

## 2003 marks another year of income tax breaks & cuts

**T**he *Jobs and Growth Tax Relief Reconciliation Act of 2003* (the Act) is one of the largest tax cuts in history.

The Joint Committee on Taxation estimates the cost to be \$330 billion over the next 10 years. Many believe the true cost to the U.S. Treasury will exceed \$800 billion.

The Act is intended to stimulate the economy by reducing taxes, especially taxpayers with younger children and those with investments.

Even though most provisions provide benefits lasting only two to five years, you have to wonder how a future Congress will act facing increasing deficits and expiring tax reductions.

The Act lowers tax rates for individuals and accelerates the rate reductions originally scheduled to take place over several years.

Capital gains rates have been slashed to 15% and expanded to include certain stock dividends.

Finally, the long-awaited relief from the marriage penalty is now

in place, and the child tax credit is significantly increased.

Several provisions for businesses also have been implemented. Expensing provisions related to assets used in business have been greatly expanded. The first-year bonus depreciation has increased from 30% to 50% for new business assets, and this is on top of the Section 179 expense deduction allowed for new acquisitions.

### Planning strategies require caution

Considering a change in investment strategy in light of the reduced capital gain and dividend tax rates? Keep in mind these reductions, as well as many others, are temporary and currently set to expire after 2008.

Don't get caught in a situation where the long-term economic costs outweigh the short-term tax benefits.

The chart on page 2 provides a general idea of when the current provisions expire.

Inside this issue you'll find key planning strategies for individuals

and businesses that will help you take advantage of tax-saving opportunities. As always, be sure to consult your BKD tax advisor before implementing any strategy. □

### Inside

- ✓ **IRS cracks down on abusive shelters**
- ✓ **A review of the home sale exclusion rules**
- ✓ **Retirement plans offer small businesses tax-savings opportunities**
- ✓ **What to include—or not—in W-2s**

### Tax shelters attracting negative PR

**R**ecently, there has been a lot of negative publicity about tax shelter strategies marketed by accounting firms.

Such strategies have been challenged by the Internal Revenue Service (IRS) and also are the subject of legal actions initiated by clients now under IRS examination.

**BKD, LLP** does not and has not marketed tax shelters such as those described in the news media and which usually require a nondisclosure agreement to be signed.

BKD has not required clients to sign nondisclosure agreements in connection with any tax advice or strategies we have recommended. We do, however, provide tax-planning strategies to our clients. When properly used, they are not the type of tax shelters targeted by the IRS.

For more information on tax shelters, see "IRS cracks down on abusive tax shelters" on page 3.





With an increased standard deduction for married taxpayers in 2003, expect more married taxpayers to claim the standard deduction.

If you don't plan to itemize your deductions this year, consider bunching them in 2004 by delaying payment of some deductible items. That way, deductible expenses may exceed the standard deduction amount next year.

For example, if a couple with \$9,000 of itemized deductions each year moves \$2,000 of those expenses into 2004, the couple would claim the \$9,500 standard deduction in 2003 and itemize \$11,000 of deductions in 2004.

Some of the information in this Advisor is specific to 2003 and may not be relevant after December 31, 2003. As always, talk with your BKD advisor before taking any action.

By the way, contact your BKD advisor to schedule a presentation on "2003 Strategies to Save Taxes" for members of your community, business, civic or charitable organizations.

# Individual tax planning

## Rate reductions

Both the 10% and 15% tax brackets were expanded to include more income taxable at these rates.

For the higher tax brackets, rates were lowered 2% from those in 2002, with the exception of the top tax bracket; the highest tax rate was reduced from 38.6% to 35%. **These reduced rates are only in effect through 2010.**

## Lower taxes for married couples

Before 2003, married couples who filed a joint return that claimed the standard deduction generally paid more taxes than two single taxpayers with the same income, also referred to as the "marriage penalty."

The Act partially addresses the marriage penalty by increasing the standard deduction to twice that of the single taxpayer's standard deduction. **However, this provision is only in effect for 2003 and 2004.**

In addition, the Act expands the 15% tax bracket to help married taxpayers in the lower-income tax brackets.

Some married couples receive a marriage *bonus* instead of a mar-

riage *penalty*, *i.e.*, the married couple will pay less tax as joint filers than if they were single, which generally occurs when one spouse is the wage earner and the other spouse doesn't work. Under the Act, these married couples will receive an even larger bonus than under previous law.

## Long-term capital gains tax rate reduced

Taxpayers who have long-term capital gains will see a tax reduction. For most taxpayers, "adjusted net capital gains" will now be taxed at 15% instead of 20%. This rate applies to both the regular and the alternative minimum tax (AMT).

Adjusted net capital gain is the net long-term capital gain reduced by the sum of the 28% rate gain on collectibles and the unrecaptured Section 1250 gain taxed at the 25% rate. This lower capital-gains rate applies only to gains recognized after May 5, 2003.

For taxpayers in the 10% or 15% rate brackets, a tax rate of 5% will apply and the 5% rate will be reduced to zero for 2008. **However, unless a future Congress amends the law, this zero rate will sunset December 31, 2008, and**

**the previous 20% and 10% rates will apply.**

## Dividend tax rate reduced

Dividends receive a preferential tax rate under the Act. Qualified dividends will be taxed at 15% for taxpayers with incomes above the 15% rate bracket and 5% for taxpayers with incomes in the 10% or 15% rate brackets.

To be eligible for the lower rate, the stock must generally be owned 60 days during a 120-day period that begins 60 days before the ex-dividend date. **Note:** The holding period is longer for certain preferred stock.

