J.K. LASSER'S™

NEW TAX LAW SIMPLIFIED 2004

GET A BIGGER REFUND!

WILEY

John Wiley & Sons, Inc.

J.K. LASSER'S™

NEW TAX LAW SIMPLIFIED 2004

Look for these and other titles from J.K. Lasser™—Practical Guides for All Your Financial Needs

J.K. Lasser's Year-Round Tax Strategies by David S. De Jong and Ann Gray Jakabin
J.K. Lasser's Taxes Made Easy for Your Home-Based Business by Gary W. Carter
J.K. Lasser's Pick Winning Mutual Funds by Jerry Tweddell with Jack Pierce
J.K. Lasser's Your Winning Retirement Plan by Henry K. Hebeler
J.K. Lasser's Strategic Investing After 50 by Julie Jason
J.K. Lasser's New Tax Law Simplified
J.K. Lasser's Small Business Taxes by Barbara Weltman
J.K. Lasser's Choosing the Right Long-Term Care Insurance by Ben Lipson
J.K. Lasser's Winning Ways to Save for College by Barbara Wagner
J.K. Lasser's 1001 Deductions by Barbara Weltman
J.K. Lasser's Homeowner's Tax Breaks by Gerald Robinson

J.K. LASSER'S™

NEW TAX LAW SIMPLIFIED 2004

GET A BIGGER REFUND!

WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

This book was originally published as *J.K. Lasser's Tax Savings in Your Pocket*, by Barbara Weltman, John Wiley & Sons, 2002.

Library of Congress Cataloging-in-Publication Data:

JK Lasser's new tax law simplified 2004 : get a bigger refund!
p. cm.—(J.K. Lasser series)
Includes index.
ISBN 0-471-45464-8 (paper)
1. Taxation—Law and legislation—United States. I. Title: New tax law simplified 2004. II. J.K. Lasser Tax Institute. III. Series.
KF6289 .3 .J13 2004
343 .7305'2—dc22 2003018878

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

Contents

CONTENTS

Introduction

The tax law is constantly changing. Within two years, Congress enacted four major tax packages that may greatly impact your taxes today:

1. The Economic Growth and Tax Relief Reconciliation Act of 2001, signed into law on June 7, 2001, the largest tax cut bill in 20 years ($1.35 trillion), makes over 400 changes in income, estate, and gift tax rules.
2. The Victims of Terrorism Tax Relief Act of 2001, signed into law on January 23, 2002, provides significant tax assistance to military personnel, victims of terrorism, and their families.

3. The Job Creation and Worker Assistance Act of 2002, signed into law on March 9, 2002, is a $38.7 billion stimulus package providing numerous tax breaks for small businesses and individuals.
4. The Jobs and Growth Tax Relief Reconciliation Act of 2003, signed into law on May 28, 2003, is the third largest tax cut in history, providing across-the-board rate reductions, including a decrease in the rates for capital gains and dividend income, and incentives for equipment purchases by businesses.

Many of the provisions created by these and other laws start to take effect in 2003. The new rules provide important tax-saving opportunities for individuals in 2003 and in years to come. Generally, the new rules provide incentives in such areas as:

- Investing in equities, especially dividend-paying stocks and stock mutual funds.
- Building up retirement savings, both within individual retirement accounts (IRAs) and qualified retirement plans as well as in personal securities portfolios.
- Saving and paying for college.
- Investing in capital equipment and hiring new workers for businesses.

It is imperative that you are prepared to take advantage of every opportunity available to you. With the economy poised for recovery and the stock market still in flux, it is now more important than ever to watch over your tax expenses.

The changes in the tax laws are not limited to income taxes; they extend to estate, gift, and generation-skipping transfer taxes as well. Changes in these laws allow you to transfer more of your property to others on a tax-free basis—during your lifetime or at death—enabling your family and others to keep more of the assets you have amassed.

These new laws are not the only changes affecting tax planning for 2003 and 2004. Cost-of-living adjustments to various deductions and credits, important court decisions, key Treasury regulations and IRS pronouncements, as well as law changes enacted in earlier years that take effect now all have an impact on your taxes this year. These changes combine to make tax planning complex and challenging—but most of all rewarding in the tax savings you can realize if you know what to do.

You do not have to be a tax professional to learn which new rules to take advantage of and how to go about doing so. All you need is an understanding of what the new rules are, including their eligibility requirements. Then you can decide which changes fit your situation and lifestyle so you can make the most of the tax-saving opportunities available.

This book is designed to acquaint you with the income tax changes affecting your 2003 returns as well as the estate, gift, and generation-skipping transfer taxes taking effect in 2003. It also highlights when you need to file amended returns in order to benefit from law changes that affect prior years. And it points out new rules that will take effect in 2004 or later years so that you can adopt comprehensive strategies to save yourself tax dollars not only in 2003 but in the coming years as well.

Income Tax Rate Reductions

Our federal income tax rate structure uses graduated tax rates to impose a higher rate of tax as your income rises. But changes in each of these graduated tax brackets mean that just about every individual will see some rate reduction relief. How are these changes accomplished? Through rate reductions to brackets above the 15 percent bracket, expansion of the 10 percent bracket for joint filers and single taxpayers, and expansion of the 15 percent bracket for married couples.

This chapter explains how the income tax rates decline for 2003 and what you can do to take advantage of the changes. You will also learn about the alternative minimum tax (AMT)—what it is, whether it applies to you, the changes for 2003, and what you can do to avoid or reduce this tax.

General income-shifting strategies are provided to enable you to redistribute wealth within your family in order to save income taxes. Finally, special coverage is given to adjusted gross income (AGI)—the measuring rod for determining eligibility for many of the tax breaks discussed throughout this book—and what you can do to control your AGI in order to increase your eligibility for these tax opportunities.

The cuts in the tax rates on capital gains and dividends are explained in Chapter 3.

Income Tax Rates

The tax rates for 2003 have been reduced for almost every taxpayer through a variety of changes:

- Rates above the 15 percent bracket have been cut to 25 percent, 28 percent, 33 percent, and 35 percent (down from 27 percent, 30 percent, 35 percent, and 38.6 percent).
- The 10 percent tax bracket has been broadened by $1,000 for single taxpayers and by $2,000 for married taxpayers filing joint returns.
- The 15 percent tax bracket has been increased for married taxpayers filing joint returns to twice the amount for singles.

- Tax brackets above 10 percent have been adjusted for inflation. As a result of the adjustments, you can earn more income in 2003 without being pushed into a higher tax bracket.

The combination of these changes boils down to paying less tax on the same income in 2003 than you would have paid in 2002 on the same amount of income. (See Example 1.)

The complete tax brackets for all filers in 2003 can be found in Tables 1.1 to 1.4.

The adjustment in the tax brackets for married persons filing jointly to provide relief from the so-called marriage penalty is explained in greater detail in Chapter 2.

LOOKING AHEAD

In 2004 and later, all of the tax brackets, including the 10 percent bracket, will again be adjusted for inflation.

Tax Planning

Any tax planning you undertake depends on your personal situation. However, the following generalities provide some guidance for taking advantage of changes in

Example 1

You are married and file a joint return, reporting taxable income in 2003 of $70,000. Your tax on this income is $11,120. In 2002, the tax on that same income was $12,606, or $1,486 more.

TABLE 1.1 2003 Tax Rate Schedule—Single

Taxable Income				
Over	But Not Over	Pay	+ Percentage on Excess	Of the Amount Over
$ 0	$ 7,000	$ 0	10%	$ 0
7,000	28,400	700.00	15	7,000
28,400	68,800	3,910.00	25	28,400
68,800	143,500	14,010.00	28	68,800
143,500	311,950	34,926.00	33	143,500
311,950		90,514.50	35	311,950

TABLE 1.2 2003 Tax Rate Schedule—Head of Household

Taxable Income				
Over	But Not Over	Pay	+ Percentage on Excess	Of the Amount Over
$ 0	$ 10,000	$ 0	10%	$ 0
10,000	38,050	1,000.00	15	10,000
38,050	98,250	5,207.50	25	38,050
98,250	159,100	20,257.50	28	98,250
159,100	311,950	37,295.50	33	159,100
311,950		87,736.00	35	311,950

TABLE 1.3 2003 Tax Rate Schedule—Married Filing Jointly or Qualifying Widow(er)

Taxable Income					
Over	But Not Over	Pay	+	Percentage on Excess	Of the Amount Over
$ 0	$ 14,000	$ 0		10%	$ 0
14,000	56,800	1,400.00		15	14,000
56,800	114,650	7,820.00		25	56,800
114,650	174,700	22,282.50		28	114,650
174,700	311,950	39,096.50		33	174,700
311,950		84,389.00		35	311,950

TABLE 1.4 2003 Tax Rate Schedule—Married Filing Separately

Taxable Income					
Over	But Not Over	Pay	+	Percentage on Excess	Of the Amount Over
$ 0	$ 7,000	$ 0		10%	$ 0
7,000	28,400	700.00		15	7,000
28,400	57,325	3,910.00		25	28,400
57,325	87,350	11,141.25		28	57,325
87,350	155,975	19,548.25		33	87,350
155,975		42,194.50		35	155,975

the tax rates. In planning, keep in mind that reference to "your tax bracket" means the highest bracket in which your income falls. For example, as Table 1.1 shows, if you are single and your taxable income in 2003 is $150,000, portions of the first $143,500 are taxed at 10, 15, 25, and 28 percent rates; however, "your tax bracket" is 33 percent (even though most of this income is taxed within the lower brackets).

INCOME DEFERRAL. Shifting income from the current year into a future year saves you money because it postpones the time when you pay the tax on the income. For example, if you receive income in December 2003, you owe the tax on that income by April 15, 2004. But if you defer that income for one month—to January 2004—you don't owe the tax until April 15, 2005.

But tax postponement is not the main incentive for income deferral. Because of cost-of-living adjustments to the tax brackets, income shifted from 2003 into 2004 may be taxed at a lower rate. This translates into a real tax savings. Whether income deferral produces this result depends on whether that income falls into a lower tax bracket. (See Example 2.)

How do you defer income into a later year? There are several proven strategies you can use to shift income from 2003 into 2004.

- Make investments that pay income after December 31, 2003. For example, after June 30 you invest in

Example 2

You have \$500 in income that you can shift to 2004 instead of realizing it in 2003. Assume that if you had received it in 2003, it would have exceeded the limit for the 15 percent bracket and so would have fallen into the 25 percent bracket. But because you receive the income in 2004 it is still in the 15 percent bracket because of adjustments made to the bracket that allow more income to be received at that rate. So instead of paying \$125 tax on the \$500 income (\$500 × 25%), you pay only \$75 tax on that same income (\$500 × 15%), a \$50 tax savings.

a six-month certificate of deposit that will come due after the end of the year. Interest is not considered to have been received on this CD until 2004. Similar results can be obtained with three-month and six-month Treasury bills that come due after the end of 2003.

- Self-employed individuals on the cash method of reporting their income and expenses can delay year-end billing so that accounts receivable for work performed in 2003 or goods sold in 2003 will be paid in 2004. Of course this deferral strategy is *not* advisable where there is any concern about collecting the accounts receivable—in such a case it is better to bill and collect as soon as possible.

Longer deferral may prove even more advantageous because of the continued adjustment to the tax brackets for cost-of-living changes. So income shifted from 2003 into later years may be taxed at even lower rates. However, the current low rates are *not* permanent. They are scheduled to sunset at the end of 2010, so starting in 2011 the rates above the 15 percent rate will rise to 28 percent, 31 percent, 36 percent, and 39.6 percent (the rates that were in effect prior to the 2001 tax act). This factor may limit the extent of deferral you wish to undertake.

There are several reliable strategies you can use to defer income from 2003 until several years into the future.

- Make contributions to tax-deferred accounts, such as 401(k) plans, 403(b) annuities, 457 plans, deductible IRAs, and commercial annuities. You may find yourself in a lower tax bracket when funds are withdrawn later on (e.g., during your retirement years) than you are in now.
- Arrange for deferred compensation. Your employer may be willing to defer the payment of a year-end bonus or a percentage of your salary until you leave the company (typically upon retirement). Again, at that time you may find yourself in a lower tax bracket than you are in in 2003. Generally, the deferred compensation arrangement must be entered into *before* the income is earned.

Caution

You can't shift income merely by refusing to accept it in 2003. Under a tax rule called "constructive receipt," if you have the right to income in 2003, it is yours even if you don't accept it. For example, if you receive a check at the end of December, it is income to you even though you don't cash or deposit it until January. And you risk collection of the deferred compensation down the road since the funds remain subject to the claims of the company's creditors (if they are secured then you are treated as being in constructive receipt of them).

DEDUCTION ACCELERATION. The flip side to deferring income is accelerating deductions into 2003 that might otherwise be taken in 2004 if you expect to be in a lower tax bracket in 2004 than in 2003. This is because deductions are worth more when tax brackets are higher. (See Example 3.)

Example 3

You itemize deductions and plan to make a $100 charitable contribution in either 2003 or 2004. Assume that in 2003 you are in the 25 percent tax bracket but in 2004 you expect to be in the 15 percent tax bracket because your income will remain constant while the tax bracket adjusts to allow more income to be received at the lower rate. Your $100 charitable deduction made in 2003 saves you $25; in 2004, in contrast, it will produce only a $15 tax savings. Acceleration creates an added $10 tax benefit.

Here are some strategies you can use to accelerate into 2003 deductions you might otherwise have taken in 2004:

- Make discretionary expenditures—elective medical procedures that are not reimbursed by insurance and which are deductible (e.g., additional prescription sunglasses) and charitable contributions. For instance, if you have pledged this year to contribute $1,000 a year for five years to your alma mater, you may wish to satisfy that pledge in full in 2003 when the deduction for this charitable contribution is worth more than if you fulfill the pledge in a later year when you might be in a lower tax bracket.
- Prepay state and local income and real estate taxes. For example, state and local tax payments due in January 2004 can be paid in December 2003 so they become deductible in 2003. ***Caution:*** Don't prepay these taxes if you are subject to the alternative minimum tax (AMT) (explained later in this chapter); you can't deduct these taxes for AMT, so you lose the tax benefit of the prepayment.
- If you have a self-employed business on the cash method of accounting, prepay certain expenses that can be deducted this year. For instance, stock up on supplies and pay off all outstanding bills for deductible items before the end of the year. ***Caution:*** Don't prepay multiyear items (e.g., three-year subscriptions or multiyear insurance premiums) since they are deductible only over the period to which they relate.

Alternative Minimum Tax Rates

The alternative minimum tax (AMT) is a shadow tax system designed to ensure that all individuals—even those with substantial write-offs—pay at least some federal income tax. Unlike the tax brackets for the regular income tax, the two AMT rates of 26 percent and 28 percent are *not* indexed annually for inflation. The AMT rates have *not* been lowered by any of the new laws.

EXEMPTION AMOUNT. Only alternative minimum taxable income—your taxable income for regular tax purposes adjusted by special tax preferences and other adjustment items—above a certain amount is subject to the AMT. This threshold is determined by your AMT exemption amount. The AMT exemption amounts have been increased for 2003 as shown in Table 1.5.

LOOKING AHEAD

The increased exemption amounts apply only for 2003 and 2004 unless Congress extends the law. After 2004, the exemption amounts decline to $33,750 for singles and heads of household, $45,000 for married filing jointly and surviving spouses, and $22,500 for married filing separately.

TABLE 1.5 AMT Exemption Amount

Filing Status	AMT Exemption
Single and head of household	$40,250
Married filing jointly and surviving spouse	58,000
Married filing separately	29,000

For a child under age 14 who is subject to the kiddie tax on unearned income, there is a special AMT exemption. The exemption amount is higher in 2003 than it was in 2002. The child's AMT exemption amount in 2003 is limited to $5,600, plus earned income (up from $5,500 in 2002). However, the child's AMT exemption amount cannot exceed the exemption amount for a single individual—$40,250.

LOOKING AHEAD

After 2003, the use of personal credits to offset AMT is restricted to the child tax credit, the adoption credit, and the foreign tax credit. This means that unless Congress takes further action, you lose the benefit of your other tax credits to the extent you are subject to the AMT.

TAX CREDITS. Even if you do wind up with a tentative AMT liability, you may not have to pay it. This liability can be offset by certain tax credits. The earned income credit is no longer reduced by the alternative minimum tax. Also, personal tax credits (e.g., the child tax credit, education credits, the dependent care credit, and the adoption credit) can be used to offset both the regular tax and the AMT. As in the past, AMT liability may also be offset by the foreign tax credit.

AMT Planning

In order to plan effectively to minimize or avoid the AMT, you must understand how this alternative tax system works. Certain write-offs allowed for regular tax purposes cannot be used in figuring AMT (called adjustments). And certain income items that were not subject to regular tax are now taxable for AMT purposes (called preferences). Too many adjustments and preferences will trigger or increase AMT. It is difficult to estimate the precise point at which adjustments and preferences will trigger AMT (sophisticated computer programs are needed for this). For planning purposes, however, if you have over about $20,000 of adjustments and preferences, expect to fall subject to the AMT; planning can reduce or eliminate any AMT liability.

