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Dear Client:

Tax Planning Opportunities

For the third year in a row, Congress has passed a major tax relief package; legislation designated as one of the largest tax cuts in U.S. history. With change comes opportunity, and the 2003 Act has created an environment in which taxpayers can choose among a number of options to invest more and deduct more, all while paying less taxes. Whether working with a professional advisor or planning on your own, effective and efficient tax planning is now much more than a year-end task to defer some income while accelerating a few expenses. The current economic conditions have raised the stakes for tax planning, and doing nothing can be the worst course of action that can be taken by anyone.

Importance of Tax Planning

If you compute your federal income tax on a calendar-year basis, as most individuals do, your opportunity for tax planning generally ends on December 31. Thus when you prepare your tax return two or three months after the close of the tax year, it is generally too late to do anything except file your return on the basis of what took place in the preceding year. There are some exceptions. For example, many individuals and small business owners can make post-year-end IRA or SEP IRA plan contributions and reduce their taxes for the prior year.

Tax planning primarily concerns the timing and the method by which your income is reported and your deductions and credits are claimed. The basic strategy for tax planning is to time your income so that it will be taxed at a lower rate and to time your deductible expenses so that they may be claimed in years when you are in a higher tax bracket. This usually means that, if you expect to be in a lower tax bracket in 2004 compared to 2003, you should defer the receipt of income to 2004 and accelerate your deductions into 2003.

Example: You and your spouse are both over age 60 and have been retired for several years. Your house is paid for and you've been living on savings and social security. You expect your taxable income for 2003 and 2004 to be \$18,375 for each year. Near the end of 2003, you decide that you want to withdraw \$50,000 from a traditional IRA in order to pay for major home improvements as well as paying off some of your high-interest credit card debt. Should you make the withdrawal in 2003 or wait until 2004?

Neither. The correct timing strategy is to allocate the amount of the IRA withdrawal between 2003 and 2004. For 2003, the withdrawal should be \$38,425, which will be taxed at 15%. (For joint filers in 2003, \$56,800 is the top end of the 15% tax bracket; \$38,425 + \$18,375 = \$56,800.) The balance of the \$11,575 should be withdrawn after January 1, 2004 taking 2004 taxable income to \$29,950 (\$11,575 + \$18,375). By splitting your IRA withdrawal between 2003 and 2004, you will achieve an overall federal tax savings of \$1,158. In addition, allocating your

IRA distribution over two tax years accomplishes two other objectives:

- It makes maximum use of your lowest tax brackets (10% and 15%) for both years.
- It avoids, or postpones, the 25% tax bracket, and gives you tax free use of a portion of the money for a year.

Income Level

The biggest variable determining your marginal tax rate is your income level, so big changes in income from this year to the next may open the door to several tax planning opportunities. Marriage and divorce often have a drastic effect on your income level, as do job changes, retirement, illness, cash windfalls, and sales of assets (e.g., stocks, mutual funds, or your home).

Ways to Postpone Income

If your tax planning shows that you will be in the same or a lower tax bracket next year, you probably will want to delay the receipt of year-end income until early next year, provided the delay does not jeopardize your prospect of collecting the income. Here are a few techniques you may be able to use to achieve that goal:

Delay collections. If you are a small business owner or are self-employed, delay year-end billings until late enough in the year that payments won't come before the end of the year.

Deferred compensation. If you are employed, negotiate a deferred compensation agreement with your employer. This type of agreement does not have retroactive effect, though. So act as soon as you can if you want the maximum deferral into next year or beyond. Many employers will agree to pay interest on the money they hold back, so you don't have to lose anything by having your compensation deferred.

Year-end bonuses. Year-end bonuses do not have to be paid before the end of the year, so strike a deal with your employer to have your bonus paid in January. Generally, your employer will not lose its deduction for the current year by delaying your payment until next year, as long as its obligation to pay you is fixed before the end of its tax year and paid within 2 ½ months of the close of its tax year.