**The lower rates are effective for all of 2003 through 2008, though the rate is reduced to zero for taxpayers in the 10% or 15% bracket for 2008 only. The reduced rates will sunset after 2008.**

Eligible dividends are those received on stocks of U.S. corporations and qualified foreign corporations, *i.e.*, if the stock of the foreign company is traded on an established U.S. stock exchange or the corporations are incorporated in a U.S. possession.

Eligible dividends include

## Years Provisions of the 2003 Act are in Effect

Tax Provision	2003	2004	2005	2006	2007	2008	2009	2010
Rate reductions	✓	✓	✓	✓	✓	✓	✓	✓
Expansion of 10% bracket	✓	✓						
Marriage penalty relief	✓	✓						
Lower rates on dividends & capital gains	✓	✓	✓	✓	✓	✓		
Increase in child credit	✓	✓						
Small business provisions	✓	✓	✓					

## IRS cracks down on abusive tax shelters

The IRS's recent crackdown on abusive tax shelters has made many taxpayers wary about investing in such schemes. The government is investigating nearly 80 tax shelter promoters and has issued more than 200 summonses to obtain investor lists, while at least 78 cases have been referred to the Department of Justice for further enforcement action and more cases and investigations developed during October.

While it is difficult to determine whether a tax shelter may come under IRS scrutiny, the following warning flags suggest caution:

- ✓ Use of a series of sales transactions to drive up the basis of assets and then use to generate artificial losses
- ✓ Arrangements that leave the investor no worse off financially but produce a tax benefit
- ✓ Requirement by the promoter to have the investor sign a confidentiality agreement not to disclose any part of the transaction
- ✓ Absence of any economic gain or loss in connection with the transaction
- ✓ Use of an offshore trust or partnership as part of the arrangement

If a promoter approaches you about a tax shelter, obtain the details and check with us before making any commitments.

Meanwhile, deferred compensation arrangements, use of 401(k) plan, purchase of real estate, like-kind exchanges and use of charitable trusts are examples of **legitimate** strategies that provide tax shelter without the fear of getting caught up in a tax-evasion scheme. □

those passed through from mutual funds, other regulated investment companies, partnerships, other pass-through entities or a common trust, assuming distributions would be classified as dividend income by individual shareholders.

The Act contains no restrictions on the dividends subject to the lower rates even if the distributing corporation that has earnings and profits borrowed money to pay dividends or paid no tax at the corporate level on its earnings because of extensive tax credits.

Distributions from tax-deferred retirement plans, *e.g.*, 401(k) and 403(b), are not eligible for the lower rates.

### AMT relief

AMT is payable to the extent your tentative minimum tax exceeds the regular income tax.

**More taxpayers will be subject to AMT as a result of the Act.**

The AMT imposed on noncorporate taxpayers is 26% of the first \$175,000 (\$87,500 for married filing separately) of alternative minimum taxable income (AMTI) exceeding an exemption amount and 28% of the remaining AMTI.

Depending on filing status, the exemption amount is phased out as AMTI increases over a certain threshold. **For tax years beginning in 2003 and 2004, the Act increases the AMT exemption.**

### Child credit increases

Under previous law, qualified taxpayers who claimed an exemption for a qualifying child (or stepchild, sibling, stepsibling or a descendant of any of these) under age 17 at the end of the tax year could claim a tax credit of \$600 per child.

The Act increases the credit from \$600 to \$1,000 for 2003 and 2004. **In 2005, the credit reverts to that allowed under previous law as shown in the table below.**

In July 2003, the IRS started issuing advance payment checks of up to \$400 per qualifying child to individuals who claimed the child tax credit for 2002. You qualify if you were allowed a child credit in 2002, as reflected on the 2002 tax return, *and* had one or more qualifying children in 2002 under age 17 as of December 31, 2002.

The advance child credit checks are not rebates or reimbursements. Rather, they are advances on the 2003 credit. Thus, any amount received will reduce the allowable credit on the 2003 return.

#### Child Credit

Tax Year	Amount per Child
2005 - 2008	\$ 700
2009	800
2010	1,000

Beginning in 2011, credit reverts back to \$500

### Divorce settlements & IRAs

It's not uncommon to use an IRA as part of a divorce settlement, but take care to avoid taxes.

*(continued on page 6)*

### Tax Strategies



**More taxpayers will be subject to the AMT as a result of the 2003 Act because the regular tax rates were reduced, and the AMT rates were not.**



**If you own a family business, you may be able to hire your children and reap tax benefits. For example:**

- Social Security taxes aren't due when an owner of a sole proprietorship or a husband and wife partnership hire their own children under age 18
- Federal unemployment insurance taxes aren't owed on children under age 21
- Because a child's pay is taxed at a lower rate, the shift in income from the parent to the child usually results in income-tax savings
- Children can use a standard deduction to offset a portion of the income, which results in income-tax savings (the standard deduction is \$4,750 for 2003)
- Purchase a Roth individual retirement account (IRA) for your children; help them start building a lifetime of financial security

**Note:** children must work real jobs and receive reasonable pay for their work or the IRS may disallow the arrangement.

## Tax Strategies



With a 20% spread between rates on ordinary income and capital gains, it becomes more important to avoid short-term gains, which are taxed at ordinary income rates. Hold assets for more than one year whenever possible before selling them.



Teachers and other education workers, save your receipts for books, equipment and other supplies you buy for your classroom. 2003 is the last year you can deduct up to \$250 in eligible expenses.