DEDUCTION PLANNING. For AMT purposes, no deduction is allowed for state and local income taxes. This means that accelerating state and local income tax payments to boost regular tax deductions for the year may prove meaningless if it triggers or increases AMT. Before making any year-end payments of state and local income or property taxes otherwise due in January of next year, consider the impact that this prepayment will have on AMT.

For AMT purposes, no deduction is allowed for miscellaneous itemized deductions. If you have substantial legal expenses, unreimbursed employee business expenses, investment expenses or other miscellaneous expenses, you lose the benefit of their deduction for regular tax purposes if they trigger or increase AMT. To avoid this result, it may be helpful to minimize your miscellaneous deductions.

- When retaining an attorney for a legal action involving a contingency fee, be sure that the arrangement creates an interest for the attorney in the recovery under your state's law so that you need report only any net recovery (the amount you receive after the attorney receives a share). If you do not, or if state law does not create such an interest, then you must report the recovery in full and claim any legal fees as a miscellaneous itemized deduction for regular income tax purposes (but not for AMT purposes).
- Request that your employer use an accountable plan to cover employee business expenses. Under an accountable plan, employer advances or reimbursements for travel and entertainment costs are not treated as income to you; you must substantiate your business expenses to your employer and return any excess reimbursements. In contrast, if your employer has a nonaccountable plan, employer reimbursements for your business expenses are treated as additional income to you. Then you can deduct your business expenses, but only as a miscellaneous itemized deduction. Such expenses become deductible only to the extent that the total exceeds 2 percent of your adjusted gross income. And this itemized deduction is *not* allowable for AMT purposes, which may result in triggering or increasing AMT.

Another write-off for regular tax purposes that can't be claimed for AMT purposes is the deduction for personal exemptions. It may be advisable in appropriate circumstances to waive the dependency exemption. Since personal exemptions are not deductible for AMT purposes, even middle-income taxpayers with a substantial number of dependents may fall victim to the AMT. (See Example 4.)

INCENTIVE STOCK OPTION PLANNING. If you hold incentive stock options (ISOs), which give you the right to buy a set number of shares of your employer's stock at a set price within a set time, exercising them does not produce any income for regular tax purposes. But the spread between the option price and stock price on the date the ISOs are exercised is an adjustment to alternative minimum taxable income. In effect, even though the exercise of ISOs does not produce any regular income tax consequences, such action may trigger AMT. Thus, it is important to time carefully the exercise of ISOs to avoid the AMT.

Example 4

You and your siblings all contribute to the support of your elderly parent. If you may be subject to the AMT but your siblings are not, let one of them claim the exemption under a multiple support agreement. Forgoing the dependency exemption for regular tax purposes ($3,050 in 2003) may mean avoiding or reducing your AMT exposure.

Generally it is advisable to spread the exercise of ISOs over a number of years rather than exercising them all at once. This will minimize any adverse tax impact.

But tax considerations may have to take a backseat to other factors. Watch out for expiration dates on the options. Also consider moves in the stock prices and the availability of cash to exercise the options.

Income Shifting

One intrafamily tax-saving strategy is to shift income from someone in a higher tax bracket to someone in a lower tax bracket. In this way, the income remains in the family but the tax bite is reduced. In the past, when top tax rates were higher, the tax savings from income shifting were more dramatic. But even with today's reduced tax rates, there can still be considerable tax savings for the family. (See Example 5.)

Income shifting for capital gains tax savings is explained in Chapter 3.

Strategies for Income Shifting

Income can be shifted from a family member in a higher tax bracket to one in a lower bracket by giving income-producing property. You generally cannot shift income unless you shift the property itself (and not merely the right to receive the

Example 5

In 2003, parents in the 35 percent tax bracket give property worth $22,000 to their teenager, age 16, who is in the 10 percent tax bracket. Assuming the property yields ordinary income of $2,000, the tax would be only $200 ($2,000 × 10%) for the teenager. If the parents had kept the property, they would have paid $700 ($2,000 × 35%). The transfer keeps the $2,000 income in the family but saves the family $500 in taxes ($700 – $200).

income from it). For example, if you want to shift interest on a corporate bond, you must give away the bond itself. (The rules on making tax-free gifts in 2003 are discussed in Chapter 7.)

Here are some types of property to consider giving away for income-shifting purposes:

- Cash that can be invested in income-producing property.
- Corporate bonds and Treasury securities.
- Shares of stock or in mutual funds (see Chapter 3).
- Interests in an S corporation, limited liability company, or partnership owned by the parent or grandparent. Doing so means that the child's share of the entity's income passes through to the child and is taxed at the child's lower tax rate.

Caution

It is generally not advisable to shift income to a child under the age of 14 because of the kiddie tax. The child's unearned income (e.g., interest on a bank account) over $1,500 in 2003 is taxed to the child at the parent's highest marginal tax rate (i.e., the parent's tax bracket).

Adjusted Gross Income

Adjusted gross income is more than a line on your tax return. (Note that the line on Form 1040 for adjusted gross income is different on the 2003 return than it was in 2002—it is now line 34 instead of line 35.) It is a figure that is used to determine whether you are eligible for more than two dozen tax benefits—many of which are discussed throughout this book. These include:

- A $25,000 rental loss allowance.
- The portion of Social Security benefits included in income.
- An exclusion for interest on U.S. savings bonds used to pay higher education costs and an exclusion for employer-paid adoption expenses.
- Eligibility to make contributions to Coverdell education savings accounts, Roth IRAs, and deductible IRA contributions if an active plan participant.

- Eligibility to convert traditional IRAs to Roth IRAs.
- Above-the-line deductions for college tuition and student loan interest.
- A reduction in personal exemptions.
- Ability to claim itemized deductions—medical expenses, charitable contributions, casualty and theft losses, and miscellaneous itemized expenses.
- A limit on itemized deductions.
- An ability to claim credits—child tax credit, dependent care credit, Hope and lifetime learning credits, earned income credit, credit for the elderly and disabled, adoption credit, and credit for elective deferrals and IRA contributions.
- Determining which estimated tax safe harbor rule to rely upon.

MODIFIED ADJUSTED GROSS INCOME (MAGI). In some cases, you can't simply look at the line on your tax return labeled "adjusted gross income" (line 34 of the 2003 Form 1040) to find the correct AGI limit—you must adjust your AGI by certain items. These items vary with the tax benefit involved. Typically, AGI is modified by ignoring certain exclusions (such as the exclusions for foreign earned income and savings bond interest used to pay higher education costs) to arrive at modified adjusted gross income (MAGI).

STRATEGIES FOR CONTROLLING AGI. Generally you aim to keep your AGI down so you are eligible to claim various tax write-offs or other benefits. However, in limited situations you may want to *increase* your AGI for certain purposes (such as to claim greater charitable contribution deductions). Here are some ways to achieve your objectives of decreasing (or increasing) AGI.

- *Using salary reduction options to decrease AGI.* To the extent you reduce your income, your AGI is lower. You can do so without forgoing earnings by taking advantage of various salary reduction arrangements you may be offered. These include making contributions to 401(k) plans, 403(b) annuities, and SIMPLE (savings incentive match plan for employees) plans and contributing to flexible spending arrangements (FSAs) to pay for medical and dependent care expenses on a pretax basis. The amounts you contribute to salary reduction arrangements are *not* treated as current income—they are not included in your W-2 pay—so your AGI is lower even though you obtain a tax benefit from your earnings (retirement savings, selection of benefit options, etc.).
- *Investing for tax-free or tax-deferred income to decrease AGI.* To the extent you can avoid reporting income this year you can keep your AGI down. Consider investing in tax-free bonds or tax-free bond funds if you are in a tax bracket above 25 percent. Also consider deferral-type investments—U.S. savings bonds and annuities—where income is not reported until a future year. You may even wish to

switch from dividend-paying stocks to growth stocks to eliminate current income while attaining appreciation that will be reported as capital gains later on (even though dividends are taxed at the same low rates as capital gains, they are still counted in full in determining AGI).

- *Selling on an installment basis or making a tax-free exchange to decrease AGI.* An installment sale spreads your income over the term you set so that your income won't spike in the year of the sale. Or defer the gain by making a tax-free exchange of investment or business property; any gain realized on the initial exchange is postponed until the property acquired in the exchange is later disposed of.
- *Using year-end strategies to decrease AGI.* Defer income as explained earlier in this chapter to minimize your AGI for the current year. ***Important:*** Increasing your itemized deductions, such as deductions for medical expenses or charitable contributions, by accelerating discretionary payments won't cut your AGI (itemized deductions are taken into account *after* you figure your AGI).
- *Taking advantage of above-the-line deductions to decrease AGI.* Make full use of the $3,000 capital loss write-off against ordinary income. If any of your investments have not done well, make sure that you realize sufficient losses before the end of the year to use the write-off while the sales proceeds enable you to reposition your holdings.

- *Reporting a child's income on your return to increase AGI.* If you have a child under age 14 whose only income for 2003 is less than $7,500, all of which is from interest, dividends, or capital gains distributions, you can elect to report the child's income on your return. Generally, this election is *not* advisable, because it increases your AGI, thereby limiting your eligibility for many tax items. In some cases, though, the election not only saves you the time and money of preparing a child's separate return, but it also enables you to achieve some benefits. For example, you may be able to boost your investment interest deduction by adding your child's investment income to your own. Or you may be able to claim a larger charitable contribution deduction by increasing your AGI.

Tax Relief for Families

The tax law provides important tax breaks for families—in the form of various exclusions, deductions, and credits. Families are not limited to the old notion of two parents with 2.3 children; for tax purposes families can mean just about any living arrangement (for example, foster care).

It is important to note that there are various definitions of a "child" for different purposes in the tax law. While there has been talk in Congress of adopting a single definition, no such rule has yet been enacted; so be sure to use the right definition of a child in each context.

This chapter covers the rules on dependency exemptions, tax benefits for adoption expenses, and a number of different tax credits.

Personal and Dependency Exemptions

Each taxpayer can claim a personal exemption on his or her return. In addition, parents can claim a dependency exemption for each child or other dependent. There is no limit on the number of exemptions that can be claimed. The amount of each exemption for 2003 is $3,050 (up from $3,000 in 2002). Thus, a family of four—two parents and two children—will have an additional $200 deduction in 2003 as compared with 2002 ($3,050 × 4 versus $3,000 × 4).

Caution

The higher exemption amount can be a detriment in certain cases. While it certainly boosts write-offs for regular tax purposes, those with a large number of dependents may find themselves subject to the alternative minimum tax. The reason: The personal and dependency exemptions are not deductible for AMT purposes (see Chapter 1). Thus, even middle-income taxpayers with large families may become liable for AMT.

PHASEOUT FOR HIGH EARNERS. If your adjusted gross income (AGI) exceeds a threshold amount, you lose some or all of the benefit of claiming personal exemptions. However, in 2003, due to cost-of-living adjustments, the phaseouts start at higher income levels than they did in 2002. Table 2.1 compares the phaseout ranges for 2002 with those for 2003 based on your filing status. (See also Examples 1 and 2.)

TABLE 2.1 Phaseout Ranges for Personal Exemptions

Filing Status	2002 Beginning of Phaseout	2002 End of Phaseout	2003 Beginning of Phaseout	2003 End of Phaseout
Married filing jointly	$206,000	$328,500	$209,250	$331,750
Head of household	171,650	294,150	174,400	296,900
Single	137,300	259,800	139,500	262,000
Married filing separately	103,000	164,250	104,625	168,875

Example 1

In 2003, the Browns, a married couple filing jointly, claim their two children as dependents. Their AGI is $150,000. Their deduction for exemptions is $12,200 ($3,050 × 4). There is no phaseout because their AGI is below $209,250.

Example 2

Same facts as in Example 1 except the couple's AGI is $350,000. Here they cannot deduct anything for their exemptions. Their AGI exceeds the phaseout limit of $331,750.

DEFINITION OF "CHILD." Any child of yours may qualify as a dependent as long as you provide more than half of the child's support and his gross income in 2003 does not exceed $3,050 (and certain other tests are met). If your child is under age 19 or is a full-time student under age 24, there is *no* gross income requirement. In other words, your child can earn any amount without your losing a dependency exemption as long as you provide more than half of the child's support.

LOOKING AHEAD

The phaseout of exemptions for high earners is set to be eliminated by 2010. This elimination is made in steps over five years, but does not start until 2006.

Important: If you claim your child as a dependent he cannot be viewed as liberated for purposes of financial aid for college or graduate school. This means that your income and resources and his are considered in determining eligibility for financial aid. If your child is planning to attend graduate school, you may wish to forgo the dependency exemption in his senior year so he may apply for aid for graduate school based on his own income and resources.

Child Tax Credit

The tax law provides taxpayers with a credit simply for having a child. The credit amount for 2003 is $1,000 per eligible child (up from $600 in 2002).

Taxpayers with income above a limit may not claim the credit. The credit begins to phase out for singles with AGI of $75,000 and for married couples filing jointly with AGI of $110,000. This AGI threshold has not changed from 2002.

LOOKING AHEAD

For 2008 and 2009, to claim a child tax credit the AGI limit for married couples filing joint returns increases to $115,000. For 2010, the threshold is $150,000. The limit for single taxpayers remains unchanged.

Refundable Credit

At least a portion of the credit may be refundable—and may even be paid to you in excess of your tax liability. In 2003, the refundable amount is 10 percent of earned income from wages or self-employment in excess of $10,500 (up from $10,350 in 2002), up to the per-child credit amount. (See Example 3.)

Taxpayers with three or more eligible children may figure their refundable credit under the pre-2001 rule (based on FICA or self-employment tax in excess of the earned income credit) if this produces a larger refund than under the 10 percent rule. (See Example 4.)

Example 3

In 2003, you have one qualifying child and earned income of $28,000. The refundable credit is $1,000 since this is less than $1,750 (10% of $28,000 – $10,500).

Example 4

In 2003, you have three qualifying children and your earned income is $30,000. You pay FICA of $2,295. Your earned income credit is $772. Under the 10 percent rule your refundable credit is $1,950 (10% of $30,000 – $10,500), which is less than your credit amount of $3,000 (3 children × $1,000). Under the old rule, your refundable portion would be $1,523 ($2,295 – $772). Thus, you rely on the 10 percent rule.

DEFINITION OF "CHILD." For purposes of this credit a child is any dependent under the age of 17 at the end of the year.

Advance Payments

You may have already received part of the tax credit through a check from the federal government for up to $400 per eligible child. When the law increased the credit from $600 to $1,000, the IRS sent out checks for the increase to eligible taxpayers starting in July 2003. Checks were mailed on the basis of information contained on 2002 returns.

IF YOU RECEIVED A CHECK. If you received a check for $400 per eligible child and this amount is correct, then you claim only up to $600 as your child tax credit on your 2003 return. Figure the additional amount of the credit to which you are entitled on a special worksheet (called the "Child Tax

Credit Worksheet") for this purpose found in the instructions to your return. If in going through the worksheet you discover that the advance payment check you received was more than you were entitled to, you *don't* have to pay back the difference.

IF YOU DID NOT RECEIVE A CHECK. You may be entitled to a full credit on your return, even though no check was sent to you. Check your eligibility if:

- You had a baby in 2003.
- You adopted a child in 2003.
- You filed your 2002 return late.
- Your AGI declined below the income limit for claiming the credit.

Adoption Expenses

The tax law rewards by means of a tax credit parents who adopt a child if they pay expenses out of pocket. Alternatively, they may be eligible for an exclusion from income if an employer pays such expenses for them. These tax breaks are designed to offset to some degree the high cost of adoption, which ranges up to $2,500 for public agency adoptions and to $30,000 or more for private agency fees.

The amount of the adoption credit increases in 2003 to $10,160 (up from $10,000 in 2002). Similarly, the amount you can exclude for employer-paid expenses under a company's adoption assistance plan in 2003 is $10,160. What's more, the credit and the exclusion can now be claimed for a special needs child without regard to actual expenses; the benefit is claimed simply for making the adoption.

INCOME LIMIT INCREASED. The full credit and exclusion may be claimed only by taxpayers with modified AGI up to $152,390 in 2003 (up from $150,000 in 2002). The credit phases out so that no credit can be claimed once modified AGI exceeds $192,390 (up from $190,000 in 2002). ***Important:*** The same modified AGI limit applies regardless of filing status (that is, married couples filing jointly have the same limit as single parents).

DEFINITION OF "CHILD." A child for purposes of the adoption credit and exclusion is anyone under the age of 18 or someone who is physically or mentally incapable of self-care regardless of age.

WHEN TO CLAIM THE CREDIT. The timing of when you can claim the credit can be tricky. Timing depends on the nature of the child and when the adoption becomes final.

- *Non-special-needs child who is a U.S. citizen or resident.* If the adoption is not final by the end of the year, then the credit can be claimed only in the year after the year in which payments have been made (even if the adoption is still not final). Expenses paid in the year in which the adoption is final are eligible for the credit at that time. Similarly, expenses paid in a later year (after the adoption is final) qualify for the credit at that later date. (See Example 5.)

- *Special-needs child.* The credit may be claimed *only* in the year in which the adoption is final. No credit may be claimed for expenses paid after the year the adoption becomes final.
- *Foreign child.* The credit may not be claimed until the year the adoption becomes final. Adoptive parents who bring a foreign-born child into the United States with an IR-3 visa following a "full and final" adoption in the foreign country may treat the adoption as final in the year in which the foreign court or agency enters the adoption decree. Expenses paid in a later year qualify for the credit at that later time. (See Example 6.)

