investigation division has announced they are at a high water mark in terms of attentiveness to employment tax cases. Failure to deposit payroll tax withholdings is one of the worst IRS-related mistakes you can make.

### *IRS Boosts Audits*

The IRS vows to boost audits of small and mid-sized companies and pass-through entities. Increased audit coverage is the goal of the IRS's Large and Mid-Size Business Division, which previously concentrated on the 1,300 largest corporations in the country. Small to mid-sized businesses will see an increase in audit coverage.

The IRS also plans to increase its audits of partnerships, S corporations, and other pass-through entities, which are believed to be an area of risk for taxpayer noncompliance. Historically, businesses operated as partnerships or S corporations were generally less likely to be examined, but that is changing.

### *Schedule K-1 Matching*

On the flip side, the IRS is also concerned with the reporting of pass-through income on the individual's return. The recently reactivated Schedule K-1 matching program is an important compliance tool for the IRS. The matching program classifies returns for audit and also feeds information into the non-filer program, which identifies taxpayers who haven't filed returns.

In order to identify potential audit targets among taxpayers using pass-through entities, the IRS is studying a three-year database of information from the Schedule K-1.



### *IRS Implements Color-Coded Warning Notices*

Perhaps taking their lead from Homeland Security, the IRS has announced implementation of a new color-coded notice system. This is intended to alert taxpayers about concerns over potentially abusive tax shelter transactions. A "yellow light" notice is a caution signal and indicates that the IRS has questions about these deals and will address the transactions. Transactions the IRS believes are legitimate get a "green light" notice, and a clearly abusive tax shelter is flagged with a "red light" notice.

### *Abusive Tax Schemes and Shelters in the Bulls-Eye*

Recent news stories have highlighted the IRS's emphasis on targeting what it terms tax shelters, listed transactions, and abusive tax schemes. Most of these are complicated transactions that seek to be something they are not. The IRS may decide these are "sham" transactions,

impose penalties, and insist that the taxpayer should have known better.

Other aggressive tax planning strategies, while not improper, may be caught in the same net until (hopefully) the facts can be sorted out and the IRS is convinced they are okay.

Many investments and transactions will face increased IRS scrutiny.

### *Criminal Tax Prosecution Also Up*

The government is also getting tougher on tax cheats. The IRS is pursuing more tax criminals and getting more of them to court. This comes after a number

of years of declining enforcement during which the agency spread its resources thin to concentrate on drug enforcement, money laundering, and other criminal matters. Now the focus is on tax cases.

The Justice Department is going along with the trend. The acceptance rate for prosecution on tax cases referred by the IRS is well over 90%, with about a 70% rate of successful prosecution once the cases get to court. Statistics show that of the convictions the government wins in court, 84% of the people sentenced actually serve some kind of prison time, with the average being 42 months.

### *If You Hear from the IRS*

If the IRS, under any of these expanded enforcement programs, contacts you or your company, call us. We can help you determine what action to take and can be your interface with the IRS. Also get advice before you enter into any tax-motivated investment or transaction. Make sure you understand the tax ramifications and the potential risks. ■

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## TEN COMMON ESTATE PLANNING MISTAKES

**6) Not recognizing that there is now a difference between the amount that can be transferred free from gift tax during your lifetime and the amount that can pass free from estate tax upon death.** The maximum amount that can be given away during life without incurring gift tax is \$1 million, whereas the amount sheltered at death is currently \$1.5 million, scheduled to increase in increments to \$3.5 million, with repeal of the estate tax (but not the gift tax) currently scheduled for 2010. You can make yearly gifts up to the annual exclusion amount (currently \$11,000 per person) that don't count against your \$1 million gift tax exemption.

**7) Failing to maximize the benefits of the income tax basis "step-up" at death.** Low-basis/high-value assets

should generally not be given away during your lifetime, since the basis for capital gain computation purposes will be increased to fair market value at death. The basis remains at the property's original cost if the asset is given away.

**8) Failing to indicate your desired funeral arrangements.** A pre-arranged funeral can greatly relieve family members from additional stress upon your death. And, you get the send-off you want.

**9) Failing to plan for disability.** In the absence of adequate medical care directives, powers of attorney, or trusteeship of assets, costly and time-consuming court proceedings may be required in order to appoint a guardian or conservator to act on your behalf if you become disabled.



**10) Not reviewing and updating your estate plan on a regular basis.** Changes in the law and in your personal financial and family situation over time make it essential that you review your estate plan periodically to make sure it still carries out your wishes.

Some of these common mistakes can be avoided with a few, simple actions. Others may require some effort on your part. We can help you with these actions, or with other estate planning needs. ■

## *Health Savings Accounts May Be the Right Medicine*

The recently enacted Medicare law created a new savings vehicle for health care costs. The new health savings account (HSA) is similar to an IRA. Beginning in 2004, any eligible individual under the age of 65 can establish an HSA for the purpose of putting aside money, on a tax-favored basis, to be used for qualified medical expenses. An employer can also establish a plan for "eligible individuals".

To be eligible for an HSA, the individual must be covered by a high-deductible health plan (HDHP), and no other health plan. An HDHP is a health plan with an annual deductible amount of at least \$1,000 for individuals and \$2,000 for families. An HDHP can include a preventative care benefit, which is not subject to the high deductible. In addition, the restriction on "no other plan" does not apply to disability coverage, dental care, vision care, or long-term care. However, the "no other

plan" rule applies to a health FSA within an employer's flexible spending account (FSA). Individuals who are eligible for Medicare cannot contribute to an HSA, but they can use HSA funds that have accrued prior to reaching Medicare age.

The annual contribution limit to an HSA is the lesser of the HDHP deductible or \$2,600 for an individual and \$5,150 for a family. These amounts will be indexed for inflation in future years. Individuals age 55 or older may make additional contributions of \$500 in 2004. This additional contribution amount increases ratably until it reaches \$1,000 in 2009.

An individual can fund an HSA with tax-deductible contributions, and interest on the HSA account can accumulate tax-free. An employer can also contribute to an HSA, with the contribution being deductible by the employer, but not includable in the employee's income.

The HSA can be set up as part of an FSA. As a component of an FSA, an HSA can be funded with both pre-tax salary reduction dollars and employer contributions. Increased salary reduction dollars, with the attendant payroll tax savings, may offset the employer's contribution cost.

Distributions from HSAs that are used to pay for qualified medical expenses will be tax-free. Qualified medical expenses are those defined in Internal Revenue Code Section 213(d), plus qualifying over-the-counter (OTC) drugs. HSA funds can also be used to pay for long-term care insurance premiums, COBRA premiums, and health insurance premiums for persons receiving unemployment compensation.

Non-qualifying distributions are subject to income tax and a 10% penalty tax. However, there is no penalty for distributions following death, disability, or retirement upon attaining Medicare eligibility age.