To be eligible for the deduction, you must work at least 900 hours during the school year as a teacher, instructor, counselor, principal or aide in either an elementary or secondary public or private school.

The deduction is available regardless of whether you itemize or not.



You have an option if you have investment-interest expense going unused because it exceeds your taxable investment income subject to regular tax rates.

You can elect to deduct the otherwise unused interest to the extent you have dividends and capital gains.

In making this election, you will forego the special lower tax rates afforded dividends and capital gains, but you may end up with a smaller tax liability for the year.

# A review of the home sale exc

by Jerry Isaacs, Tulsa

**B**ecause Congress has historically encouraged home ownership, several Internal Revenue Code provisions provide relief to homeowners. One of these provisions is Section 121, which excludes gains of up to \$500,000 on the sale of a qualifying principal residence.

In December 2002, the IRS issued some additional regulations about this section that offer opportunities for saving tax dollars.

The sale of your residence for more than its adjusted basis results in a realized gain, and all realized gains must be recognized for tax purposes unless the Code provides an exception.

One such exception allows you to exclude all or part of the gain resulting from the sale of a principal residence. **To qualify, you must have owned and used this residence as your principal residence for two or more years during the five-year period ending on the date of sale or exchange.**

## Principal residence

Your residence can be a house, as well as a houseboat, a house trailer, stock in a cooperative housing unit and any other dwelling place. A residence also can include surrounding land not used for business or profit.

For a property to qualify as your principal residence, you must occupy the property for a majority of the time during the year.

The new regulations state if you alternate between two or more properties during the year, the determination of which property qualifies as the principal residence is based on facts and circumstances.

Generally, however, the property you occupy for the majority of the time is your principal residence. Since you must occupy the residence for the majority of time, a vacation home or a weekend-use houseboat does not qualify for the exclusion.

Other relevant factors to consider in determining your principal residence, include:

- ✓ Place of employment
- ✓ Principal place of abode of family members
- ✓ Address listed on your federal and state tax

returns, driver's license, automobile registration and voter registration card

- ✓ Mailing address for bills and correspondence
- ✓ Location of your bank(s)
- ✓ Location of religious organizations and recreational clubs you are affiliated with

If you have multiple residences, you need to maintain appropriate records to properly substantiate which home is the principal residence. These may include copies of:

- ✓ Voter registration card
- ✓ Employment or business cards
- ✓ Completed homestead exemption form
- ✓ Mailing address on federal or state income tax returns
- ✓ Evidence of church or other local organization membership
- ✓ Bills or bank statements
- ✓ School records for children

## Vacant land

Vacant land may qualify for the exclusion of gain on principal residences even if sold separately from the residence. The exclusion for the combined gain from the sale of the principal residence and the vacant land, however, is limited to one maximum exclusion of \$500,000 (\$250,000 for single or married filing separate filers). How often can the exclusion be used? Generally, it can be applied to gain from the sale of only one principal residence every two years.

To be considered part of the principal residence, IRS says the vacant land must be:

- ✓ Adjacent to land containing the principal residence
- ✓ Owned and used as part of principal residence
- ✓ Sold or exchanged within two years of the sale or exchange of the qualifying principal residence
- ✓ Satisfy all other requirements of Section 121; both spouses must meet the two-year use test to qualify for the \$500,000 maximum exclusion

**Example:** A single person owned a house for several years, got married and their spouse moved in.

If the couple sells the house less than two years

## Exclusion rules

later, the maximum exclusion would be \$250,000. If, instead, they remain in the house for two years, the maximum exclusion would rise to \$500,000 even if ownership of the home remained in one person's name.

Alternatively, suppose one individual owns a house and, without them marrying, another individual moves in. Assuming ownership of the house remains in one person's name, the maximum exclusion would be \$250,000, regardless of how long the unmarried partner lives there. If, however, they marry after living together for two years, they can sell the house immediately and qualify for a \$500,000 exclusion.

If unmarried individuals each have an interest in the home's ownership and use the property as their principal residence for at least two of the last five years, each may exclude up to \$250,000 of their proportionate gain.

If both spouses each own a principal residence, each of them is eligible for a \$250,000 exclusion on the sale of his/her property even if they file a joint return.

If a single taxpayer marries someone who has used the exclusion within the two years before the marriage, the newly married taxpayer (who has not claimed the exclusion within two years) is allowed a maximum exclusion of \$250,000.

### Exception to two-year rules

In certain situations, if you fail to meet the requirements for the full \$250,000 gain exclusion under the regular requirements of Section 121, you may still qualify for a lesser exclusion. These situations fall into three categories:

- ✓ Change in your place of employment
- ✓ Change in your health
- ✓ Other unforeseen circumstances, such as:
  - Involuntary conversion of the residence
  - Natural or manmade disasters, acts of war or terrorism resulting in a human casualty at the residence
  - Death of a qualified individual
  - Cessation of a qualified individual's employment as a result of which the individual is eligible for unemployment compensation



- Change in a qualified individual's employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household
- Divorce or legal separation
- Multiple birth pregnancies

### Property used partially for business

A personal-use requirement must be satisfied for the exclusion to apply to any portion of property sold or exchanged.

If you have used a portion of the property separate from the dwelling unit for business purposes, the gain realized on the sale of this portion of the property is not excludable and must be recognized.

However, allocation of the gain is not required if the use requirement is satisfied and both residential and nonresidential portions are part of the same dwelling unit.