LOOKING AHEAD

The $10,160 credit limit and the $152,390 to $192,390 AGI phaseout range may be adjusted for inflation.

Example 5

In 2003, Mr. and Mrs. Green pay $3,000 in adoption fees and expenses to adopt a child who is a U.S. citizen with no special needs. They pay an additional $5,000 in 2004. The adoption does not become final until February 1, 2005. No credit may be claimed on the Greens' 2003 return. However, the $3,000 paid in 2003 can be taken into account in figuring their credit for 2004. The fees paid in 2004 can be taken into account in figuring their credit for 2005.

Example 6

In 2003, Mr. and Mrs. Grey pay $6,000 in adoption fees and expenses to adopt a child born and living abroad. They pay an additional $3,000 in 2004. The adoption does not become final until February 1, 2005. No credit may be claimed in 2003 or 2004. In 2005, the Greys may base their credit on $9,000 in adoption expenses.

Earned Income Credit

Low-income taxpayers may be eligible for a credit that encourages them to work. The credit is refundable and it can be paid to the taxpayer even if it exceeds the amount of tax for the year. In effect, it is a negative income tax designed to put money back into the pockets of low earners. However, this credit is highly complicated and produces more errors on tax returns than just about any other provision in the law. For example, some taxpayers assume they must support a child in order to claim the credit; in reality, though, the credit is available to low earners who have no qualifying child. Changes in the rules for the earned income credit do *not* make things any easier.

INCOME LIMITS INCREASED. For 2003, the definition of "low earner" is changed through cost-of-living adjustments

TABLE 2.2 Earned Income Credit Limits

	Number of Qualifying Children		
Item	**One**	**Two or More**	**None**
Earned income amount	$ 7,490	$10,510	$ 4,990
Maximum amount of credit	2,547	4,204	383
Threshold phaseout amount	13,730	13,730	6,240
Completed phaseout amount	29,666	33,692	11,230
Threshold phaseout amount, married filing jointly	14,730	14,730	7,240
Completed phaseout amount, married filing jointly	30,666	34,692	12,230

that are made to certain limits. Table 2.2 shows the limits for 2003.

- "Earned income amount" is the amount of earned income at or above which the maximum credit can be claimed. Earned income does not include any nontaxable benefits (for example, elective deferral contributions to 401(k) plans and employer-paid educational assistance). Effectively, earned income is the amount reported as wages on an employee's W-2 form or, for self-employed individuals, the amount reported as net earnings from self-employment.
- "Threshold phaseout amount" is the greater of AGI or earned income above which the maximum credit starts to phase out.

- "Completed phaseout amount" is the greater of AGI or earned income at which no credit can be claimed.

Fortunately, figuring the credit is not difficult; you figure your earned income in a worksheet included in the instructions to your return for this purpose. Then you merely look up the amount you are entitled to in an IRS earned income credit table, which has been revised for 2003.

UNEARNED INCOME LIMIT INCREASED. The credit cannot be claimed if unearned income—from interest, dividends, and other investments—exceeds a certain amount. For 2003, the unearned income limit is $2,600 (up from $2,550 in 2002).

DEFINITION OF "CHILD." The relationships that can entitle a child to be a qualifying child have been broadened to include descendants of a stepchild. Thus, a qualifying child includes a child, stepchild, sibling, stepsibling, or descendant of any of these.

A qualifying child must live with the taxpayer for at least six months of the year. Under a new IRS certification program designed to increase compliance (i.e., prevent taxpayers from claiming a credit to which they are not entitled), taxpayers contacted by the IRS can "precertify" that their child meets the six-month residency test. Precertifying means that credit claims will be processed more promptly to ensure quicker refunds. Taxpayers who opt not to precertify will have to attach the same documentation for proving the child's residency to the tax return (instead of the precertification form).

In 2003, the earned income credit is not reduced by the alternative minimum tax. Thus, even a taxpayer who is subject to the AMT can still claim the earned income credit (and use it to offset the AMT).

Child and Dependent Care Tax Credit

This credit is designed to assist taxpayers who incur care expenses in order to work. The child and dependent care tax credit has been substantially broadened to provide greater relief in 2003. Here are the three key changes to note:

1. The limit on expenses that can be taken into account in figuring the credit increases to $3,000 for one eligible dependent and $6,000 for two or more eligible dependents (up from $2,400 and $4,800 respectively in 2002).
2. The maximum percentage for figuring the credit is raised to 35 percent (up from 30 percent in 2002).
3. The reduction in the credit starts at a higher income level—$15,000 (instead of $10,000 in 2002). As a result, the minimum credit of 20 percent of eligible expenses starts at $43,000 (up from $28,000 in 2002). (See Example 7.)

Example 7

In 2003, a single parent with one eligible dependent spends $5,000 for child care so she can work. If her AGI is $50,000, her dependent care credit is $600 (20% of $3,000, the maximum amount of expenses taken into account in figuring the credit). If her AGI had been $15,000 or less, her credit amount would have been $1,050 (35% of $3,000).

DEFINITION OF "CHILD." For purposes of this credit a child is an individual under age 13. A dependent can also be a spouse or other person of any age who is physically or mentally incapable of self-care (although a nonrelative must be a member of your household for the entire year).

Marriage Penalty Relief

Under the current tax system, married couples can pay more tax than they would pay if they were single. This extra tax cost is referred to as a "marriage penalty" and generally affects all married couples whose incomes are split more evenly than 70–30. Changing the 15 percent tax bracket and standard deduction amounts for joint filers to twice the amount for singles and increasing the threshold for the phaseout of the child tax credit are two law changes that are designed to reduce the marriage penalty.

As a practical matter, the increase in the 15 percent tax bracket benefits all joint filers, even those who would not be considered to have a marriage penalty. The increase in the standard deduction benefits only joint filers who do not itemize their deductions, so it is of relief to only some married couples.

FIFTEEN PERCENT INCOME TAX BRACKET. The amount of the 15 percent tax bracket has been doubled to twice the amount for singles. This increase applies for 2003 and 2004. Starting in 2005, the tax bracket for joint filers will be the bracket amount for singles multiplied by the percentages in Table 2.3.

TABLE 2.3 Post-2004 Increases in the 15 Percent Tax Bracket

Tax Year	Applicable Percentage
2005	180%
2006	187
2007	193
2008 and thereafter	200

TABLE 2.4 **Post-2004 Increases in the Standard Deduction for Joint Filers**

Tax Year	Applicable Percentage
2005	174%
2006	184
2007	187
2008	190
2009 and thereafter	200

STANDARD DEDUCTION. For 2003 and 2004, the standard deduction for joint filers is increased to double the amount allowed for singles. However, starting in 2005, the standard deduction amount for joint filers will be the standard deduction amount for singles multiplied by the percentages to be found in Table 2.4.

THRESHOLD FOR THE CHILD TAX CREDIT. There is no marriage penalty relief with respect to the child tax credit in 2003. However, starting in 2008, the threshold will increase as discussed earlier in this chapter.

CHAPTER 3

Tax Relief for Investors

Investments are a large part of what drives our economy. When investors have confidence in the stock market, money flows into investments, driving up stock prices and increasing wealth. People who feel confident in the economy also spend money, which drives the economy even more. In order to get our sluggish stock market to heat up, which is expected to help restore confidence in the economy, the new law cuts the tax rates on long-term capital gains and dividend income.

This chapter explains the varying rates that apply to investment income from sales and exchanges as well as dividends. It also tells you which investments do and do not qualify for the new tax-favored rates.

Investment strategies in light of tax rate changes are detailed for you.

Capital Gains Rates

Some of the capital gains tax rates have been reduced for 2003. There are more than a half dozen different capital gain rates to contend with. The applicable rate can depend on the types of assets you own, how long you have held them, when you sold them, and the income tax bracket you find yourself in for the year in which you sell the assets. As explained in Chapter 1, "your tax bracket" means the highest bracket in which you fall. For example, if you are married filing jointly and your taxable income in 2003 is $150,000, your tax bracket is 28 percent (even though much of this income is taxed within the lower brackets).

IF YOU ARE IN THE 10 PERCENT OR 15 PERCENT TAX BRACKET. The general rate on long-term capital gains for assets sold before May 6, 2003—gains from the disposition of capital assets held more than one year—is 10 percent. For assets held more than five years, the rate drops to just 8 percent. But for long-term capital gains after May 5, 2003, there is only one rate: 5 percent. This rate applies even if you held the asset for more than five years. All of these rates apply regardless of the type of capital asset involved. (See Example 1.)

Example 1

On February 1, 2003, you sell stock you acquired on May 1, 1995, for a gain of $1,000. You are in the 15 percent tax bracket. Your gain is taxed at a rate of 8 percent. But if you acquired the stock on May 1, 2001, you would pay 10 percent of the gain because you owned the stock more than 12 months but not more than five years. And if you sold the asset on June 1, 2003 (instead of February 1, 2003), you would pay just 5 percent of the gain, whether the asset was acquired on May 1, 1995, or May 1, 2001.

IF YOU ARE IN A TAX BRACKET ABOVE 15 PERCENT. The general rate on long-term capital gains is 20 percent (including assets held more than five years) for assets sold before May 6, 2003. (See Example 2.) For sales and exchanges (and payments received from prior transactions) after May 5, 2003, the rate on long-term capital gains is 15 percent.

LOOKING AHEAD

In 2008, taxpayers in the 10 percent or 15 percent bracket pay *no* tax on capital gains; they have a zero tax rate for this one year. After 2008, the capital gains rates return to the old rates (those in effect for sales before May 6, 2003).

For those in tax brackets above the 15 percent rate, there are other capital gains rates that may apply to long-term capital gains. These other rates include:

Example 2

On February 1, 2003, you sell stock you acquired on May 1, 1995, for a gain of $1,000. You are in the 33 percent tax bracket. Your gain is taxed at a rate of 20 percent. If you sell the asset on June 1, 2003 (instead of February 1, 2003), you would pay just 15 percent of the gain.

- The 25 percent rate on unrecaptured depreciation. This is all straight-line depreciation claimed on real estate other than a principal residence and such depreciation claimed after May 6, 1997, with respect to a principal residence (for example, on the portion of a residence used as a home office).
- The 28 percent rate on collectibles gains and gains on certain small business stock (called Section 1202 gains). However, those in the 25 percent tax bracket effectively pay only 25 percent, not 28 percent, on these gains.

Note: There had been an 18 percent rate that was to be effective starting in 2006 on sales of assets acquired after December 31, 2000, and held more than five years. This rate was also set to apply to assets held at the start of 2001 for which you elected on your 2001 return to report as a "deemed sale." You reported the gain to January 1, 2001 (January 2, 2001, in the case of publicly traded securities) that would have resulted had you actually sold the asset on that date and revised your tax cost basis and holding period to reflect this action. In view of the reduction in the basic capital gains rate to 15 percent, the 18 percent rate no longer applies. Whether you will be permitted to amend your 2001 return to back out of the deemed sale and obtain a refund of the tax you paid on the deemed sale remains to be seen; no guidance on this option had been issued by the time this book went to press.

SHORT-TERM CAPITAL GAINS. For assets held one year or less on the date of sale, the gain (i.e., short-term capital gain) continues to be taxed at ordinary income rates. This means that the 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, or 35 percent rate applies, depending on your other income.

CAPITAL LOSSES. The tax treatment of capital losses remains unchanged from prior years. This means that capital losses are deductible in full to the extent of your capital gains for the year. A special ordering rule applies so that capital losses offset similar capital gains first, before offsetting other capital gains. For example, short-term capital losses must offset short-term capital gains before offsetting any long-term capital gains.

If your capital losses (both short-term and long-term) exceed your gains (both short-term and long-term), you can then deduct up to $3,000 of capital losses against your ordinary income.

Congress had considered raising the $3,000 limit but there was no change included in the new law. The limit may be raised in the future.

Tax Rates on Dividends

Dividends are now taxed at the same capital gains rates that apply to sales and exchanges of property for long-term capital gains. These rates apply retroactively to January 1, 2003 (not simply dividends after May 5, 2003, as is the case with capital gains). This new tax-favored treatment for dividends means substantial savings for those with dividend income. (See Example 3.)

Dividends declared by a corporation at the end of 2002 that were received in January 2003 are taxable in 2003, qualifying for the new tax-favored rates. But dividends declared by mutual fund companies in October, November, or December 2002 that were paid in January 2003 were already taxed in 2002 and so do not qualify for the new tax-favored rates.

Example 3

In 2003, a taxpayer in the top tax bracket (now 35 percent) receives dividends of $10,000. The tax on this income is $1,500 (15% of $10,000). Under prior law the tax would have been $3,860 (38.6% of $10,000).

Qualified Dividends

In order to be subject to capital gains rates, dividends must be eligible for this tax break. This means that payments are made from a corporation's earnings and profits. The stock must be held for at least 60 days during the 120-day period surrounding the ex-dividend date. Ordinary dividends generally qualify. Here is a listing of entities that *cannot* make qualified dividend payments:

- Foreign corporations that are not listed on a U.S. exchange (dividends paid by a listed foreign corporation can be qualified).
- Credit unions, mutual insurance companies, and farmers' cooperatives.
- Tax-exempt cemetery companies, nonprofit voluntary employee benefit associations (VEBAs), benevolent life associations, and certain trusts exempt from tax.
- Mutual savings banks and similar institutions.
- Certain real estate investment trusts (REITs).
- Regulated investment companies.

Payments from mutual funds may be comprised of several different types: ordinary dividends, short-term capital gains, and long-term capital gains. The mutual funds will identify dividends qualifying for tax-favored rates (there is a new box on Form 1099-DIV for this purpose).

TAX RETURNS. If you have dividend income in 2003, then completing your tax return is more complex than it was in the past. There is a new line on the tax return for "qualified dividends," which are dividends eligible to be taxed at the new low rates.

In order to make sure that these dividends are taxed at no more than the applicable capital gains tax rate, you must complete either:

- A separate worksheet found in the instructions to the return (called "Qualified Dividends and Capital Gain Tax Worksheet") if you have only qualified dividends and capital gain distributions and are not required to complete Schedule D.
- Schedule D if you are required to file Form 1040 and to complete this schedule.

Investment interest, such as margin interest on a brokerage account, is deductible as an itemized deduction to the extent of your net investment income (investment income less related expenses). In figuring net investment income, you generally cannot treat dividends as investment income. However, you can opt to do so if you do not use capital gains rates for the dividends, treating them instead as ordinary income. You can treat *some* of your dividends as ordinary income (enough to offset investment interest to make it currently deductible); this is not an all-or-nothing election.

Investment Planning Strategies for Capital Gains

> **LOOKING AHEAD**
>
> **Since the new rates on capital gains are set to apply only through 2008, you will have to decide at that time whether to take some or all of your gains or continue to hold investments that may produce higher taxes on later profits.**

Investment planning to obtain long-term capital gain treatment is more important than ever. The spread between the top rate on ordinary income and the capital gains rate has widened as a result of new law changes. The spread used to be just 18.6 percent (38.6 percent on ordinary income compared with 20 percent on long-term capital gains); now the spread is 20 percent (35 percent versus 15 percent). This makes capital gains more attractive than ever.

Basic Capital Gain (or Loss) Rules

To plan effectively to take advantage of tax-favored capital gains rates, you must understand how to determine your gain (or loss). To do this, you need to know your basis and holding period in the property. This is because gain or loss is the difference between what you receive on the sale (generally the sale price) and your basis. And whether this gain or loss is short-term or long-term depends on your holding period. Use the following explanations to determine your basis and holding period.

BASIS. Generally this is your cost—what you paid to acquire the property. When you inherit property, your basis is the value of the property for estate tax purposes, which is generally its value on the date of the death of the person who left you the property. For example, if your mother bought land for $10,000 that is worth $100,000 at her death when you inherit it, your basis is $100,000. (Special rules, called alternate valuation date rules, may peg the basis at a date after the date of death—six months after death, or the date of sale if property is sold within six months.)

When property is gifted, the recipient generally takes over the same tax basis and holding period as the donor. The precise rules on basis depend on whether the recipient sells the property at a gain or a loss and whether the donor paid any gift tax when the donor made the gift.

- *Sale at a gain.* Basis is the same as in the hands of the donor (but not more than the value of the property at the time of the gift), plus any gift tax paid by the donor.
- *Sale at a loss.* Basis is the lower of the donor's basis or the value of the gift at the time it was made. (See Examples 4 and 5.)

Example 4

You paid $1,000 for property on May 1, 1993, and give it to your teenager on May 1, 2003. At the time of the gift the property is worth $1,200. A month later your child sells it for $1,300. Your child's basis for determining the gain is $1,000 (the same as yours) and your child's holding period starts on May 1, 1993 (the same as yours).

Example 5

Same facts as in Example 4 except that at the time of the gift the value of the property has declined to $900 and the child sells it in 2004 when the value of the property has declined still further to $500. In this instance, the child's basis is $900, which is less than your basis of $1,000.

HOLDING PERIOD. Generally, your holding period is the time you own the property, starting with the day after your acquisition and ending on the date of sale. (See Example 6.)