Incentive stock options. If your employer gives you a qualified incentive stock option (ISO) to purchase its stock or stock in a parent or subsidiary corporation, you are not taxed until you dispose of the stock. In other words, there is no regular tax on receipt or exercise of the option, thus you may delay income by holding on to the option or stock. However, the bargain element on the option must generally be considered for Alternative Minimum Tax (AMT) purposes when your rights in the option become transferable or when these rights are no longer subject to a substantial risk of forfeiture.

Annuities. Another way to defer income is to transfer funds from interest-bearing accounts to a commercial annuity.

Maximize retirement plan contributions. Make sure that you are contributing the maximum allowable amount to your retirement plans (e.g., 401(k)s, 403(b)s, IRAs, or SEPs). If you are age 50 and over, additional catch-up contributions to a traditional or Roth IRA are permitted beginning in 2002. For 2002 through 2005, the amount of catch-up contribution is \$500.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a "like-kind", you will be able to defer recognition of gain or loss. While your gain will eventually be subject to income tax, you may be able to defer taxation for a number of years.

Installment Sales. If you must sell property (other than stock or securities) this year, delay receipt of part of the proceeds by having the payments made to you in installments over the next few years. The installment method may allow you to reduce your total tax on the sale by preventing your taxable gain from pushing you into a higher tax bracket in the year of sale. Make sure, though, that the payments are secured and that the buyer pays interest on the unpaid balance.

Ways to Accelerate Income

A rule of thumb says you should defer income if at all possible. But in the following situations, it may pay you to accelerate your income:

- Change in filing status. An upcoming marriage or divorce that will put you in a higher tax bracket next year may dictate accelerating 2004 income into 2003.
- Change in income level. Anticipated changes in employment, sales of assets, etc., next year could put you in a higher bracket, making the tax on accelerated income lower this year.
- Too many deductions. If your itemized deductions exceed your taxable income this year, don't lose the excess deductions. Accelerate enough income to cover them. Follow the same strategy if you have carryover deductions from previous years that will expire this year.

Here is how you do it:

Collect receivables. If you are a small business owner or self-employed, make sure you do all the billing you can, and then be sure to collect! Remember, if you are using the cash method of accounting, which I recommend, income is not taken into account until you receive it.

Year-end bonus. If your employer pays bonuses after the end of the year or you arranged to have your bonus deferred for tax reasons, negotiate a change. Get that bonus into your hands by the end of the year.

Restricted Stock. If you receive, as compensation from your employer, stock that is subject to restrictions (for example, stock that may be subject to forfeiture if your employment is terminated before a specified number of years), you generally are not taxed on the stock until it is vested. You may, however, elect to treat the stock as vested and pay the tax right away. This is done by filing a statement with the IRS within 30 days after you receive the stock. The risk in this is that you may not undo the tax damage if you later forfeit the stock. Whether you decide to make the election all depends on the value of the stock at the time and on how secure you are that you will eventually be vested.

Incentive stock options. If you have an ISO that you received from your employer, exercise the option and dispose of the stock. With due regard to investment considerations.

IRA or retirement plan distributions. If you are over age 59 ½ and you either have a traditional IRA or are covered by an employer's retirement plan, you may increase this year's income by making withdrawals. (In the case of the retirement plan, your right to make withdrawals is determined by the plan.)

Installment notes. The installment sale you made in a previous year for the purpose of deferring taxable gain can be undone if you need the income this year rather than in the future, and there are three ways to accomplish this. The first is to arrange for your debtor (the buyer) to pay off the note before the end of the year. The second is to use the note as collateral for a loan. The third is to sell the note to a third party. In any case, the portion of the gain that you haven't yet reported will become reportable.

Dividends. If you have control over a corporation that pays you dividends, arrange for them to be paid before the end of the year.

Lawsuits, insurance claims, etc. If you have a dispute with someone you believe owes you taxable money (for example, claims for wages, damages to property in excess of the damaged property's basis, etc.), you are not taxed on the money until you are paid. One way to accelerate this income is to settle your dispute. You may take less, but you could make it up in lower taxes.