Thus, these new regulations provide a very pro-taxpayer rule for mixed-use residences as long as the mixed use is within the same dwelling unit.

**Example:** In 2000, Jim purchased a new home and set up a home office. The office uses approximately 10% of the home. He has claimed depreciation deductions of \$1,000 each year. In December 2003, he sells the home for a realized gain of \$60,000. Jim may exclude \$56,000, the entire gain less the depreciation (\$60,000 realized gain less \$4,000 depreciation recapture). □

## Tax Strategies



The lower rates on dividends may alter your strategy if you receive dividend income.

You may prefer to hold your dividend-paying investments outside your retirement accounts so tax savings can be reaped from the reduced maximum tax rate on dividend income.

Also, with lower rates on dividends, you may focus more on stocks that pay dividends instead of growth stocks.

Because interest income will still be taxed at ordinary income rates, investors may switch their debt securities investments to stocks paying dividends.



You should maintain appropriate records to validate your principal residence.

Also, if you own multiple residences, plan which residence you consider your primary residence and, when practical, arrange your affairs accordingly.

Of course, the home-sale exclusion is not the only tax factor in this equation. Retirees with multiple homes are often motivated by state income tax and inheritance tax considerations.

## Tax Strategies



The lower tax rates for individuals make flow-through entities, *e.g.*, S corporations and limited liability companies taxed as partnerships, more attractive when compared with C corporations.

Also, the reduced tax rates for dividend income make this a good time to bail out earnings from C corporations by having them make distributions.

On the other hand, using the lower C corporation tax brackets, *i.e.*, the rates applied to lower amounts of corporate income, remains a good idea, especially with the prospect of someday bailing out earnings as tax-favored dividends or capital gains.



Storm victims who incurred losses as a result of a natural disaster may be eligible for a tax deduction for this year or for last year.

To be eligible you must live in a place designated by the President as a natural disaster area.

Then, you can either take a "casualty loss" deduction this year, or, to speed a tax refund, file an amended return for last year. Of course, the loss must be reduced by any insurance recoveries you received.

(continued from page 3)

If the court orders the transfer, it is not taxable. If the court does not order the transfer, and the IRA is used to make a payment on the divorce court's final decree, the transfer is taxable and subject to a 10% early withdrawal penalty.

Of course, the penalty doesn't apply if you are age 59 ½ or meet any of the other exceptions.

## Health insurance deduction increases for self-employed

The deduction for health insurance paid by self-employed taxpayers has finally reached 100% beginning in 2003. The deduction

## Standard Mileage Rates

	2003	2004
Business	36 cents per mile	37.5 cents per mile
Charitable	14 cents per mile	14 cents per mile
Medical & Moving	12 cents per mile	14 cents per mile

was limited to 70% in 2002.

## Filing status

If you are single or married but living apart from your spouse and provide a home for more than half the year for your unmarried child, grandchild, or other dependent, you may be able to use the

favorable "head of household" tax rates.

This may apply even if your parent does not live with you but you contribute to his/her support, even if your dependent parent lives in a nursing home. The person you support must qualify under the tax rules as your dependent.

## Individual Tax Rate Schedule

Status	2003 Rates		Estimated 2004 Rates	
	Rate (%)	Bracket	Rate (%)	Bracket*
Single	10%	\$0 - 7,000	10%	\$0 - 7,150
	15	7,001 - 28,400	15	7,151 - 29,050
	25	28,401 - 68,800	25	29,051 - 70,350
	28	68,801 - 143,500	28	70,351 - 146,750
	33	143,501 - 311,950	33	146,751 - 319,100
	35	Over 311,950	35	Over 319,100
Head of Household	10%	\$0 - 10,000	10%	\$0 - 10,200
	15	10,001 - 38,050	15	10,201 - 38,900
	25	38,051 - 98,250	25	38,901 - 100,500
	28	98,251 - 159,100	28	100,501 - 162,700
	33	159,101 - 311,950	33	162,701 - 319,100
	35	Over 311,950	35	Over 319,100
Married Filing Jointly	10%	\$0 - 14,000	10%	\$0 - 14,300
	15	14,001 - 56,800	15	14,301 - 58,100
	25	56,801 - 114,650	25	58,101 - 117,250
	28	114,651 - 174,700	28	117,251 - 178,650
	33	174,701 - 311,950	33	178,651 - 319,100
	35	Over 311,950	35	Over 319,100
Married Filing Separately	10%	\$0 - 7,000	10%	\$0 - 7,150
	15	7,001 - 28,400	15	7,151 - 29,050
	25	28,401 - 57,325	25	29,051 - 58,625
	28	57,326 - 87,350	28	58,626 - 89,325
	33	87,351 - 155,975	33	89,326 - 159,550
	35	Over 155,975	35	Over 159,550

\*These brackets have been adjusted for inflation in 2004. However, the IRS has not yet released the official amounts.

# Business tax planning

## Business vehicle depreciation limits

Most cars, trucks and sport utility vehicles (SUVs) with gross vehicle weight under 6,000 pounds are subject to special depreciation limitations.

The first-year bonus depreciation and Section 179 depreciation allowance apply to most so-called "luxury autos," but the deductions are capped.

For luxury autos purchased in 2003, depreciation deductions are capped as shown in the table below.