If you inherit property, you automatically have a long-term holding period, regardless of how long you or the person you inherited the property from owned the property. (See Example 7.)

Example 6

On June 1, 2003, you buy stock in Y Corporation. You sell it on June 1, 2004. Your holding period, which begins on June 2, 2003, is short-term because you did not hold the stock for more than one year; you held the stock for exactly one year (not more than one year as needed for long-term capital gain or loss treatment). A sale on June 2, 2004, would meet the long-term holding period requirement.

Example 7

On May 1, 2003, your uncle bought stock in X Corporation for $5,000. He died on November 1, 2003, leaving you this stock. At the time of his death, the stock has doubled in value to $10,000. You sell it a month later for $11,000. You have a $1,000 gain (the difference between what you received in the sale, $11,000, and your basis of $10,000). The gain is treated as a long-term capital gain, even though neither you nor your uncle—nor you and your uncle combined—held the stock for more than one year.

Income Shifting

Income shifting can produce substantial savings if capital gain producing property can be shifted from a higher to a lower tax bracket member. (See Example 8.)

Example 8

In 2003, parents in the 35 percent tax bracket give property worth $22,000 (for which they paid $10,000 six years ago) to their teenager who is in the 10 percent tax bracket. If the teenager sells the asset in July 2003, he would pay a capital gains tax of $600 (5% of $12,000). If the parents sell the property, they would owe a capital gains tax of $1,800 (15% of $12,000 gain). The transfer keeps the $12,000 profit in the family but saves it $1,200 in taxes ($1,800 – $600).

Dividend Planning

Dividends on stock or stock mutual funds held within an IRA, qualified retirement plan, or variable annuity ("tax-deferred investments") effectively lose the benefit of tax-favored rates on dividends. All distributions or payments from these investments are taxed as ordinary income, regardless of the source of that income. It is advisable to review your investment holdings, both inside and outside of tax-deferred investments, so that dividend-paying stock and stock mutual funds are held where they produce a tax advantage (i.e., in your personal portfolio and not in tax-deferred investments).

Caution

Even though dividends are taxed at the same rates as capital gains, they cannot be used to offset capital losses.

You can build up your holdings without commissions by investing in corporations offering dividend reinvestment plans (DRIPs). There are nearly 1,000 public companies with DRIPs. You pay only a modest cost to have corporate dividends reinvested in the corporation's stock. Usually your dividends buy you only fractional shares, but over time these can add up. Opting into DRIPs does *not* change your tax treatment; dividends continue to be currently taxed at capital gains rates. But you can add these taxable amounts to the basis in your stock so that when you sell shares later on, your gain is minimized (or your loss is increased). (See Example 9.)

Planning for Other Investments

Decisions on other types of investments are influenced by reductions in the tax rates on ordinary income and on capital gains and dividends. In making decisions, keep nontax factors in mind. Do not let tax considerations drive investment decisions; they are merely one factor to consider.

Municipal Bonds

Cuts in the ordinary tax brackets may affect your decision to continue to hold or to acquire municipal bonds. Municipal bond investments (or holding municipal bond funds)

Example 9

You are in the 28 percent tax bracket and buy 100 shares in Z Corporation for $5,000. You also join the DRIP for Z Corporation. In 2003, you receive dividends of $100 that buy you 0.1483 shares of Z Corporation. The $100 is taxed at $15 ($100 × 15%). At the end of 2003, your basis in the 100.1483 shares of Z stock is $5,100 ($5,000 initial cost plus $100 dividends).

makes sense when the rate on these bonds, which is tax free for federal income tax purposes, is higher than the after-tax rate on comparable taxable bonds, such as Treasuries and corporate bonds. To compare apples to apples, you must figure the after-tax yield on a taxable bond (what interest income you would keep after paying taxes on the interest) and then contrast it with the interest payable on a tax-free bond. Obviously, your after-tax yield depends on your tax bracket. (See Table 3.1.) Use the following formula to make the comparison, as demonstrated in Example 10. (This comparison considers only federal income tax; state tax savings, where applicable, should also be factored in.)

$$\text{Taxable interest rate equivalent} = \frac{\text{Tax-exempt interest rate}}{\begin{array}{l}\text{Applicable percentage}\\ \text{for your tax bracket}\end{array}}$$

TABLE 3.1 Percentage for Figuring the After-Tax Yield of Taxable Instruments

Your Tax Bracket	Applicable Percentage
10%	0.90%
15	0.85
25	0.75
28	0.72
33	0.67
35	0.65

Example 10

You are in the 33 percent tax bracket. A municipal bond is paying 4 percent. A taxable bond would have to pay more than 5.97 percent to beat this rate (0.04 ÷ 0.67).

Variable Annuities

Variable annuities, which allow you to invest in equity mutual funds, may no longer make sense in view of the spread between ordinary income and capital gains rates. Investments in variable annuities are taxed at ordinary income rates, even though it was capital gains that produced the earnings in the annuities. In effect, you lose the benefit from the underlying capital gains investments.

Tax Relief for Educational Expenses

The cost of higher education continues to escalate faster than the ordinary rate of inflation. According to the College Board, over a 10-year period ending in 2001, after adjusting for inflation, the cost of tuition and fees at public institutions rose by 40 percent and at private institutions by 33 percent. College Board's 2002 Trends in College Pricing show that the average annual cost of a four-year public institution for tuition, fees, room and board that year was $12,841, at a typical private college $27,677, and at an Ivy League school $36,604. In order to help meet the challenge of paying these costs Congress has created various incentives. The tax law encourages you to save for higher education and helps you pay for education costs for yourself and your family by means of exclusions, deductions, and tax credits. There have been many favorable changes in this area of law to provide you with greater tax savings than ever before.

In this chapter, you will learn about changes in education-related exclusions for interest on U.S. savings bonds. You will also learn about changes in deductions you can take for student interest, higher education costs, and teachers' out-of-pocket expenses. You will find out about changes in the rules for higher education savings plans—qualified tuition programs (529 plans) and Coverdell education savings accounts (ESAs). Finally, you'll learn about changes in tax credits you can claim for higher education—the Hope credit and the lifetime learning credit.

Interest on Savings Bonds

You can exclude from income the interest earned on U.S. savings bonds—series EE or I—that you redeem to pay for qualified higher education costs for yourself, your spouse, or your dependent. The exclusion applies only to interest on bonds purchased in your name after 1989 (and you must be at least 24 years old at the time of purchase).

You can claim the exclusion only if your modified adjusted gross income (MAGI) is no more than a set limit. This limit is adjusted annually for inflation. Table 4.1 shows the 2003 MAGI limits for fully or partially excluding savings bond interest based on your filing status. (See also Example 1.)

TABLE 4.1 Savings Bond Interest Exclusion

Filing Status	Full Exclusion for MAGI Up To—	Exclusion Phaseout Range
Single (including head of household)	$58,500	$58,500 to $73,500
Married filing jointly	$87,750	$87,750 to $117,750

Example 1

You are single and redeem bonds in 2003 to pay your child's college tuition. Interest on the redeemed bonds is $4,000 (all of which is used to pay qualified costs). If your MAGI is $68,500, you may exclude $2,000 of interest from your income.

Other Exclusions

Interest on U.S. savings bonds is not the only possible exclusion related to paying for higher education. There are three additional exclusions, all of which apply without regard to your AGI:

1. Employer-paid education assistance up to $5,250 per year. This exclusion applies to both undergraduate- and graduate-level courses, whether or not related to your job.
2. Employer-paid education assistance for job-related courses (there is no dollar limit).

3. Scholarships and fellowships to degree candidates for tuition, fees, books, and supplies. The exclusion does not cover amounts for room and board, incidental expenses, or payments for services required as a condition of receiving the grant.

Student Loan Interest Deduction

Interest on student loans is deductible up to $2,500. This deduction is an adjustment to gross income; it can be claimed regardless of whether other deductions are itemized.

The deduction can be claimed only if your modified adjusted gross income (MAGI) is below set amounts. For 2003, the MAGI limits have *not* been increased above the 2002 amounts. Table 4.2 shows the point at which the deduction starts to phase out and the point at which MAGI is too high to allow any deduction to be claimed.

LOOKING AHEAD

These MAGI limits for the student loan interest deduction may be indexed for inflation after 2003.

TABLE 4.2 MAGI Limits on Student Interest Deduction

Filing Status	Full Deduction If MAGI Is Below—	No Deduction If MAGI Is Above—
Single (including head of household)	$ 50,000	$ 65,000
Married filing jointly	$100,000	$130,000

Deductions for Education Costs

Whether you pay for education costs with savings or borrowed money, you may be eligible for special write-offs that produce tax savings for you. If you are a teacher, your out-of-pocket classroom expenses may also be deductible.

Tuition and Fees Deduction

A tax deduction may be claimed for those who pay higher education costs. Like the student interest deduction, the deduction for higher education costs is an adjustment to gross income (an "above-the-line" deduction) that can be claimed whether or not other deductions are itemized.

The maximum deduction in 2003 is $3,000 per year of eligible higher education expenses—tuition and fees. However, the maximum deduction may be claimed only by taxpayers with MAGI below a set limit. ***Important:*** There is no phaseout of the deduction—even $1 of excess MAGI prevents you from claiming the deduction. Those in danger of losing out on this deduction because of potentially excess MAGI should review the strategies in Chapter 1 on keeping AGI down.

The deduction for higher education costs is set to increase in 2004 and expires at the end of 2005. Table 4.3 shows the maximum deduction for qualified expenses. (See Example 2 for a demonstration of how the MAGI limit is applied.)

TABLE 4.3 Maximum Deductions for Qualified Higher Education Expenses

Year	MAGI	Maximum Deduction
2003	$65,000 or less if single* $130,000 or less if married filing jointly	$3,000
	More than $65,000 if single* More than $130,000 if married filing jointly	None
2004 and 2005	$65,000 or less if single* $130,000 or less if married filing jointly	$4,000
	More than $65,000 but not more than $80,000 if single* More than $130,000 but not more than $160,000 if married filing jointly	$2,000
	More than $80,000 if single* More than $160,000 if married filing jointly	None

*Single includes head of household.

Example 2

In 2003, you are single and pay your own way at college, attending classes at night while working during the day. Your tuition and fees for the year are $7,500. Your MAGI is $60,000. You may deduct $3,000 as an above-the-line tuition and fees deduction even though you claim the standard deduction. (Your MAGI is too high to claim an education credit, discussed later in this chapter.)

Itemized Deduction for Education Costs

If you pay for job-related education costs and you can't deduct them as an above-the-line tuition and fees deduction (for instance, your income is over the limit), you may still be able to enjoy a tax write-off for these expenses. These costs continue to be deductible as a miscellaneous itemized deduction subject to the 2 percent of AGI floor if they are taken to maintain or improve your job skills or are required by your employer as a condition of employment and the courses do not qualify you for a new trade or business.

Note: This deduction is quite broad and includes more items than the tuition and fees deduction. For example, this deduction includes travel costs to and from classes and books and supplies.

Educator's Out-of-Pocket Expenses

According to a 1996 study by the National Education Association, grade school teachers paid on average $400 each year on classroom supplies for which they did not receive any reimbursement. The law now gives them a modest tax break.

Educators who pay for classroom supplies out of their own pockets can now claim an above-the-line deduction for these ex-

LOOKING AHEAD

The educator deduction expires at the end of 2003 unless Congress extends it.

penses—up to $250 per year for 2003. If you qualify, the deduction can be claimed even if you do not itemize other deductions.

The term “educators” includes not only teachers but also counselors, principals, and aides working at least 900 hours during the school year in grades K through 12. “Supplies” means ordinary and necessary expenses, including books, computer equipment, software, and supplementary materials, as well as athletic supplies for courses of instruction in health or physical education.

Caution

The exclusion for an educator’s out-of-pocket expenses is limited to amounts in excess of certain other exclusions (savings bond interest, distributions from 529 plans, and distributions from Coverdell ESAs).

529 Plans

You may be able to save for your child’s or grandchild’s college education through a tax-advantaged qualified tuition plan—referred to as a 529 plan after the section of the Internal Revenue Code that governs it. There are two types of 529 plans:

1. *Prepaid tuition plans*. Contributions are applied toward guaranteed tuition payments (even if tuition costs increase). These plans may be set up by states and private institutions (for example, see the Independent 529 Plan at www.tuitionplan.org).
2. *Savings-type plans*. Contributions are invested by plan managers, and funds available for college costs depend on the plan's investment performance. These plans may be set up only by states (not by private institutions).

OVERVIEW. While contributions to 529 plans are *not* deductible for federal income tax purposes, there are significant tax benefits to these savings arrangements:

- Income earned within the plan is tax-deferred (and may become tax free).
- Distributions for qualified higher education costs can be tax free.
- Amounts not used by one beneficiary can be used by another family member simply by designating a new beneficiary. ***Caution:*** Naming a beneficiary who is a generation below the original beneficiary is treated as a taxable gift. So, for example, if you originally contributed to a 529 plan on behalf of your son and you now want to substitute your grandchild as the beneficiary, any funds

amassed in the account are treated as a taxable gift by your son (not you) to the grandchild—even though you direct the change in beneficiary.

- Contributions may in some cases be deductible for state income tax purposes. For example, New York allows each taxpayer an annual contribution deduction of $5,000, or $10,000 by a married couple (regardless of the number of beneficiaries for whom contributions are made).
- Contributions can be used for estate planning reasons even though the contributor retains control over the plan. This is discussed later in this chapter.

PLAN DISTRIBUTIONS. Distributions from state 529 plans to beneficiaries for the payment of qualified education costs are now tax free.

Distributions that are not used for qualified education purposes (for example, distributions that are taken to pay for the beneficiary's wedding) are taxable to the extent they represent earnings on contributions. In addition they are subject to a 10 percent penalty). The 10 percent penalty does not apply in certain cases:

LOOKING AHEAD

Starting in 2004, distributions or disbursements from prepaid tuition plans of private institutions also qualify for tax-free treatment.

- Death or disability of the beneficiary.
- Receipt of a scholarship.

PLAN INVESTMENTS. Generally contributors may not have any control over investments made in the plan. Plan managers (such as Fidelity and TIAA-CREF) decide on investments, including asset allocations, on the basis of the beneficiary's age and other factors. However, as a practical matter, you do retain a measure of control over investments:

- You may be able to select from a menu of investment options.
- You can switch investment choices. The IRS now allows such changes to be made once a year and whenever the beneficiary designation changes.
- You can roll over plan assets from one state plan to another one that offers the types of investments you prefer. ***Note:*** There may be plan-imposed restrictions on plan withdrawals.

ESTATE PLANNING. You may remove substantial assets from your estate on a gift tax free basis by contributing to a 529 plan—apparently even though you effectively retain control over the account. The beneficiary need not be your child or even your grandchild: you may wish to fund a plan for a niece, nephew, or other relative.

In 2003, you can contribute up to $55,000 gift tax free. A special rule allows you to treat your contribution has having been made equally over five years and apply your annual gift tax exclusion to each year. Since the annual gift tax exclusion in 2003 is $11,000 per donee, $55,000 is effectively shielded by this exclusion over the five-year period. (See Example 3.)

Example 3

In 2003, you want to make sizable contributions to 529 plans on behalf of your five grandchildren so they will have the funds for college and you will reduce the size of your estate. You can contribute up to $275,000 in 2003 without any gift tax, but you do have to file a gift tax return to elect this special treatment. Assuming when you die your estate is in the 45 percent tax bracket, the contribution saves your family $123,750 in estate taxes.

If your spouse joins in making the contribution, together you can contribute up to $110,000 per donee gift tax free. ***Note:*** If you die before the end of the five-year period, any excludable amount remaining is included in your gross estate. (See Example 4.)

Example 4

Same facts as in Example 3 except that you die in 2006. Here you have used up your exclusion in 2003, 2004, and 2005. Thus, two-fifths of the gift, $110,000 ($275,000 × $^2/_5$), is included in your estate.

Caution

Estate tax and generation-skipping transfer tax implications of 529 plans are not entirely clear. Final regulations on the estate and generation-skipping tax ramifications have not yet been issued. It is important to discuss any substantial funding of these plans with your tax adviser.

In deciding whether to contribute to a 529 plan and, if so, which plan to select, be sure to compare the contribution limits, plan managers, fees, and other aspects of state plans. In the Appendix you will find a state-by-state listing of the fund managers for each plan as well as contact information. For further information (including state-by-state comparisons), visit www.savingforcollege.com.

Coverdell Education Savings Accounts (ESAs)

Coverdell education savings accounts (ESAs), formerly called education IRAs, are another tax-advantaged education savings type vehicle. Like 529 plans, no federal income tax deduction is allowed for contributions. And, like 520 plans, distributions from Coverdell ESAs used for qualified education purposes are tax free.

Coverdell ESAs offer several unique advantages over 529 plans:

- A contributor can control investments while building up a savings fund for the beneficiary.
- Distributions can be used not only for higher education purposes, but also for elementary and secondary school—both public and private. Thus, disbursements can now be made tax free for the payment of tuition to religious day schools.
- Qualified expenses include not only tuition and room and board, but also related expenses—computer technology and equipment (e.g., a computer, software, peripherals, and Internet access), academic tutoring, uniforms, transportation, and supplementary items and services (e.g., extended day programs).
- Contributions for the year may be made up to the due date of the tax return. For example, contributions for 2003 can be made up to April 15, 2004; any such contribution is treated as having been made on December 31, 2003.