Capital gains. When dealing with capital gains, your greatest flexibility comes from your ability to decide when to sell assets. If you have assets that have appreciated in value, a sale before the end of the year can give you the income you need to meet your tax planning goals.

EE bonds. If you have elected to defer taxes on your EE bond interest, you can cash in the bonds and take the accrued interest into income.

Taking Advantage of Flexible Spending Accounts

Setting up a flexible spending account (FSA) with your employer can result in substantial tax savings. An employee can set up an account with pre-tax wages to pay in advance for eligible health and / or dependent care expenses. Contributions to each account are limited to \$5,000 per year. The \$5,000 limit applies whether you are single or married (\$2,500 for married filing separate). Wages placed in the account are not subject to income and FICA

taxes. When you incur eligible expenses, you may file a claim for reimbursement from your account. It's up to you to designate how much money you want withheld from your paycheck over the entire year and deposited to your account. Generally, the amount you specify will be prorated over the number of regular paychecks you receive in a year.

Incentive Stock Options

If your employer offers you an incentive stock option, take it because this gives you the right to purchase stock of your employer, often at a discount, without recognizing income until the stock is sold.

There are, however, some risks. Although no taxable income is recognized when the option is granted or exercised, the difference between the fair market value and the exercise price is an item of Alternative Minimum Tax (AMT) preference and can trigger a significant AMT liability in the year of exercise if a large amount of appreciated stock is involved. Generally, most of the AMT liability will be recovered in the year the stock is sold as an AMT credit against regular tax if the value of the stock has not decreased after the exercise of the option.

Making Your Deductions Count

An important element of tax planning is making sure, before it's too late, that you meet the technical requirements for all of your deductions. Following are two checklists of deductible business and personal expenses:

Deductions for Business or Profession

Accounting, engineering and legal fees	Employee Expenses	Office Expenses
Advertising	-Employment related insurance	-Porter and janitor service
Bad Debts	-Professional fees, dues, licenses, etc.	-Postage
Banking charges-interest paid, safe deposit boxes, etc.	-Tools	-Rent for office
Business and professional books, journals, reports	-Uniforms	-Security (night watch service, etc.)
Car, truck, or other vehicle business expenses	Freight charges	-Stationery-letter heads, cards, etc.
Casualty losses (storm, fire, etc.)	Health insurance, personal (100% in 2003 and thereafter)	-Utilities (lights, telephone, water, garbage, etc.)
Charitable contributions	Insurance on business property	Repairs and maintenance of business property
Conventions, cost of attending	Meal and lodging expenses	Research and experimental expenditures
Depreciable assets (car, furniture, fixtures, etc.) acquired for employee's use	Moving expenses	Salaries, wages, commissions, bonuses, etc.. paid
Education expense (travel, tuition, etc.) to maintain or improve skills required in the trade of business		Taxes and costs of preparing returns
		Theft losses, not compensated by insurance
		Travel and entertainment expenses

Personal Deductions on Schedule A (Form 1040)