**Note:** If you lease a vehicle, certain limitations apply.

### 2003 Depreciation Deductions

Car with bonus depreciation before 5/6/03	\$7,660
Truck, van, SUV with bonus depreciation purchased by 5/6/03	\$7,790
Cars with bonus depreciation purchased after 5/5/03	\$10,710
Trucks, vans, SUVs purchased after 5/5/03	\$11,010
Cars with no bonus	\$3,060
Trucks with no bonus	\$3,360

\* Depreciation deductions in future years also are capped

## Section 179 expensing increases

The Act increases the amount you may elect to expense in the

### 2003 Depreciation Expense

(Asset Cost: \$150,000)

Section 179 Deduction	\$100,000
50% Bonus Depreciation (.50 x \$50,000)	25,000
MACRS Depreciation [.2 x (\$50,000 - \$25,000)]	5,000
<b>Total 2003 Depreciation Expense</b>	<b>\$130,000</b>

first year under Section 179. Qualifying property is generally defined as depreciable tangible personal property used in the active conduct of a trade or business placed in service in tax years beginning after 2002 and before 2006.

Qualifying property also includes off-the-shelf computer software, *i.e.*, software readily available for purchase by the general public, software subject to a nonexclusive license and software that has not been substantially modified.

This is a benefit to small businesses because before the Act, such software was not eligible for Section 179 expensing and had to be amortized on a straight-line method over 36 months.

Under Section 179, eligible taxpayers could deduct up to \$25,000 of qualifying property placed in service before the end of the tax year prior to the Act.

The Act increases the \$25,000 amount to \$100,000 for qualifying property placed in service in tax years beginning in 2003 and before 2006.

The Section 179 amount is still limited to taxable income and is phased-out if total asset additions exceed \$400,000.

The \$100,000 and \$400,000 amounts will be indexed for inflation. As under the old law, any

amounts unused because of the taxable income limitation can be carried over to future years.

For depreciation purposes, the cost or other depreciable basis must be reduced by any amount allowed under Section 179, but the 50% bonus depreciation can be taken on the remaining basis.

**Example:** On July 1, 2003, you purchase qualifying assets costing \$150,000 and have \$300,000 taxable income (before the Section 179 deduction).

Under the Act, you can expense \$100,000 under Section 179. The remaining basis for depreciation will be \$50,000 (\$150,000 - \$100,000).

If you elect to take the 50% bonus depreciation, the total deduction for 2003 will be calculated as shown in the table above.

## First-year depreciation increases

The Act provides for significant increases in depreciation deductions for qualified personal property used in a trade or business or held for production of income. It increases the additional first-year depreciation deduction from 30% to 50% of the adjusted basis of qualified property.

Qualified property includes most depreciated business assets,

## Tax Strategies



Taxpayers who use their cars for business driving can choose between deducting their actual expenses or calculating their deduction using a standard mileage rate (36 cents per mile in 2003).

The expanded first-year depreciation provides greater incentive to comply with the more detailed recordkeeping requirements for using the actual expense method.



There is no maximum purchase or taxable income limitation on eligibility for the bonus depreciation as there is for the expensing election under Section 179. You may elect out of the 50% additional first-year depreciation for any class of property for any tax year.



As year end approaches, you should monitor the aggregate cost of equipment purchases made during the year.

If you are approaching the \$400,000 limit, you may prefer to delay making some purchases until next year.

On the other hand, if you had intended to put less than \$400,000 of equipment into service in 2003, but expect to surpass that threshold in 2004, you may seek to accelerate your purchase so that some of the additional equipment can be placed in service this year.

## Tax Strategies



If you plan to acquire or construct a new building, you may want to perform a cost-segregation study to help identify building components that qualify for the bonus depreciation.



Most off-the-shelf computer software packages used in your business also qualify for increased expensing and first-year depreciation benefits.



Closely held C corporations should reconsider high-income employee/shareholder pay packages to include more dividends instead of salary and bonuses.

C corporations in the 15% tax bracket, along with shareholders in the top marginal tax bracket, will find this to be advantageous, as will C corporations with large accumulated earnings.

other than buildings, placed in service after May 5, 2003, and before 2005. But if a binding contract for its purchase was in effect before May 6, 2003, such property will not be eligible for the 50% deduction.

Also, only new property is eligible for the extra depreciation, *i.e.*, used property does not qualify for either the 30% or 50% extra depreciation, and the property's original use must commence with

the taxpayer during the qualifying periods.

If the property was acquired in a like-kind exchange or is replacement property for like-kind property destroyed in an involuntary conversion and all or part of the gain was deferred, you are allowed to depreciate the carryover basis of the old property as new property.

Thus, the additional cash or other boot given on the exchange,

plus the carryover basis of the old property is considered new property eligible for bonus depreciation.

## New rules for taxable year end

If you are a shareholder or partner in a partnership, and the S corporation or partnership changes its taxable year end, you may now elect to defer some income tax.

New IRS rules allow pass-

## Retirement plans offer businesses tax-s-

by Chip Storey, Springfield

**Y**ou still have time to set up a retirement plan for your employees or yourself and reap the benefits in 2003.

Defined benefit, profit-sharing and 401(k) plans must be set up by the end of the year, but a self-employed pension (SEP) can be set up by the due date of your 2003 tax return, including extensions. A tax credit is available for a qualifying employer with 100 or fewer employees that starts a pension plan.

The credit may be taken in each of the first three plan years and is equal to one-half of the plan start-up costs but can not exceed \$500 per year.

### Contribution limits

Individuals 50 and over can make elective catch-up contributions to their retirement accounts. The catch-up amounts are in addition to the existing contribution limits. The maximum allowed elective deferral retirement contributions are in the table below.