However, there are considerable restrictions on Coverdell ESAs that don't apply to 529 plans. These restrictions on Coverdell ESAs include:

- Annual contributions to Coverdell ESAs are limited to $2,000 per year per beneficiary. There is no federal tax law limit on contributions to 529 plans.
- A contributor's MAGI cannot exceed a set dollar amount as set forth in Table 4.4. There is no MAGI limit on contributors to 529 plans.

TABLE 4.4 MAGI Limits on Coverdell Education Savings Account Contributions

Filing Status	Full Contribution If MAGI Is No More Than—	Contribution Phaseout Range
Single (including head of household)	$ 95,000	$ 95,000 to $110,000
Married filing jointly	$190,000	$190,000 to $220,000

- Contributions can be made only for someone who is under age 18, and distributions must be made (or are treated as having been made) at age 30. However, starting in 2002 these age restrictions do not apply to a special-needs beneficiary. This is someone who, due to a physical, mental, or emotional impairment (including a learning disability) requires additional time to complete his or her education.

EXCESS DISTRIBUTIONS. When an education credit is claimed in the same year in which distributions are taken from an ESA, education expenses are first taken into account in figuring the credit. Where distributions exceed qualified expenses, the excess is included in gross income. (See Example 5.)

WAIVER OF THE 10 PERCENT PENALTY. Where distributions from ESAs are included in income solely because an education credit is claimed, the 10 percent penalty on ESA distributions does not apply. In effect, if the distributions from the

Example 5

You have contributed to a Coverdell ESA for your child who will attend college in the fall of 2003. To cover costs of $2,500, $2,500 is withdrawn from the ESA. You claim a Hope credit of $1,500 (based on $2,000 of education expenses). Education expenses are first taken into account for the education credit. Thus the excess ESA distribution of $500 ($2,500 qualified expenses reduced by $2,000, used for the higher education credit) is subject to tax.

ESA *would have been excluded* had no credit been claimed (i.e., the funds are used to pay qualified education costs), then the 10 percent penalty is waived. Thus, in Example 5 above, the $500 excess ESA distribution included in income because of claiming an education credit does not result in a 10 percent penalty.

EXCESS CONTRIBUTIONS. Suppose a beneficiary's parent and aunt each contribute $2,000 to a Coverdell ESA for the same year. The law allows excess contributions to be withdrawn penalty free (if the overfunding remains in the account there is a 6 percent excess contribution penalty imposed each year).

In the past, the deadline for withdrawing excess contributions penalty free was the due date of the beneficiary's return (including filing extensions) or April 15 of the year following the contribution year if the beneficiary is not required to file a return. Now the deadline is May 31 of the year following the year of the contribution. (See Example 6.)

Planning Strategies for Coverdell ESAs

Those prevented from making a contribution because of the MAGI limit can, of course, gift such funds to someone else whose MAGI is within set limits; then that person can make the contribution.

Those who own closely held corporations are in a unique position to have their children's education funded through company contributions. Since there is no MAGI limit on corporate contributors, your personal MAGI is irrelevant. However, corporate contributions on your behalf may constitute taxable dividends so be sure to

Example 6

In 2003, two separate taxpayers each contribute $2,000 to a Coverdell ESA for Junior. The excess contribution—$2,000—must be withdrawn (taken back by the contributor) no later than May 31, 2004. If there are two separate ESAs, excess amounts can be withdrawn from one or more of them as long as the total excess amount is withdrawn.

consult with a tax adviser before arranging any such contributions.

Individuals who do not expect their children or grandchildren to need financial aid may want to contribute to *both* Coverdell ESAs and qualified tuition plans in order to save as much as possible in tax-advantaged savings vehicles.

Education Tax Credits

If you pay for higher education costs for yourself, your spouse, or your dependent, you may be eligible to claim an education credit. (Remember that a tax credit is worth more than a deduction since it reduces your tax liability on a dollar-for-dollar basis.) You can claim the credit even if you borrow the money to pay the education costs. There are two types of education credits:

1. *Hope credit*. The credit is 100 percent of qualified tuition and related fees up to $1,000 and 50 percent of such expenses in excess of $1,000, for a top credit of $1,500. The credit applies only to the first two years of a student's higher education. The credit is figured on a per student basis. Thus, if your twins are both freshmen in college, you can claim a total credit of up to $3,000.
2. *Lifetime learning credit*. The credit in 2003 has increased to 20 percent of the first $10,000 in qualified

tuition and related fees, for a top credit of $2,000 (it had been 20 percent of the first $5,000 in qualified costs in 2002). The credit can be claimed for any higher education and applies on a per taxpayer basis. Thus, if you can claim the credit for expenses you paid for yourself and for your child who is a senior in college, your total credit is limited to $2,000.

INCOME LIMITS. The credit may be claimed only if your MAGI is below set limits. In 2003, the income limits have been increased for married couples filing joint returns; they remain unchanged for single taxpayers. The MAGI limits for the education credits are shown in Table 4.5.

Important: If your MAGI prevents you from claiming the credit, your child may be able to do so—even though you paid the expenses. In order for your child to claim the credit, you must waive a dependency exemption for him (an action that may not result in any tax increase to you if your exemptions are already phased out because of your high income). Also, your child must have tax liability (for example,

TABLE 4.5 MAGI Limits for Higher Education Credits

Filing Status	Full Credit If MAGI Is No More Than—	Credit Phaseout Range
Single (including head of household)	$41,000	$41,000 to $51,000
Married filing jointly	$83,000	$83,000 to $103,000

Example 7

In 2003, when qualified higher education costs are $14,000, $10,000 is distributed from a 529 plan and $2,000 from a Coverdell ESA to pay $12,000 of your child's higher education costs. Qualified expenses are first reduced by $5,000 taken into account in figuring a lifetime learning credit for your child (who is a junior in college). An allocation must be made of distributions from the Coverdell ESA and the 529 plan in order to determine whether and how much of each distribution is taxable. Here is how the reduced expenses of $9,000 ($14,000 – $5,000) are allocated:

529 plan: $9,000 × ($10,000 ÷ $12,000) = $7,500

Coverdell ESA: $9,000 × ($2,000 ÷ $12,000) = $1,500

resulting from mutual fund distributions) in order to benefit from the credit. In deciding whether to let your child claim the credit, weigh the tax savings you would receive from claiming the exemption against the tax savings to your child, and choose the option that provides the greater tax benefit for the family.

COORDINATION OF EDUCATION CREDITS AND DISTRIBUTIONS FROM COLLEGE SAVING PLANS. In figuring whether credits can be claimed in the same year in which distributions are taken from Coverdell ESAs, expenses are taken into account first for the education credits. If distributions are taken from both Coverdell ESAs and qualified tuition plans, then expenses must be allocated between them if total distributions exceed total reduced expenses (expenses after they have been taken into account for an education credit).

LOOKING AHEAD

The income limits may again be adjusted for inflation. Also, the amount of expenses taken into account in figuring the Hope credit may be increased for inflation (even though no adjustment has yet been made).

The law does not set forth any particular method for making such an allocation. However, it seems reasonable to make an allocation based on a ratio of the distribution from the Coverdell ESA and 529 plan to total distributions from both. (See Example 7.)

CHAPTER 5

Pension and IRA Relief

Retirement income generally comes from three sources: Social Security benefits, qualified retirement plans and IRAs, and personal savings. In order to have a financially secure retirement, you cannot rely on Social Security benefits as your primary source. And today it is difficult to save money for retirement in personal accounts after paying your current bills (including taxes) and other expenses and saving for other purposes (such as the purchase of a home or a child's college education). So the main way for most people to provide a comfortable retirement income is through retirement plans and IRAs. Fortunately, recent law changes make it easier than ever before to save more money on a tax-advantaged basis.

There are two tax aspects to retirement savings—putting money into tax-advantaged accounts and taking money out of these accounts. During your working years you are building up retirement savings through contributions to 401(k) plans and personal IRAs. At retirement you are tapping into these funds, balancing two key considerations: what you need to live on and what the law requires you to take in order to avoid penalties.

This chapter explains the new retirement savings opportunities, including some new contribution limits for 2003 and thereafter, as well as tax incentives to encourage you to save in retirement plans. This chapter also discusses the highly favorable rules on taking required distributions from qualified plans and IRAs so that if you are financially able to get by with other funds you can withdraw as little as possible from these accounts without incurring any tax penalties.

Contribution Limits

There are new contribution limits for qualified retirement plans such as 401(k) plans. The limits for IRA contributions remain unchanged for 2003, but will increase in future years. Contributions that are deductible are to some extent paid for with government money (the tax savings you realize from making the contributions). (See Example 1.)

There are two ways in which contributions are made: cash

Example 1

If you are eligible to contribute to a deductible IRA in 2003 and make the maximum contribution for someone under age 50 ($3,000), the government effectively contributes up to $1,050 if you are in the top tax bracket of 35 percent. This dollar amount is your tax savings—you need to come up with only $1,950 to max out on your contribution after factoring in the tax savings from your deduction for the contribution.

contributions and elective deferrals (designating under a salary reduction agreement to use part of your salary *before tax* as your plan contribution amount). Cash contributions are required for IRAs. Elective deferrals can be made to the following types of plans:

- 401(k) plans.
- 403(b) annuities.
- 457 government plans
- Salary reduction simplified employee pensions (SARSEPs) established before 1997.
- SIMPLE plans.

Elective Deferral Limits

PLANS OTHER THAN SIMPLE PLANS. For 2003, the tax law has raised the elective deferral limit for all plans other than

SIMPLE plans to $12,000 (from $11,000 in 2002). This is called the "basic" elective deferral limit.

If you are age 50 or older by the end of 2003, there is an additional elective deferral limit, called a "catch-up" amount, of $2,000 (up from $1,000 in 2002). Thus, someone who is 55 in 2003 can agree to contribute up to $14,000 of salary to a 401(k) plan. The catch-up contribution is designed to allow those who previously failed to make contributions—for example, women returning to the workforce after raising children, who missed years of contribution opportunities—to make up for lost time. But, in operation, you do not have to show that you failed to make prior contributions. The *only* requirement for the additional catch-up amount is meeting the age 50 condition.

PLANNING. If you will celebrate your 50th birthday *during* the year, you can agree to make a catch-up contribution *throughout* the year. You do not have to wait until your birthday actually passes to start these additional elective deferrals.

For participants in 457 plans, there is a special limit for the three years prior to retirement. The limit during these three years is twice the otherwise applicable elective deferral limit. (See Example 2.)

How much can you contribute? The answer depends not only on the new law limits (and what you can afford), but also on the terms of your plan. The law allows contributions up to 100 percent of compensation to the plan (up to the applicable dollar limit). However, your employer plan may put a percentage limit on your contribution—for exam-

Example 2

A state worker, age 59, is set to retire in three years at age 62. His contribution limit for 2003 is $28,000 ($14,000 basic plus catch-up amount × 2).

ple, up to 5 percent of your annual compensation. Thus, if you earn $50,000, your limit under the terms of the plan may be only $2,500, even though the law provides an elective deferral limit for someone age 50 and older of $14,000.

In order for plans to allow you to take advantage of the new limits, the plans must be amended to adopt these limits as well as eliminate self-imposed percentage limitations. Your plan administrator will advise you of your salary reduction options.

LOOKING AHEAD

The basic elective deferral amount *and* the catch-up amount are scheduled to increase in the future (see Table 5.1).

Table 5.1 shows your elective deferral limits (based on age) in the coming years.

SIMPLE PLANS. For 2003, the basic elective deferral limit for these plans has been raised to $8,000 (from $7,000 in 2002). In addition, there is a catch-up amount for those age 50 and

LOOKING AHEAD

The basic elective deferral amount *and* the catch-up amount for SIMPLE plans are scheduled to increase in the future (see Table 5.2).

TABLE 5.1 Elective Deferral Limits

Year	Limit for Those under Age 50	Limit for Those 50 and Older
2004	$13,000	$16,000
2005	14,000	18,000
2006	15,000*	20,000*

*After 2006 the basic $15,000 limit and the additional $5,000 catch-up amount are each indexed for inflation in increments of $500.

older by year-end of $1,000 (up from $500 in 2002). Thus, in 2003, if you are at least age 50 you can make an elective deferral contribution of up to $9,000.

Table 5.2 shows your elective deferral limits (based on age) after 2003.

IRA Limits

For 2003, you can contribute up to $3,000 to a traditional IRA or a Roth IRA, the same limit that applied in 2002. This is called the "basic" contribution limit.

TABLE 5.2 Elective Deferral Limits for SIMPLE Plans

Year	Limit for Those under Age 50	Limit for Those 50 and Older
2004	$ 9,000	$10,500
2005	10,000	12,000
2006	10,000*	12,500*

*After 2005 the basic $10,000 limit will be indexed for inflation in increments of $500. Thus, the contribution limits in 2006 may be *more* than $10,000/$12,500 (depending on inflation adjustments). Starting in 2007, the additional $2,500 amount will also be indexed for inflation in increments of $500.

If you are age 50 or older by the end of 2003, your contribution limit is $3,500. This is comprised of your basic contribution ($3,000) plus a catch-up contribution of $500. The catch-up contribution limit for IRAs remains the same as it was in 2002. The catch-up contribution is based solely on attaining the age of 50 by the end of the year—it has nothing to do with whether you made contributions in the prior years.

For married couples, the additional catch-up contribution depends on the age of the IRA owner, not the contributor. (See Example 3.)

LOOKING AHEAD

The basic contribution limit *and* the catch-up contribution limit for 2004 are the same as in 2003. However, starting in 2005, they are scheduled to increase in the future (see Table 5.3).

Table 5.3 shows your contribution limit (based on age).

ELIGIBILITY TO MAKE DEDUCTIBLE IRA CONTRIBUTIONS. If you are a participant in a qualified retirement plan, such as a company profit-sharing plan or pension plan, you can make deductible IRA contributions only if your modified AGI

Example 3

In 2003, Mary, age 48, works for X Corporation. Her husband Juan, age 51, is a full-time student who has no earnings. Mary may contribute only $3,000 to her own IRA, but she may contribute up to $3,500 to an IRA for Juan.

TABLE 5.3 IRA Contribution Limits

Year	Limit for Those under Age 50	Limit for Those 50 and Older
2004	$3,000	$3,500
2005	4,000	4,500
2006	4,000	5,000
2007	4,000	5,000
2008 and thereafter	5,000*	6,000*

*The basic contribution limits will be adjusted for inflation in increments of $500, but there will be *no* adjustment to the additional contribution limit of $1,000.

(MAGI) is below set limits. MAGI over a set limit causes the contribution to be phased out; it is fully phased out when MAGI exceeds another limit. The phaseout limits have increased for 2003 and are scheduled to increase further (without any indexing for inflation), as shown in Table 5.4.

TABLE 5.4 IRA Contribution Phaseout Limits

Year	Single Taxpayers	Joint Filers
2003	$40,000–$50,000	$60,000–$70,000
2004	45,000– 55,000	65,000– 75,000
2005	50,000– 60,000	70,000– 80,000
2006	50,000– 60,000	75,000– 85,000
2007 and thereafter	50,000– 60,000	80,000–100,000

PLANNING. The interplay between the increasing IRA contribution limits on the one hand and the increasing phaseout limits on the other makes it highly complicated to determine your annual deductible contribution limit. Depending on changes in income and age, your limits may increase or decrease each year (see Examples 4 and 5).

ELIGIBILITY TO MAKE ROTH IRA CONTRIBUTIONS. The income limits for making nondeductible Roth IRA contributions and for converting a traditional IRA to a Roth IRA remain unchanged for this year. Both limits are based on modified adjusted gross income (MAGI). For 2003, the limits are:

Example 4

In 2003, a single individual, age 45, who participates in her company retirement plan wants to make deductible IRA contributions. Her MAGI is $45,000. Her deductible contribution limit is $1,500.

Example 5

In 2004, this single individual's MAGI rises to $47,500. Her deductible contribution limit increases to $2,250 even though her income increased (the MAGI phaseout limits also increased).

- *Contribution phaseout limits:* $95,000 to $110,000 for singles and $150,000 to $160,000 for joint filers.
- *Conversion limits:* MAGI of $100,000 regardless of filing status (but no conversion is allowed for a married person filing separately).

Planning for Higher Contribution Limits

While the higher contribution limits provide an excellent opportunity for you to save for your future retirement income, your current financial obligations may limit your ability to take full advantage of the opportunity. For instance, you may be able to afford to save only $3,600 ($300 a month) in 2003. If this is so, then it is important for you to use your limited resources in the plan where they will produce the highest returns for you.

If you face the choice between making a contribution to your employer's 401(k) plan or funding a personal IRA, generally it is advisable to opt for the company plan. The reason: You can usually achieve more significant benefits.

- *Employer matching contributions.* These are essentially free additional retirement savings (although you will have to pay tax on these amounts when you later take withdrawals). This benefit is improved by more rapid vesting requirements for employer contributions, discussed in the next subsection. However, not all plans provide employee matching contributions, so check with your plan administrator.