Deductible Only if Deductions are Itemized

Amortizable premiums on taxable bonds	IRA fees (2% floor)	- Damages for breach of employment contract
Appraisal fees (2% floor)	Legal expenses-nonbusiness	- Depreciation on computers and cell phones
Casualty and theft losses-business property (2% floor)	Loss on deposits (2% floor)	- Dues to professional societies or chamber of commerce
Casualty and theft losses-nonbusiness property	Medical, dental, hospital (7.5% floor)	- Education related to work
Charitable contributions	Repayments of income (2% floor)	- Home office
Clerical help and office rent (2% floor)	Repayments of social security benefits (2% floor)	- Job search expenses
Depreciation on home computer (2% floor)	Repayments under claim of right	- Legal fees
Excess deductions on an estate (2% floor)	Safe deposit box rent (2% floor)	- Licenses and regulatory fees
Expenses in earning taxable income (2% floor)	Service charges on dividend reinvestment plans (2% floor)	- Occupational taxes
Fees to collect interest and dividends (2% floor)	Tax advice and preparation (2% floor)	- Repayment of income aid payment
Gambling losses-limited by winnings	Cooperative housing taxes (2% floor)	- Research expenses of a college professor
Hobby expenses (2% floor)	Estate taxes on income in respect of decedent	- Subscriptions to professional journals and trade magazines
Impairment-related work expenses	Foreign income and real property taxes paid	- Summer school expense of teachers
Indirect deductions of pass-through entities (2% floor)	State and local income, personal property, and real property taxes paid	- Tools used in work
Interest Expense	Self-employment tax (one-half)	- Travel, Transportation, Meals, Lodging, and Gifts
-Home mortgage interest	Taxes on property producing rent or royalties	- Union dues and expenses
-Investment interest (limited)	Unrecovered investment in an annuity	- Work clothes and uniforms
-Student loan interest (limited, but not itemized)	Unreimbursed employee business expenses (2% floor)	
Investment fees and expenses (2% floor)	- Business bad debt	
	- Business liability insurance	

One significant factor to keep in mind is that many deductions may be reduced if your adjusted gross income (AGI) level is too high. For example, itemized deductions and personal exemptions are phased out based on the excess of AGI over established threshold levels. Also, other deductions may be claimed only if they exceed a certain percentage of AGI (2% for miscellaneous itemized deductions, 7.5% for medical expenses, and 10% for casualty losses). Accordingly, if you plan to accelerate income into 2003, be aware that not only will the additional income be taxed, but also there may be fewer deductions to offset your total income amount.

2003 Phaseout Thresholds for Higher-Income Taxpayers

Filing Status	Personal Exemption Phaseout Begins:	Personal Exemption Phaseout Completed:	3% Reduction of Itemized Deductions Begins*
Single	\$139,500.00	\$262,000.00	\$139,500.00
Married, filing jointly	\$209,250.00	\$331,750.00	\$139,500.00
Head-of-household	\$174,400.00	\$296,900.00	\$139,500.00
Married, filing separately	\$104,625.00	\$165,875.00	\$69,750.00
			*Reduction is limited to 80% of your deductions

Summary: From the most complex questions to the most basic (i.e. Are you having enough tax withheld from your wages?) I am here year-round to help you with your tax and financial planning needs.

Tax planning appointments and related research fees are \$50 per hour. A recent meeting revealed that a change in the clients filing status would yield a tax savings of \$10,000. If the savings were \$1,000, would it be worth \$50? I'll let you do the math.

If you would like to schedule an appointment please call (no walk-ins). You will need to bring current pay stubs, income and expense records, investment reports, mortgage statements, etc. When you arrive please have your questions prepared and as much documentation as required to help me do the job. Most appointments are brief information gathering meetings. The numbers crunching and preparation of written planning memos is generally done outside of these appointments. Unwritten plans and advice cannot be relied upon for accuracy.

News

IRS Announces Application Fee for Offers in Compromise

The IRS will charge an application fee of \$150 for Offers in Compromise beginning November 1, 2003. If you owe a large amount in back taxes, have very little equity in your assets, and your monthly income and expenses are roughly equal, you may benefit from filing an Offer in Compromise. This is a great way to settle your tax debt often for pennies on the dollar. If you think you may qualify and want to save the extra \$150, please call for an appointment.

4-Serenity Checklist. Are you adequately insured? Does your business vehicle have commercial insurance coverage? Are your books and records up to date? Are you keeping track of your business and personal mileage? Are your investments properly diversified? Is your 401(k) allocated properly? Will you have enough income when you retire? Will you owe taxes this year? Have you filed all of your tax returns? Does your payroll service meet your needs? Is your business taking advantage of special tax elections? Are tax liens blocking your future plans? Are you saving enough for your child's (children's) education? Are you following a plan, or just going with the flow?

Serenely,

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