Elective deferrals are amounts an employee instructs the employer to take out of regular pay and put into a pension account. Employers with defined

contribution plans with pension *and* profit-sharing benefits are required to contribute additional funds to employee pension accounts. The total sum of an employee's combined pension contributions can't exceed \$40,000 for 2003 and \$41,000 for 2004.

An employer's tax deduction for contributions can't exceed 25% of all employees' annual compensation, further limited by taking into account individual compensation. For defined benefit plans, the maximum annual benefit for 2003 is limited to \$160,000 and increased to \$165,000 for 2004.

### Nonqualified deferred compensation

"Rabbi trusts" can be used to provide additional retirement benefits to select employees. Since they are not qualified plans, the nondiscrimination rules do not apply.

Rabbi trusts are basically employer/employee contracts for future compensation in consideration of continued employment.

Rabbi trusts are funded at the discretion of the employer and are subject to the claims of creditors. Essentially, the trust is under the employer's control

and, structured properly, will result in a deferral of income taxes for the employee on the amount of compensation deferred.

Employer contributions are deductible only when amounts attributable to those contributions are distributed to the employee.

### Contribution Limits

	2003	2004
401(k), 403(b), 457 & SAR-SEP Plans – Under 50	\$12,000	\$13,000
401(k), 403(b), 457 & SAR-SEP Plans – 50 & Over	\$14,000	\$16,000
Traditional & Roth IRAs – Under 50	\$3,000	\$3,000
Traditional & Roth IRAs – 50 & Over	\$3,500	\$3,500
SIMPLE Plans – Under 50	\$8,000	\$9,000
SIMPLE Plans – 50 & Over	\$9,000	\$10,500

through owners to defer income from a short taxable year resulting from certain changes in accounting period.

**Example:** An S corporation is changing its taxable year from a fiscal year ended September 30 to a calendar year end in 2003, and as a result, it will file two tax returns, one for the fiscal year ended September 30, 2003, and another for the short period ended December 31, 2003.

Under the old rules, S-corporation shareholders would recognize 15 months of income on their 2003 individual tax returns. The new rules allow the shareholders to defer the taxable income on the short-period return and pay the tax on it over four years.

This deferral applies to short periods ending on or after May 10, 2002, but before June 1, 2004. Not all changes qualify, and a special election is required.

## Split-dollar life insurance

New IRS regulations overhaul the tax treatment of split-dollar life insurance arrangements so they will no longer be attractive compensation tax strategies. The new regulations generally treat these arrangements as taxable compensation, gifts or loans.

In the typical split-dollar arrangement, a business makes  
*(continued on page 12)*

## Tax Strategies



**SUVs rated at more than 6,000 pounds gross (loaded) vehicle weight—and there are quite a few of these—are exempt from the luxury-auto dollar caps because they fall outside of the definition of a passenger auto.**

**As a result, the cost of a heavy SUV used 100% for business may be expensed entirely under Section 179 and/or may be eligible for the 50% first-year depreciation.**



**A frequent mistake of small-business owners is to have the operating corporation own the real estate or to have a separate C corporation own the property and lease it to the business.**

**A double tax bill will result when the company eventually disposes of the property. First, the C corporation will be taxed on the appreciation on the disposition of the real estate, and then, the shareholder(s) will be taxed on the proceeds of the disposition when they are distributed to them as a dividend or through liquidation.**

**A better approach might be for the business owners to own the real estate personally in a limited liability company or in a partnership with other investors, and then lease it to the operating business.**

## Savings opportunities

### Age-weighted profit sharing

As an employer, you may set up a qualified profit-sharing plan in which an employee's age is considered when allocating employer contributions.



Age-weighted plans work best where business owners are significantly older than the rank-and-file employees. An age-weighted plan increases the amount of employer contributions to older

employees, reducing the cost of deferred compensation for younger employees.

Employer contributions can vary from year to year at the employer's discretion, and there is no requirement that any contribution be made in a given year.

### Keogh plan for directors' fees

If you receive directors' fees from serving on a board of directors, you may be able to defer the tax on a portion of this income through the use of a Keogh plan, a retirement plan for self-employed individuals.

There are special rules that apply to Keogh plans, but essentially, deductible contributions of up to 20% of this income—up to a maximum of \$40,000—may be made to it.

Contributions to a Keogh plan generally do not limit the amounts you can contribute to any qualified retirement plan you may already be participating in. Be aware the IRS has attempted to treat fees earned by a director who also is an employee of the corporation as part of the compensation earned by an employee

and not as self-employed income. The IRS has retreated from this position, at least for the time being.

This strategy may not work if you are an owner or are related to an owner of the business.

### Net unrealized appreciation rules

If you are planning to take your retirement in the near future and a sizeable portion of your retirement benefit consists of stock of your employer, consider receiving a lump-sum distribution of your retirement benefit. In doing so, you may take advantage of the rules for net unrealized appreciation.

Under these rules, only the benefit plan's basis in the employer stock you receive in a lump sum distribution is currently taxable. The difference between this basis and the stock's fair market value is not subject to tax until you sell the stock. And when you sell the stock, the difference is taxed at the lower long-term capital gains rate, even if you do not hold the stock for over a year.

On the other hand, your employer stock can decline in value significantly between now and your retirement date, as evidenced by the affect the Enron bankruptcy had on its plan participants. So, the benefit of the net unrealized appreciation rules must be balanced against the risk that the stock will decline in value.