- *Creditor protection for funds in the plan.* If you experience serious financial difficulties, the funds in a company plan (both your contributions and employer contributions on your behalf) are fully protected from the claims of your creditors. Creditor protection for IRAs depends on state law (some states provide complete creditor protection while others provide limited or no protection for this asset).

MORE RAPID EMPLOYER VESTING. In some cases employers can or must make matching contributions with respect to employee elective deferrals. For example, employer matching of at least a certain amount is required for SIMPLE plans. And employers often make certain matching contributions to 401(k) plans in order to encourage rank-and-file employees to participate so that highly compensated employees can also make elective deferrals without causing the plan to be discriminatory.

Employers must now adopt one of two vesting schedules for new plans (existing plans must have made the selection for 2002):

- *Cliff vesting:* 100 percent vesting after three years. Prior to 2002, cliff vesting for these employer contributions could be delayed until five years.
- *Graded vesting.* 20 percent after two years, 40 percent after three years, 60 percent after four years, 80 percent after five years, and 100 percent vesting after six years. Prior to 2002, graded vesting for employer contributions could be spread over seven years.

Note: The more rapid vesting schedule for employer matching contributions does not have to be used for other employer contributions to a qualified retirement plan.

WORKING COUPLES. If, as a couple, you have limited funds to contribute, it is important to coordinate where the family funds should be directed so that they will do the greatest good. Consider these factors if you have to make this important decision:

- *Eligibility for plan participation.* If each spouse is eligible to participate in a company plan, then decide which plan offers the greater benefit (factoring in employer matching contributions and investment options discussed next). If only one spouse is eligible to participate in a plan, then decide whether funds should be directed to that plan or to IRAs.
- *Employer matching contributions.* Obviously contributions should be made where they will earn the greater employer matching contributions. For example, if one spouse's plan has 3 percent matching and the other plan has 50 percent matching up to a set limit, the latter plan is probably a better option.
- *Investment options.* Under the law, 401(k) plans are required to provide a certain number of investment options. Compare the options under each plan. If you opt for an IRA, however, you obtain virtually an unlimited number of investment options by setting up a self-directed IRA.

TAX SAVINGS. Consider using "found money" from the reduction in the tax rates, the increased child tax credit, and other breaks from the 2003 tax act that apply to you to fund your retirement accounts. For example, if you have two children, use the additional $800 in tax credits (which may have been sent to you as an advance refund check) to make a retirement plan contribution. Doing so may even entitle you to further tax benefits; in addition to a reduction for IRA contributions or income deferral for 401(k) contributions, you may be eligible for a tax credit for making the contribution (discussed next).

Tax Credit for Making Contributions to Retirement Plans and IRAs

The tax law encourages individuals to save for their retirement. It also rewards small business owners for setting up qualified retirement plans. Both credits, introduced in 2002, remain unchanged for 2003.

RETIREMENT SAVINGS CONTRIBUTIONS CREDIT. A special tax credit, called the retirement savings contributions credit, encourages individuals to fund retirement plans. Low- and moderate-income individuals may be able to double-dip—that is, enjoy a tax benefit from making the contribution, such as a deduction for an IRA contribution or tax deferral on salary contributed to a 401(k) or SIMPLE plan, as well as be able to claim a new tax credit for the same contribution.

The credit is figured on contributions or elective deferrals up to $2,000. The amount of the credit is your applicable percentage, determined by your filing status and adjusted gross income, as shown in Table 5.5. (See also Example 6.)

TABLE 5.5 **Applicable Percentage for Retirement Savings Contribution Credit**

Adjusted Gross Income						
Joint Filers		Heads of Household		Other Filers		
Over	Not Over	Over	Not Over	Over	Not Over	Applicable Percentage
$ 0	$30,000	$ 0	$22,500	$ 0	$15,000	50%
30,000	32,500	22,500	24,375	15,000	16,250	20
32,500	50,000	24,375	37,500	16,250	25,000	10
50,000		37,500		25,000		0

Example 6

In 2003, you contribute $6,000 of your salary to your company's 401(k) plan through elective deferrals. You are single and your adjusted gross income for the year is $24,000. In addition to *not* being immediately taxed on the $6,000 of salary you contributed to the plan, you can claim a tax credit of $200 (10 percent of $2,000, the maximum amount taken into account in figuring the credit). If your AGI is $25,001, you cannot claim any tax credit—your AGI exceeds the limit for the credit.

Caution

The contribution amount for purposes of figuring the tax credit is reduced by any distributions you take from a qualified plan that are includable in income during a "testing period." The contribution amount is also reduced by any Roth IRA rollover during the testing period that is not a qualified rollover.

The testing period includes the two preceding years, the current year, and the following year through the due date of the return (including extensions). Thus, for purposes of figuring the credit for 2003, consider whether any distributions were taken in 2001, 2002, 2003, and up to April 15, 2004 (assuming there are no filing extensions obtained).

PLANNING. You must weigh very carefully whether to take withdrawals—for example, IRA withdrawals to pay for the purchase of your first home or to cover medical or educational expenses. Such distributions can be taken without incurring the 10 percent penalty on early withdrawals, but they may cost you the credit (in addition to ordinary income taxes on the distributions).

LOOKING AHEAD

The retirement savings contribution credit is set to run only through 2006. The percentages, AGI limits, and $2,000 maximum amount taken into account in figuring the credit will *not* be adjusted for inflation in the coming years.

EMPLOYER CREDIT FOR STARTING A RETIREMENT PLAN. Small businesses may be eligible for a tax credit designed to encourage starting up a qualified retirement plan. The credit covers the administrative costs of plan setup and employee education and runs for the first three years of the plan's existence.

Required Minimum Distribution Rules

The tax law does not allow funds to remain in qualified retirement plans and IRAs indefinitely, building up income that isn't currently taxed. At a certain point you *must* take distributions from your retirement accounts—at least enough to avoid penalties. This amount is referred to as your annual required minimum distribution (RMD).

In 2002, final regulations on figuring minimum distributions were released. These regulations provide highly favorable rules that effectively do not require you to take as much as under prior rules, allowing you to leave funds in retirement accounts to build up on a tax-deferred basis if you do not need to withdraw the money for retirement income. The final regulations officially become effective in 2003, although you were allowed to use them voluntarily to figure minimum distributions in 2002. The following discussion details distribution rules that apply to 2003 and later years.

Lifetime Required Minimum Distributions

The tables used to figure minimum distributions have been revised from prior tables to reflect new mortality figures.

Since people are living longer, the amount required to be distributed each year is smaller under these new tables than under previous IRS tables.

GENERAL RULE. Your required minimum distribution is your account balance as of December 31 of the prior year divided by the distribution period specified in the new Uniform Lifetime Table (Table 5.6). This distribution period assumes you have named a beneficiary who is 10 years younger than you, regardless of whether in fact you named any beneficiary and, if so, whether that beneficiary is younger or even older than you. (See Examples 7 and 8.)

Example 7

You attain age 70½ in February 2003 and your 71st birthday in the same year. Your IRA account balance on December 31, 2002, was $100,000. You take your first distribution on December 31, 2003. Using the Uniform Lifetime Table (Table 5.6), your required minimum distribution for 2003 is $3,774 ($100,000 ÷ 26.5).

Example 8

On December 31, 2003, your account balance is $101,226 ($100,000 + 5% earnings during the year – $3,774 distribution). Using the new distribution period from the Uniform Lifetime Table (Table 5.6), your required minimum distribution for 2004 is $3,954 ($101,226 ÷ 25.6).

TABLE 5.6 Uniform Lifetime Table

Age of Employee	Distribution Period
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9
76	22.0
77	21.2
78	20.3
79	19.5
80	18.7
81	17.9
82	17.1
83	16.3
84	15.5
85	14.8
86	14.1
87	13.4
88	12.7
89	12.0
90	11.4
91	10.8
92	10.2

TABLE 5.6 *(Continued)*

Age of Employee	Distribution Period
93	9.6
94	9.1
95	8.6
96	8.1
97	7.6
98	7.1
99	6.7
100	6.3
101	5.9
102	5.5
103	5.2
104	4.9
105	4.5
106	4.2
107	3.9
108	3.7
109	3.4
110	3.1
111	2.9
112	2.6
113	2.4
114	2.1
115+	1.9

YOUNGER SPOUSE. If you have named your spouse as the sole beneficiary of your account or benefits *and* your spouse is more than 10 years your junior, instead of using the Uniform Lifetime Table to find the distribution period, you use the Joint Life and Last Survivor Expectancy Table (Table 5.7). Doing so provides a smaller distribution than would be required under the Uniform Lifetime Table. Marital status for purposes of figuring your distribution for the year is determined on the first day of the year, so any changes in that status due to death or divorce are ignored. (See Example 9.)

OTHER CHANGES ON DISTRIBUTION COMPUTATIONS. For the year you attain age 70½ you can opt to take your first required minimum distribution by April 1 of the following year instead of December 31 of that year. This rule has *not* been changed by the final regulations. But the way you figure your second distribution has been changed. If you opt to delay the first distribution until April 1 of the year after

Example 9

Same facts as in Example 7 except you have named your spouse, who turned age 60 in 2003, as the sole beneficiary of your IRA. Using the Joint Life and Last Survivor Expectancy Table (Table 5.7), your required minimum distribution for 2003 is $3,676 ($100,000 ÷ 27.2). This is about $100 less than if your spouse were not more than 10 years your junior.

TABLE 5.7 Joint Life and Last Survivor Expectancy Table

	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85
52	33.4	33.3	33.2	33.1	33.0	33.0	32.9	32.8	32.8	32.7	32.7	32.6	32.6	32.6	32.5	32.5
53	32.6	32.5	32.4	32.3	32.2	32.1	32.0	32.0	31.0	31.8	31.8	31.8	31.7	31.7	31.7	31.6
54	31.8	31.7	31.6	31.5	31.4	31.3	31.2	31.1	31.0	31.0	30.9	30.9	30.8	30.8	30.8	30.7
55	31.1	30.9	30.8	30.6	30.5	30.4	30.3	30.3	30.2	30.1	30.1	30.0	30.0	29.9	29.9	29.9
56	30.3	30.1	30.0	29.8	29.7	29.6	29.5	29.4	29.3	29.3	29.2	29.2	29.1	29.1	29.0	29.0
57	29.5	29.4	29.2	29.1	28.9	28.8	28.7	28.6	28.5	28.4	28.4	28.3	28.3	28.2	28.2	28.1
58	28.8	28.6	28.4	28.3	28.1	28.0	27.9	27.8	27.7	27.6	27.5	27.5	27.4	27.4	27.3	27.3
59	28.1	27.9	27.7	27.5	27.4	27.2	27.1	27.0	26.9	26.8	26.7	26.6	26.6	26.5	26.5	26.4
60	27.4	27.2	27.0	26.8	26.6	26.5	26.3	26.2	26.1	26.0	25.9	25.8	25.8	25.7	25.6	25.6
61	26.7	26.5	26.3	26.1	25.9	25.7	25.6	25.4	25.3	25.2	25.1	25.0	24.9	24.9	24.8	24.8
62	26.1	25.8	25.6	25.4	25.2	25.0	24.8	24.7	24.6	24.4	24.3	24.2	24.1	24.1	24.0	23.9
63	25.4	25.2	24.9	24.7	24.5	24.3	24.1	23.9	23.8	23.7	23.6	23.4	23.4	23.3	23.2	23.1
64	24.8	24.5	24.3	24.0	23.8	23.6	23.4	23.2	23.1	22.9	22.8	22.7	22.6	22.5	22.4	22.3
65	24.3	23.9	23.7	23.4	23.1	22.9	22.7	22.5	22.4	22.2	22.1	21.9	21.8	21.7	21.6	21.6
66	23.7	23.4	23.1	22.8	22.5	22.3	22.0	21.8	21.7	21.5	21.3	21.2	21.1	21.0	20.9	20.8
67	23.2	22.8	22.5	22.2	21.9	21.6	21.4	21.2	21.0	20.8	20.6	20.5	20.4	20.2	20.1	20.1
68	22.7	22.3	22.0	21.6	21.3	21.0	20.8	20.6	20.3	20.1	20.0	19.8	19.7	19.5	19.4	19.3
69	22.2	21.8	21.4	21.1	20.8	20.5	20.2	19.9	19.7	19.5	19.3	19.1	19.0	18.8	18.7	18.6
70	21.8	21.3	20.9	20.6	20.2	19.9	19.6	19.4	19.1	18.9	18.7	18.5	18.3	18.2	18.0	17.9
71	21.3	20.9	20.5	20.1	19.7	19.4	19.1	18.8	18.5	18.3	18.1	17.9	17.7	17.5	17.4	17.3
72	20.9	20.5	20.0	19.6	19.3	18.9	18.6	18.3	18.0	17.7	17.5	17.3	17.1	16.9	16.7	16.6
73	20.6	20.1	19.6	19.2	18.8	18.4	18.1	17.8	17.5	17.2	16.9	16.7	16.5	16.3	16.1	16.0
74	20.2	19.7	19.3	18.8	18.4	18.0	17.6	17.3	17.0	16.7	16.4	16.2	15.9	15.7	15.5	15.4
75	19.9	19.4	18.9	18.4	18.0	17.6	17.2	16.8	16.5	16.2	15.9	15.6	15.4	15.2	15.0	14.8
76	19.6	19.1	18.6	18.1	17.6	17.2	16.8	16.4	16.0	15.7	15.4	15.1	14.9	14.7	14.4	14.3
77	19.4	18.8	18.3	17.8	17.3	16.8	16.4	16.0	15.6	15.3	15.0	14.7	14.4	14.2	13.9	13.7
78	19.1	18.5	18.0	17.5	17.0	16.5	16.0	15.6	15.2	14.9	14.5	14.2	13.9	13.7	13.4	13.2
79	18.9	18.3	17.7	17.2	16.7	16.2	15.7	15.3	14.9	14.5	14.1	13.8	13.5	13.2	13.0	12.8

Note: **For additional life expectancy factors, refer to the Supplement to IRS Publication 590, *Individual Retirement Arrangements (IRA)*.**

turning age $70\frac{1}{2}$, then for purposes of figuring your second distribution on December 31 of the year you turn $71\frac{1}{2}$ (the same year in which you take your first distribution), you need *not* reduce the account balance by the first distribution—you simply divide the account balance on December 31 by your distribution period for the second year. This new rule eliminates the need to reduce the account balance by the first distribution, simplifying your computations. However, it results in a slightly larger second distribution. (See Example 10.)

Example 10

Same facts as in Example 7 except that instead of taking your first distribution on December 31, 2003, you postponed it until April 1, 2004. The amount of the first distribution is the same, whether it is taken on December 31, 2003, or April 1, 2004, because it is based on the account balance on December 31, 2002. Assuming the account grows by 5 percent, your second required minimum is \$4,101 (\$105,000 ÷ 25.6) (do not reduce the account balance by the first distribution).

Caution

At the time this book went to press Congress was considering a rule that would eliminate tax on any minimum required distribution donated to charity. Stay alert to this possible change if you might want to take advantage of it.

Reporting for Required Minimum Distributions

Trustees and custodians are now required to inform owners by January 31 of their need to take minimum distributions during the year. They must also offer to compute the amount for the owner (but they aren't *required* to make the computation automatically). It is generally expected that in the coming years (perhaps not as soon as 2003), trustees and custodians will routinely provide owners with their distribution amounts. Of course, if you have questions, you should ask your trustee or custodian for any information that you need.

Starting in 2004, IRA trustees and custodians will report to the IRS each account for which a distribution was required in the prior year (but not the amount of the distribution). Thus, the 2004 notice to the IRS will concern 2003 required minimum distributions. Presumably, the IRS will use this information to cross-check the tax returns of taxpayers required to report their required minimum distributions to make sure they are doing so.

Postdeath Required Minimum Distributions

If you inherit retirement plan benefits or an IRA, the receipt of the inheritance is initially income tax free, but receipt of the benefits themselves (such as withdrawals from IRA accounts) is taxable. How soon you dip into your inheritance depends on your personal financial needs *and* on required minimum distribution rules. You can withdraw the funds all at once from an inherited IRA. There is no early distribution penalty even if you (or the person you inherited the account from) would be under age $59\frac{1}{2}$. The extent of withdrawals of benefits permitted from qualified plans depends on the terms of those plans (the plan administrator can inform you of your options).

Assuming you don't need the funds immediately, you still must take certain distributions in order to avoid penalties on underwithdrawals. The amount of your minimum distribution depends on whether death occurs before or after the owner had begun distributions and whether there is a "designated beneficiary" for the benefits of the IRA.

The determination of who is the "designated beneficiary" must be made no later than September 30 of the year following the year of the owner's death. The determination is based on who was named as a beneficiary before the owner's death and whether any such beneficiary is still alive and, if so, has disclaimed an interest or "cashed out" his/her benefit by this date (explained later in this chapter). If benefits are payable to the owner's estate or to a charity, there is no "designated beneficiary"; anyone receiving these benefits must take them in full no later than the end of the fifth year following the year of death if the owner died before the required beginning date or over the owner's remaining life expectancy (ignoring the fact that he/she is dead) if death occurred after the required beginning date. (See Example 11.)

SURVIVING SPOUSE. As under prior rules, if a surviving spouse inherits an IRA, she may roll over the benefits to her own

Example 11

Dad, who was predeceased by Mom, died in 2003. The benefits in his IRA pass to his estate because he never changed the beneficiary designation from Mom to someone else or named a successor/contingent beneficiary and, under the terms of the account, benefits are automatically payable to the owner's estate. Under the terms of Dad's will, Junior inherits everything in the estate. For purposes of figuring required distributions, there is no designated beneficiary, so benefits are payable to the estate. Thus, even though Junior has the right to the benefits, he is *not* the designated beneficiary so he must withdraw *all* of the funds no later than December 31, 2008, the last day of the fifth year following the year of Dad's death.

IRA. This will enable her not only to make contributions to the account if eligible to do so but also to postpone any distribution until her required beginning date—the year in which she turns age 70½.

The election to make the rollover can be done at any time after the IRA owner's death by *not* taking a distribution as described below or by contributing to the account. As a practical matter, the election is really made by changing the title to the account into the name of the surviving spouse. If funds are distributed to the surviving spouse (and they are not a required distribution), she can roll them over to her IRA within 60 days of the distribution.

The death of the owner does not eliminate the need to take the owner's required minimum distribution for the year. Thus the amount eligible to be rolled over to a surviving spouse's IRA must be reduced by the owner's last distribution.

OWNER DIES ON OR AFTER REQUIRED BEGINNING DATE. If there is a designated beneficiary, generally that beneficiary must take distributions over his/her life expectancy (based on the Single Life Table shown in Table 5.8). (See Examples 12 and 13.)

However, the beneficiary may opt to take distributions over the *owner's* remaining life expectancy. If the beneficiary

Example 12

An IRA owner dies in 2003 when he is 77 years old. His 73-year-old sister is the beneficiary of the account. She figures her distribution based on her life expectancy from the single life table (Table 5.8). Her MRD for 2003 is the account balance divided by 14.8.

Example 13

A beneficiary does not recalculate life expectancy each year but merely reduces the initial life expectancy by one year. Thus, for 2004 her MRD is the account balance divided by 13.8 (14.8 – 1).

TABLE 5.8 Single Life Table

Age	Life Expectancy	Age	Life Expectancy
0	82.4	22	61.1
1	81.6	23	60.1
2	80.6	24	59.1
3	79.7	25	58.2
4	78.7	26	57.2
5	77.7	27	56.2
6	76.7	28	55.3
7	75.8	29	54.3
8	74.8	30	53.3
9	73.8	31	52.4
10	72.8	32	51.4
11	71.8	33	50.4
12	70.8	34	49.4
13	69.9	35	48.5
14	68.9	36	47.5
15	67.9	37	46.5
16	66.9	38	45.6
17	66.0	39	44.6
18	65.0	40	43.6
19	64.0	41	42.7
20	63.0	42	41.7
21	62.1	43	40.7

(Continued)

TABLE 5.8 *(Continued)*

Age	Life Expectancy	Age	Life Expectancy
44	39.8	66	20.2
45	38.8	67	19.4
46	37.9	68	18.6
47	37.0	69	17.8
48	36.0	70	17.0
49	35.1	71	16.3
50	34.2	72	15.5
51	33.3	73	14.8
52	32.3	74	14.1
53	31.4	75	13.4
54	30.5	76	12.7
55	29.6	77	12.1
56	28.7	78	11.4
57	27.9	79	10.8
58	27.0	80	10.2
59	26.1	81	9.7
60	25.2	82	9.1
61	24.4	83	8.6
62	23.5	84	8.1
63	22.7	85	7.6
64	21.8	86	7.1
65	21.0	87	6.7

TABLE 5.8 *(Continued)*

Age	Life Expectancy	Age	Life Expectancy
88	6.3	100	2.9
89	5.9	101	2.7
90	5.5	102	2.5
91	5.2	103	2.3
92	4.9	104	2.1
93	4.6	105	1.9
94	4.3	106	1.7
95	4.1	107	1.5
96	3.8	108	1.4
97	3.6	109	1.2
98	3.4	110	1.1
99	3.1	111+	1.0

is older than the owner at the time of death (for example, the owner designated his older sister as the beneficiary of his IRA), the option to use the owner's remaining life expectancy will result in a smaller required distribution.

If there is no designated beneficiary (for example, the funds are left to the owner's estate), distributions are figured using the owner's age on his/her birthday during the year of death. Each year thereafter, the life expectancy is simply reduced by one.

OWNER DIES BEFORE REQUIRED BEGINNING DATE. If there is a designated beneficiary, he/she must take distributions over his/her life expectancy (based on the Single Life Table in Table 5.8) *unless* the IRA trustee requires or allows the beneficiary to elect to the use of the five-year rule (i.e., complete distribution by the end of the fifth year following the year of death).

If there is no designated beneficiary, the account must be distributed by the end of the fifth year following the year of death.

PUTTING THE NEW RULES INTO EFFECT FOR EXISTING HEIRS. If, as a beneficiary, you had opted to use the five-year rule, you can now change to taking distributions over your life expectancy if you act by December 31, 2003 as long as the owner died after 1996 (no change is allowed if the owner died before 1997).

The final regulations require that you look back in time to redetermine if there was a designated beneficiary and who that beneficiary was. In effect, you must look back to September 30 of the year following the IRA owner's death. This redetermination can impact your required distributions—positively or negatively, depending on the circumstances. Unfortunately, there is nothing you can do to alter the results at this time; you may be forced to take more rapid distributions than you had taken in the past if either of these two situations occur:

1. The original designated beneficiary died after the required beginning date but before the death of the IRA owner. For example, assume that an IRA owner

started taking distributions in 1997 when he turned age $70\frac{1}{2}$. His 45-year-old son was the designated beneficiary but he died in 1998. The IRA owner never named a contingent beneficiary and died in 1999. Under the old rules, distributions could continue to be paid out over the son's life expectancy in 1997 (when the distributions began). But under the new rules, starting in 2003, the account must be paid out over the IRA owner's remaining life expectancy since there was no designated beneficiary on September 30, 2000.

2. The original designated beneficiary disclaimed any interest in the IRA and no contingent beneficiary was named. Again, in this case, the account balance must be paid out over the IRA owner's remaining life expectancy.

BENEFICIARY PLANNING. In light of the MRD rules, it is important for you to review your beneficiary designations. And if you are named as a beneficiary (or a contingent beneficiary) be sure to take appropriate actions no later than September 30 following the year of the IRA owner's death if desirable.

BENEFICIARY DESIGNATIONS. Make sure that you have not only named a beneficiary for your IRA and retirement plan benefits, but also provided for a contingent (successor) beneficiary who becomes the designated beneficiary if that person is not alive on September 30 of the year following the year of your death. Keep a copy of all your beneficiary designation forms with your important papers; don't rely on your IRA custodian to do so because these forms can easily be lost (for example, if your IRA custodian is a bank, the forms can be lost upon a merger with another bank).

In making your designations, keep in mind who is or is not considered a designated beneficiary. An estate and a charitable organization may be named as a beneficiary to inherit an IRA or a part of one. But, since they have no life expectancy, they are not considered designated beneficiaries. Nonetheless, you may still wish to name them as beneficiaries—to provide liquidity for your estate if the estate is the beneficiary or to benefit your favorite charity if that charity is the beneficiary.

You may name a trust—either revocable or irrevocable—as the beneficiary of your IRA. In this instance, all trust beneficiaries are viewed as the designated beneficiaries of your IRA, so distributions are figured using the life expectancy of the oldest beneficiary. For this purpose, trust beneficiaries include both those with a life interest and those with a remainder interest. Trust beneficiaries do not include a trust's contingent beneficiaries.

You must provide the IRA custodian or trustee with certain documents, including a copy of the trust. The failure to do so will result in there being *no* designated beneficiary, so that the opportunity to stretch out required distributions over a trust beneficiary's life expectancy will be lost. ***Note:*** Trusts that failed in the past to provide this paperwork to the IRA custodian or trustee had a grace period to correct the deficiency—they were required to act by October 31, 2003, to provide all necessary documents.

If you have a single IRA, you may wish to divide your account and name separate beneficiaries for each part. This will allow each beneficiary to take distributions over his/her life expectancy. If multiple beneficiaries are named to one account, then the life of the oldest beneficiary (with the shortest life expectancy) is used to figure postdeath distributions. Of course, the beneficiaries can opt to subdivide the account after your death, but if you do it, you will avoid any problems your beneficiaries may encounter.

POSTDEATH ACTIONS. There are several actions that can be taken after an IRA owner's death to affect required minimum distributions.

- *Disclaimers.* A designated beneficiary may disclaim his/her interest, allowing it to pass to a contingent beneficiary. The disclaimer must be valid under federal law (i.e., a written disclaimer made no later than nine months after the death of the IRA owner, disclaiming any interest before any benefits have been accepted). A disclaimer can be used effectively, for example, to pass benefits to a younger beneficiary so that the distributions will be stretched out over a longer period of time. An estate may *not* disclaim the inheritance in order to create a designated beneficiary for the IRA.

- *Cash-outs.* A portion of benefits can be paid *before* the September 30 deadline. This option can be used to remove a charity as beneficiary so that remaining individuals can use their life expectancies to figure required minimum distributions.
- *Account divisions.* A single IRA with multiple beneficiaries can be divided into separate accounts for each beneficiary. This will allow each beneficiary to take distributions over his/her own life expectancy. It will also allow each of them to make investment decisions independent from the other beneficiaries.

Other Retirement Planning Changes

There have been a couple of other developments that may affect your retirement planning.

Charges against Your 401(k) Plan

The U.S. Department of Labor has approved a request by a retirement plan administrator to charge the account of a participant for certain activities. In effect, instead of the cost being spread among all plan participants as an administrative expense, certain costs are borne entirely by a particular participant. Costs might relate to:

- Processing hardship requests under which withdrawals from 401(k) plans can be made to participants to make payments on a home to avoid foreclosure and for certain other hardship situations.

- Complying with qualified domestic relations orders (QDROs) in which a court orders a divorcing spouse to share his or her retirement benefits and directs the plan to transfer those benefits to the nonparticipant spouse or ex-spouse.
- Calculating alternative payouts for a participant, such as monthly benefits as a single life annuity, joint and survivor life with 50 percent benefits to the survivor, and joint and survivor life with 100 percent benefits to the survivor, and other scenarios.

If you are involved in any of these situations, be sure to ask whether you will be charged for plan expenses on your behalf.

Roth IRA Conversions

The rules for converting a traditional IRA to a Roth IRA have not changed in 2003. The income limit on eligibility to make the conversion continues to be MAGI of no more than $100,000. This figure is *not* adjusted annually for inflation.

PLANNING. Taxpayers who converted IRAs to Roth IRAs in 2002, reporting the conversion amount on their 2002 tax returns, may wish to undo the action. The value of the account may have declined below its value at the time of conversion, so that the taxable amount was higher than it would be today. Also, the tax rates have declined so that even if the account value has remained the same, the tax paid on that amount would be lower in 2003 than it was in 2002. (See Example 14.)

Generally, you have until October 15 of the year following the year of conversion to recharacterize the transaction (i.e., retitle the Roth IRA as a traditional IRA) in order to avoid having the account treated as a taxable distribution (and subject to penalty if you are under age $59\frac{1}{2}$). But the IRS may grant an even longer time to recharacterize the account in special circumstances. In one instance a bride converted her IRA without knowing that her parents had invested in mutual funds in her name. She did not learn of the added income from the mutual funds until she went to

Example 14

In 2002, you converted your IRA, worth $50,000, to a Roth IRA. Since you were in the 27 percent tax bracket, your tax on the conversion was $13,500 ($50,000 × 27%). Assuming your income still permits a conversion, the account value is the same, and your other income and deductions are about the same, you can reconvert the account to obtain a refund of the $13,500 tax and then convert it to a Roth in 2003. In view of the tax rate reduction, your tax on the conversion would drop to $12,500 ($50,000 × 25%), or $1,000 less.

an accountant who filed her return late. In another situation, a couple each converted an IRA in 2000 but, due to health problems, did not talk with their accountant until 2002 to prepare a late return. In both cases, the IRS granted an additional six months to recharacterize the Roth IRA as a traditional IRA.

Caution

While this IRS grace has been expressed in private letter rulings that technically can't be relied on as precedent by another taxpayer, it serves to illustrate an option open to you if you find yourself in similar circumstances: Ask the IRS to grant you additional time to recharacterize an erroneously converted account. The application for additional time must be made in a formal letter ruling request; consult a tax adviser for assistance in this matter.

In deciding whether to convert an IRA to a Roth IRA, take into account the impact that the conversion may have on the taxation of Social Security benefits. The income from the conversion can trigger or increase the amount of benefits subject to tax; the effect on Social Security benefits could even kill eligibility to make the conversion by boosting income above the $100,000 AGI limit.

CHAPTER 6

Small Business Tax Relief

With the economy sagging in the past several years, Congress has created a number of tax incentives designed to spur businesses to make capital investments and to create new jobs. Presumably, if businesses act on these incentives, they will put more money back into the economy, thereby making it grow.

This chapter covers the new incentives for small business, which are expansions of existing incentives. It also alerts you to expiring small business tax breaks that end on December 31, 2003, unless Congress extends them.

Incentives for New Equipment Purchases

Businesses can recoup the cost of equipment they purchase through special write-off allowances. In some cases, the write-off is immediate (such as first-year expensing), while in other cases the write-off must be taken over several years (such as depreciation). Law changes combine to allow for faster write-offs of investments in equipment.

First-Year Expensing

A small business can elect to expense the cost of equipment (computers, office furniture, machinery, etc.) placed in service for the year instead of depreciating the cost over time, typically five to seven years. This is sometimes referred to as the Section 179 deduction because this is the section in the Internal Revenue Code governing the rule.

There is a set dollar limit on the amount that can be expensed annually. For 2003, that limit generally is $100,000 (which is up from $24,000 in 2002 and the anticipated limit of $25,000 for 2003). The same dollar limit applies whether you pay cash or finance your equipment purchase over time.

LOOKING AHEAD

The $100,000 limit on first-year expensing applies only to property acquired and placed in service before January 1, 2006 (i.e., only through 2005). It may be indexed for inflation after 2003. Starting in 2006, the $25,000 limit is scheduled to apply.

An additional $35,000 (or a total of $135,000) can be expensed if the property qualifies as New York Liberty Zone property, which is property placed in service after September 10, 2001, and before January 1, 2007, and used in a business within the Liberty Zone—the area south of Canal Street in Manhattan.

The $100,000 dollar limit phases out once a business' annual equipment purchases exceed $400,000 (up from the $200,000 limit in 2002). For every dollar over $400,000, the expense limit is reduced by $1 so that once equipment purchases exceed $500,000 in 2003, no expensing is permitted.

PLANNING. To make the most of first-year expensing when more than $100,000 has been spent on equipment, it is advisable to elect expensing for the property with the longest depreciation recovery period. (See Example 1.)

Example 1

Company A spends $200,000 in 2003 on the following equipment: a $95,000 machine with a seven-year recovery period, $20,000 in office furniture with a seven-year recovery period, and $5,000 in a copier with a five-year recovery period. It is advisable to elect expensing for the $95,000 machine and $5,000 of the $20,000 in office furniture. This will leave only $15,000 that will be depreciated over seven years and $5,000 over five years.

Bonus Depreciation

A new concept, called bonus depreciation, was introduced in 2002 for property purchased after September 10, 2001, and before September 11, 2004, and placed in service before January 1, 2005. This write-off is in addition to any first-year expensing that may be claimed. The 2003 tax act increases the bonus depreciation percentage for property acquired and placed in service after May 5, 2003 and before January 1, 2005. Thus, for 2003, there are two bonus depreciation rates:

1. Thirty percent for pre-May 6, 2003, property.
2. Fifty percent for post-May 5, 2003, property.

Bonus depreciation is applied to the adjusted basis of the property. Generally this is the cost of the property minus any first-year expensing. (See Examples 2 and 3.)

Bonus depreciation is designed merely to accelerate the write-off for equipment. It does not increase the total write-off that may be claimed—this continues to be limited to the property's basis (generally cost). Table 6.1 contrasts the write-offs for five-year property with a cost of $100,000 (assuming *no* first-year expensing election) using 50 percent bonus depreciation or waiving all bonus depreciation.

LOOKING AHEAD

Bonus depreciation applies only to property acquired and placed in service before January 1, 2005 (that is, only through 2004).

Example 2

On February 1, 2003, Company B buys equipment for $130,000. It elects to claim the maximum expense deduction of $100,000. It may also deduct $9,000 in bonus depreciation (30% × [$130,000 – $100,000]). The remaining basis of $21,000 ($130,000 – [$100,000 + $9,000]) may be depreciated over the property's recovery period. So, for example, if it is five-year property (assuming the half-year convention), the depreciation allowance for 2003 is $4,200 (20% of the $21,000). In total, Company B may deduct $113,200 of the $130,000 cost in 2003.