Of course, there are hedging strategies, such as collars and straddles that can be used to protect against declines in the value of your employer stock. □

# Tax planning for investors. . . Don't let the tax tail wag the dog

by Wayne Starr, BKD Wealth Advisors, LLC

**T**he *Jobs and Growth Tax Relief Reconciliation Act of 2003* (the Act) provides federal income tax relief to nearly every individual. But to take advantage of it as an investor means answering a few questions. Remember, the law expires in 2009.

- ✓ Have you reviewed your asset allocation with regard to the Act?
- ✓ What changes should you make in your investments, if any, because of the Act?

## Recap of tax strategies for investors

✓ Deleting an asset class, municipal bonds, for example, from your asset allocation and replacing with dividend generators may be inadvisable. Both are tax advantaged in different ways

✓ When considering a tax-favored investment, always calculate the estimated after-tax rate of return as part of the decision-making process

✓ Dividend yield is only a part of a stock's total return. You must consider the growth potential of the dividend issuing company. A stock will not be rated "buy" solely based on its dividend

### ✓ What role should dividend-paying stocks play in your portfolio?

It's often said about investments, and accurately so, that the tax tail should not wag the dog. In other words, investment decisions should not be based solely on an estimated tax result, and that's still true since the Act.

### Lower tax rate on dividends

While the tax rate on dividends has been reduced from the taxpayer's otherwise applicable rate to 15%, dividend-paying investments do not automatically jump to the top of the investment pyramid.

The rate reduction from a maximum 35% to 15% does make dividends more attractive to many investors.

Stocks also are made more attractive because of the reduction in the capital gains tax rates from a maximum 20% to 15% and from 10% to 5%. The 5% rate goes to 0% in 2008. To qualify, the holding period must be more than one year.

However, stocks owned individually or through equity mutual funds are still only one asset class. Others include real estate, bonds, commodities, money markets and cash. A balanced portfolio built on a realistic statement of goals, an understanding of time frames and an analysis of ones' risk tolerance

is still, and will likely remain, the best approach to investment success.

### Dividends vs. capital gains

Dividends will normally, but not always, be taxed at 15% or less. Qualifying dividends, *i.e.*, distributions of a corporation's profit that have already been taxed at the corporate level, are the only ones that earn the 15% rate.

Mutual funds sometimes report short-term capital gains as "dividends." Those gains and dividends were taxed at ordinary income tax rates. The two elements will need to be separated as short-term gains do not qualify for new lower capital gain rates. The part that is truly a dividend will qualify.

There is another interesting facet of the tax issues created by the 2003 Act.

If a fund earns 95% of its income from sources covered by the new lower dividend tax rate, all 100% of its income will qualify for the tax-advantaged treatment.

If 5% or less of the fund's income came from bonds, the whole distribution is subject to the new treatment as long as the remaining 95% comes from stock dividends.

Funds can take their expense fees out of the income stream and are allowed to designate income taxed at higher rates to pay for the expense ratio.

A fund that generates less than 90% of its income from stock dividends could still be eligible for 2003 Act treatment if the expenses

consumed all of the noneligible income.

**Caution:** always check the expense ratio of the funds you buy. Reasonable-to-low expense ratios are always desirable.

Expense ratios will vary from asset class to asset class, *i.e.*, the expense ratio of a large cap growth fund is usually less than that of a small cap growth fund.

BKD Wealth Advisors uses expense ratios as one of several criteria employed in selecting mutual funds for its preferred list of funds.

### Margin accounts

Individuals using margin accounts have a special issue to deal with.

The brokerage firm may lend out the securities backing the margin account. The loaned securities may then be sold short.

The investor who borrowed your shares receives the stock dividends, not you. You are reimbursed for what they receive, but those payments in lieu of dividends, do not qualify for the new low dividend tax rate.

### Holding period

One other issue of note is that of the holding period. Assume an investor buys a stock on which a dividend is declared and paid, then sells the stock. Whether or not the applicable rate is 15% is an unqualified maybe.

The lower rate is applicable only when the stock is owned for more than 60 days during the 120-day period that begins 60 days

**WealthPlan.** Advisors uses expense ratios as one of several criteria employed in selecting mutual funds for its preferred list of funds.

# dog

before the ex-dividend date. The minimum holding period is 61 days and it must be within the 120-day window to qualify.

## REIT dividends

Distributions from real estate investment trusts (REITs) do not qualify for the lower dividend tax rate. REITs are essentially pass-through entities not taxed at the REIT level as long as 90% of the income is passed on to investors. This tax treatment could make REITs less desirable but not undesirable.

Real estate is an individual asset class. REITs allow many individuals to own that class who cannot or choose not to own real estate directly.

Assume a hypothetical 7% dividend is paid by a REIT and is received by an investor who is taxed at 35%. The after-tax yield is 4.65%.

## Municipal bonds

It has been said by some that municipal bonds are no longer a good place to invest. Again, their attractiveness for investors may be diminished, but it has not disappeared. Qualifying municipal bonds are federal tax free. Tax free beats taxable even at a 15% rate.

Ruling out municipal bonds for higher tax bracket investors simply does not make sense. Always calculate the taxable equivalent yield when comparing municipal bonds to other investments.

You can arrive at the taxable equivalent by dividing the bonds' yield by one minus your federal tax bracket. If the bond is issued by

the state in which you live, then use one minus your federal and state tax rates.

For example, you are a Missouri resident, and you purchase a Kentucky bond that yields 3.5%. You are in the 35% tax bracket. One minus 0.35 equals 0.65. Dividing 3.5% by 0.65 shows a taxable equivalent yield of 5.38%.

If the same Missouri resident buys a Missouri municipal bond, there is no federal or state tax. The same 3.5% yield, when exempt from both levels of taxation, is equivalent to a pre-tax yield of 5.93%.

## Dividends a good thing

To be sure, dividends are a good thing. Lower taxation of dividends is a good thing. If the 2003 Act helps raise dividend payouts, that, too, is a good thing. Investing in companies with a history of dividend payments is a strategy designed to reduce the volatility of a stock portfolio whether owned individually or via mutual funds.

Dividend growth can add to returns over time. Some companies have strong histories of increasing dividends annually, which creates a favorable compound return based on the purchase price.

In 1985, according to Dave Anderson, president of Gold Investment Advisors, in "Overcoming the Purple People Eater" in the July 2003 issue of **Kansas City Homes and Garden**, 9% of companies paid some sort of dividend. That was a peak. The numbers declined regularly through the 1990s and into 2000.

However, during the first half of this year, 788 companies initiated or increased their dividends. Greater than half of the S&P 500 companies pay dividends that exceed the yield on the three month T-Bill. That yield was 0.91% on October 16, 2003. Not much, but it is very competitive with money market rates, with the added value of the stock having the opportunity to grow.

## Other issues

Finally, there is the issue of the impact of lower tax rates on popular strategies such as transferring wealth to children to cut taxes.

When a child reaches age 14, his/her investment income is taxed at the child's rates, usually lower than that of the parents. The rate is 5% on long-term gains, which goes to zero in 2008.

Why not transfer stocks with large gains to the kids to be held until 2008 and sold for zero tax? The problem is that the money is now theirs, and a year in Europe or a new car may be more attractive than paying for college. Further, if the gift is big enough, there will be a gift tax to consider along with the loss of control.

Again, the strategy is not flawed, and it is desirable to transfer assets to lower bracket taxpayers. But the change in the law is not sufficient to blindly seek the lower, albeit attractive, bracket.

Sound financial planning and asset allocation tactics require the analysis of all the applicable issues. There will always be trade-offs to consider before making decisions about your financial plans and investments that will help reach your goals. □

## Tale of the Tape

### Selected Returns through November 7, 2003

Benchmarks	1 Year	Year to Date
DOW	14.91%	17.60%
S&P 500	17.71%	19.71%
NASDAQ Composite	44.98%	47.56%
Russell 2000	43.26%	41.73%

### Selected Lipper Indexes - Mutual Funds

Large Cap Growth	23.22%
Large Cap Value	19.62%
Mid Cap Growth	33.90%
Mid Cap Value	31.58%
Small Cap Growth	44.17%
Small Cap Value	39.58%
Science & Technology	52.36%
International	26.06%

Source - Wall Street Journal, November 7, 2003. As with a portfolio of all stocks and bonds, a diversified portfolio gives no guarantee of safety of principal, which is subject to fluctuation.

## Tax Strategies



C corporations with accumulated earnings and profits and rental income from real estate held by the corporation may have been reluctant to make the S corporation election in the past because of the tax on passive investment income in Section 1375.

However, by distributing the C corporation accumulated earnings and profits as lower-taxed dividends, corporations can put themselves in a better position to benefit from making the S election.



Farmers don't have to pay taxes on every conservation-related payment they make. Excluded are cost-sharing payments used to help cover the expense of installing filter strips, wind breaks and other conservation measures.

Conversely, annual rental payments are generally taxable, and farmers also are subject to self-employment taxes on the rent.

*(continued from page 9)*  
premium payments on a whole-life policy, which provides life insurance coverage to an owner or employee; the business gets the cash surrender build-up in the policy.

These also are set up so the

business receives the insurance coverage, and the owner or employee gets the cash surrender build-up. Thus, the benefits of the arrangement are "split" between the business and the owner or employee.

These arrangements also are

used in a similar fashion in estate and gift tax planning. If you or your business has one of these arrangements, contact your BKD tax advisor immediately. **There are decisions that must be made before the end of 2003 to reduce the tax effect of the new rules.** □

## What to include—or not—in W-2s

It will soon be time to issue W-2s to your employees. Of course, benefits provided through a qualified welfare-benefit or pension plan are not included in W-2 wages, but did you know that other benefits can qualify?

### Items excludable from W-2 wages

- ✓ No-additional-cost services offered to employees
- ✓ Qualified employee discounts
- ✓ Company cars used for business
- ✓ Qualified educational expenses
- ✓ Employer-provided parking
- ✓ Uniform expenses and equipment allowances
- ✓ Certain club memberships
- ✓ Security services, *i.e.*, a bodyguard or chauffeur
- ✓ Occasional supper money or cab fare
- ✓ Discounted meals at an employer-operated eating facility
- ✓ Occasional company parties or picnics

- ✓ Holiday gifts such as turkeys and hams
- ✓ Business meals and lodging
- ✓ Qualified moving expenses
- ✓ Qualified adoption assistance
- ✓ Certain prizes and awards
- ✓ Premiums to provide up to \$50,000 of group term-life insurance


### Items included in W-2 wages

- ✓ Health insurance premiums and other welfare benefits on behalf of more than 2% S-corporation shareholders
- ✓ Personal use of a company vehicle, including commuting
- ✓ Compensatory bonuses
- ✓ Severance pay, including early retirement, although certain severance pay isn't subject to Federal Insurance Contributions Act
- ✓ Golden parachute payments
- ✓ Sick pay □

## A Special Year-end Planning Issue

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