Example 3

Same facts as in Example 2 except the equipment was bought and placed in service on September 1, 2003. In addition to first-year expensing of $100,000, Company B may claim bonus depreciation of $15,000 (50% × [$130,000 – $100,000]). The remaining basis of $15,000 may be depreciated; the depreciation allowance for 2003 is $3,000 (20% of $15,000). In total, Company B may deduct $118,000 of the $130,000 in 2003 (which is $4,800 more than allowed for pre-May 6, 2003, property).

TABLE 6.1 Using 50 Percent Bonus Depreciation

Recovery Year	With Bonus Depreciation	Without Bonus Depreciation
2003	$ 60,000	$ 20,000
2004	16,000	32,000
2005	9,600	19,200
2006	5,760	11,520
2007	5,760	11,520
2008	2,880	5,760
Total depreciation	$100,000	$100,000

QUALIFYING PROPERTY. Most types of depreciable property qualify for bonus depreciation. For example, it may be claimed for software that has a three-year recovery period. Bonus depreciation also applies to qualified leasehold improvement property—improvements to the interior of nonresidential property made under a lease by the lessee, sublessee, or lessor. Further, it applies to property elected to be depreciated under the alternative depreciation system (ADS).

Nonqualifying property includes the following items:

- Intangibles (e.g., trademarks and goodwill) required to be amortized over 15 years.
- Property that *must* be depreciated under the alternative depreciation system, such as cell phones and other listed property not used more than 50 percent for business and any property used predominantly outside the United States.

OTHER RULES. Bonus depreciation is not taken into account in determining the basis of property for purposes of the midquarter convention. Thus, the basis of property placed in service in the last quarter of the year is determined without regard to bonus depreciation. (See Example 4.)

ELECTING OUT OF BONUS DEPRECIATION. You are not *required* to use bonus depreciation, but it applies automatically unless you elect out of it. If you qualify for 50 percent bonus depreciation, you can elect to use 30 percent bonus depreciation or opt out entirely. Generally, an election out of bonus depreciation is advisable where current income is not enough to benefit from the added write-off but you expect income to improve in coming years.

The election out applies to all property within the same recovery class. Thus, if you want bonus depreciation to apply to some five-year property it must apply to all five-year property. By the same token if you want to elect out of bonus depreciation for some seven-year property, the

Example 4

In June 2003, Company C places in service equipment costing $30,000. In December 2003, Company C places in service more equipment, which costs $20,000. The determination of whether the midquarter convention applies to these items is based on the cost of the items without regard to any bonus depreciation.

election out prohibits bonus depreciation for any other seven-year property.

The election out of bonus depreciation is made on Form 4652, *Depreciation and Amortization*. It must be made no later than the due date of the return (including extension) for the year the property is placed in service (for example, by April 15, 2004, plus any filing extensions, for 2003 property).

Caution

If you want to make the election out but fail to do so properly, you must reduce the property's basis by the amount that you could have claimed as bonus depreciation, even if you did not take the deduction. This will affect the amount of your gain (or loss), including depreciation recapture, when you dispose of the property.

Incentives for Business Vehicles

If you buy or lease a car, truck, or van for business, special rules govern how much you can deduct and when. For certain fuel-efficient cars, you may even qualify for an extra deduction or a special tax credit.

Dollar Limits on Car Deductions

If you buy a car for use in business, you can deduct your actual costs, including an allowance for depreciation or first-year expensing. However, there is a dollar limit on depreciation write-offs for "luxury cars" (cars costing over a set amount) of 6,000 pounds or less gross vehicle weight as rated by the manufacturer. Heavier vehicles, such as certain SUVs, are exempt from the dollar limits and can be fully expensed like any other type of equipment (see the rules on first-year expensing discussed earlier in this chapter).

For cars placed in service after September 11, 2001, and before May 6, 2003, there is an added first-year dollar limit of $4,600. For cars placed in service after May 5, 2003, there is an added first-year dollar limit of $7,650. Table 6.2 shows the dollar limit on depreciation (and first-year expensing) for cars placed in service in 2003.

The dollar limit without the additional amount effectively applies to cars costing more than $15,300. With the addition of the $4,600 for pre-May 6 cars, the dollar limit does not start to apply until the cost of the car exceeds $17,500; with

TABLE 6.2 **Deduction Limit on Cars Placed In Service in 2003**

Year	Dollar Limit on Cars Placed in Service before May 6, 2003	Dollar Limit on Cars Placed in Service after May 5, 2003
2003	$7,660 ($3,060 + $4,600)	$10,710 ($3,060 + $7,650)
2004	4,900	4,900
2005	2,950	2,950
2006 and later years	1,775	1,775

the addition of the $7,650 for post-May 5 cars, the dollar limit does not start to apply until the cost of the car exceeds $17,850.

LOOKING AHEAD

The dollar limits may be adjusted for inflation in 2004. However, the additional first-year dollar limit of $7,650 will not be adjusted for inflation.

The full dollar limit applies only to cars used 100 percent for business. If you use your car 75 percent for business and 25 percent for personal purposes, you must allocate the dollar limit. (See Example 5.)

Dollar Limits on Trucks and Vans

For the first time, the IRS has recognized that trucks and vans equipped for business cost more than passenger cars and therefore should have higher dollar limits on depreciation (and first-year expensing) than passenger cars. Trucks and vans subject to the special dollar limits are defined as vehicles rated at no more than 6,000 pounds gross vehicle weight. These include nonpersonal-use vehicles,

Example 5

You buy a $22,000 car in March 2003. (Assume the car weighs less than 6,000 pounds.) You use it 75 percent for business and 25 percent for personal reasons. The most you can deduct in the first year of car ownership is $5,745 ($7,660 × 75%).

which means vehicles not likely to be purchased for other than business (e.g., a van equipped with special shelving for the business).

For 2003, the dollar limit for light trucks and vans is $300 higher than the applicable dollar limit for cars. For more information, see IRS Revenue Procedure 2003-75.

Standard Mileage Rate

Instead of deducting your actual expenses for the business use of your car, you can opt to claim an IRS standard mileage allowance. This standard mileage rate applies to both owned and leased cars used for business. The standard mileage rate takes the place of deducting gas and oil, insurance, depreciation on purchased cars (or lease payments on leased cars), and repairs and maintenance. For 2003, the standard mileage rate is 36 cents per mile (down from 36.5 cents per mile in 2002).

As mentioned earlier, this rate may be claimed whether you own or lease the car. However, it may not be claimed if you deducted actual expenses for the car in a prior year.

DEEMED DEPRECIATION. If you claim the standard mileage rate, you must reduce the basis of your car by a deemed depreciation amount. The reduction in basis is necessary for determining how long to claim the standard mileage rate (it cannot be claimed after the car has been fully depreciated according to deemed depreciation). The basis reduction is also necessary for determining gain or loss on the sale of the car. For 2003, the deemed depreciation rate is 16 cents per mile (up from 15 cents per mile in 2002). (See Example 6.)

PLANNING. If you buy or lease a car for business in 2003, decide whether it is better to use the actual expense method or the IRS standard mileage rate to deduct the car's operating costs. Remember that the standard mileage rate replaces write-offs for depreciation (or lease costs on leased cars), gas, oil, repairs, licenses, and insurance. If you use the standard mileage rate in the first year, you can switch to the actual expense method in a subsequent year—but you are limited to claiming straight-line depreciation if you own the car (no accelerated depreciation is permitted). Again, if you use the actual expense method in the first year you cannot later switch to the standard mileage rate.

The choice of which method to select depends on a couple of factors:

1. *Records of actual costs.* Using the standard mileage rate eliminates the need to keep receipts for gas, oil,

Example 6

You buy a $22,000 car in 2003. You drive it 30,000 miles on business. You must reduce the basis of the car by $4,800 (30,000 × $.16). Assuming the deemed depreciation rate remains unchanged in the coming years, your car will be fully depreciated within four years—and no additional standard mileage rate may be claimed.

and so forth. It does not eliminate the requirement to substantiate business use of the car (noting odometer readings for business use).

2. *Amount of miles.* The more you drive, the greater the standard mileage rate deduction proves to be, especially impacting modestly priced cars since the same rate applies regardless of the car's sticker price. For example, if a car is driven 40,000 miles for business in 2003, the deduction under the standard mileage rate is $14,400. This same deduction applies whether the car is a modestly priced Saturn or an expensive Mercedes.

Leased Cars

In order to roughly equate the write-offs allowed for leased cars with cars that are owned and depreciated, a special amount must be added back to income for leased cars. (See Example 7.) This is called an "inclusion amount." For 2002 (and the 2003 figure was not yet available), it applies when the original cost of the car exceeds $15,500. Table 6.3 shows the inclusion amounts for cars (other than electric cars) first placed in service in 2002 (2003 figures were not yet available).

Example 7

You lease a $35,000 car in January 2002. For 2002, the first year of the lease, you must add to income $89. In 2003, the inclusion amount is $196.

TABLE 6.3 Inclusion Amounts for Nonelectric Cars First Leased in 2003

Fair Market Value		Tax Year during Lease				
Over	**Not Over**	**1st**	**2nd**	**3rd**	**4th**	**Later**
$ 18,000	$ 18,500	10	22	33	40	45
18,500	19,000	12	26	39	46	53
19,000	19,500	14	30	44	53	61
19,500	20,000	15	34	50	59	69
20,000	20,500	17	37	56	66	77
20,500	21,000	19	41	61	73	85
21,000	21,500	21	45	66	80	92
21,500	22,000	22	49	72	87	100
22,000	23,000	25	54	81	97	111
23,000	24,000	28	62	92	110	127
24,000	25,000	32	70	103	123	143
25,000	26,000	35	77	115	137	158
26,000	27,000	39	85	125	151	174
27,000	28,000	42	92	137	165	189
28,000	29,000	46	100	148	178	204
29,000	30,000	49	108	159	191	221
30,000	31,000	52	115	171	205	236
31,000	32,000	56	123	182	218	251
32,000	33,000	59	130	194	231	267
33,000	34,000	63	138	204	245	283
34,000	35,000	66	146	215	259	298
35,000	36,000	70	153	227	272	314

TABLE 6.3 *(Continued)*

Fair Market Value		Tax Year during Lease				
Over	**Not Over**	**1st**	**2nd**	**3rd**	**4th**	**Later**
$ 36,000	$ 37,000	73	161	238	285	330
37,000	38,000	77	168	249	299	346
38,000	39,000	80	176	260	313	361
39,000	40,000	83	184	272	326	376
40,000	41,000	87	191	283	340	391
41,000	42,000	90	199	294	353	407
42,000	43,000	94	206	306	366	423
43,000	44,000	97	214	317	380	438
44,000	45,000	101	221	328	394	454
45,000	46,000	104	229	339	407	470
46,000	47,000	108	236	351	420	486
47,000	48,000	111	244	362	434	501
48,000	49,000	115	251	374	447	516
49,000	50,000	118	259	385	460	532
50,000	51,000	121	267	396	474	548
51,000	52,000	125	274	407	488	563
52,000	53,000	128	282	418	502	578
53,000	54,000	132	289	430	515	594
54,000	55,000	135	297	441	528	610
55,000	56,000	139	304	452	542	626
56,000	57,000	142	312	463	556	641
57,000	58,000	146	320	474	569	656

(Continued)

TABLE 6.3 *(Continued)*

Fair Market Value		Tax Year during Lease				
Over	Not Over	1st	2nd	3rd	4th	Later
$ 58,000	$ 59,000	149	327	486	582	672
59,000	60,000	152	335	497	596	688
60,000	62,000	158	346	514	616	711
62,000	64,000	165	361	537	642	743
64,000	66,000	171	377	559	670	773
66,000	68,000	178	392	581	697	805
68,000	70,000	185	407	604	724	835
70,000	72,000	192	422	626	751	867
72,000	74,000	199	437	649	778	898
74,000	76,000	206	452	672	804	930
76,000	78,000	213	467	694	832	960
78,000	80,000	220	483	716	859	991
80,000	85,000	232	509	756	906	1,046
85,000	90,000	249	547	812	973	1,124
90,000	95,000	266	585	868	1,041	1,202
95,000	100,000	284	623	924	1,108	1,280
100,000	110,000	309	680	1,009	1,209	1,397
110,000	120,000	344	755	1,122	1,344	1,552
120,000	130,000	378	831	1,234	1,479	1,708
130,000	140,000	413	907	1,346	1,614	1,864
140,000	150,000	447	983	1,459	1,749	2,019
150,000	160,000	482	1,059	1,571	1,884	2,175

TABLE 6.3 *(Continued)*

Fair Market Value		Tax Year during Lease				
Over	**Not Over**	**1st**	**2nd**	**3rd**	**4th**	**Later**
$160,000	$170,000	516	1,135	1,683	2,019	2,331
170,000	180,000	551	1,210	1,796	2,154	2,487
180,000	190,000	585	1,286	1,909	2,288	2,643
190,000	200,000	620	1,362	2,021	2,423	2,798
200,000	210,000	654	1,438	2,133	2,559	2,953
210,000	220,000	689	1,513	2,246	2,694	3,109
220,000	230,000	723	1,589	2,359	2,828	3,265
230,000	240,000	758	1,665	2,471	2,963	3,421
240,000	250,000	792	1,741	2,583	3,098	3,577

Note: Special inclusion amounts now apply to light trucks and vans first leased in 2003. These amounts may be found in IRS Revenue Procedure 2003-75.

For cars first leased in 2003 as well as *before* 2003, inclusion amounts for 2003 can be found in IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, at www.irs.gov.

ELECTRIC CARS. A different table is used to determine the inclusion amount for electric cars first leased in 2003 that cost $53,000 or more. This table may also be found in IRS Publication 463.

LOOKING AHEAD

Starting in 2004, the credit is reduced—by 25 percent in 2004, by 50 percent in 2005, and by 75 percent in 2006. No electric vehicle credit may be claimed in 2007 and later unless Congress extends the law.

Tax Credit for Electric Cars

If you buy a car powered primarily by electricity, you may be able to take a tax credit for its purchase. In 2003, the credit is 10 percent of the vehicle's cost or $4,000, whichever is less.

Deduction for Gas-Electric Cars

Anyone—whether for business or personal purposes—may qualify to deduct up to $2,000 for the purchase of a clean-fuel car (different limits apply to trucks or vans weighing more than 10,000 pounds). This is a one-time deduction claimed in the year the car is purchased by an original owner (it cannot be claimed for a used car). The IRS has now determined that clean-fuel cars include "hybrid cars" powered by both gas and electricity (such as the Toyota Prius and the Honda Insight). These hybrid cars do not qualify for the credit for electric vehicles because they are not powered *entirely* by electricity.

The deduction relates only to the incremental cost of the clean fuel (electricity). Manufacturers must tell the IRS this amount and receive certification. A copy of this certification may be available to purchasers of these cars.

No deduction is allowed for the portion of the car taken into account for purposes of first-year expensing (discussed earlier in this chapter).

If the car is purchased for personal purposes, the deduction is claimed as an adjustment to gross income (i.e., you can deduct this amount even if you do not itemize your other deductions).

LOOKING AHEAD

The $2,000 limit is reduced by 25 percent in 2004, 50 percent in 2005, and 75 percent in 2006. Ford anticipates its 2004 Escape will be eligible for the reduced deduction, and General Motors expects a qualified pickup truck to be out in 2005. No deduction is permitted after 2006 unless Congress again extends the law.

Substantiation Rules

Substantiation rules for travel and entertainment expenses are quite specific and must be followed in order to deduct these costs. Substantiation rules may be found in IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, at www.irs.gov. The general rules have not changed for 2003.

Estimations

The IRS and the U.S. Tax Court have made it clear that you cannot estimate or extrapolate expenses and then deduct them. (See Examples 8 and 9.)

High-Low Substantiation Rates

Instead of deducting the actual cost of lodging, meals, and incidental travel expenses, employees can substantiate business travel using a special high-low substantiation method. This method provides standard rates for travel to

Example 8

You must keep a record of the miles you drive your personal car for business. This includes keeping track of the odometer. The U.S. Tax Court refused to allow a deduction for business mileage based on atlas readings of mileage between locations.

Example 9

You cannot take a sample of employee entertainment and meal costs and then extrapolate to the entire workforce to determine your deduction. The IRS insists on actual substantiation of each entertainment and meal expense incurred, even though this may impose a high administrative burden on an employer.

specific locations—the locations are either high-cost areas or they are not.

Effective on October 1, 2003, new rates take effect for the fiscal year ending September 30, 2004. At the time this book went to press, the new rates had not yet been announced (you can find the new rates posted at www.irs.gov). You may elect to continue to use the rates that became effective on October 1, 2002, for the final quarter of 2003. The rate for high-cost areas is $204 per day, and the rate for all other areas is $125 per day. Alternatively, you may use the old rates through September 30, 2003, and the new rates for the final quarter of 2003.

Incentives for Hiring New Employees

If you own a business and have people work for you, the tax law encourages the hiring of certain workers by allowing you to take a tax credit for a portion of their wages. The type of credit depends on who you hire and where your business is located.

Work Opportunity Credit

The work opportunity credit is designed to encourage the employment of workers from certain targeted groups, such as former felons and those who are economically disadvantaged. The credit is generally up to 40 percent of a targeted employee's first-year wages up to $6,000 for those who work at least 400 hours.

The work opportunity credit can be claimed for workers who qualify as "Liberty Zone taxpayers." These are individuals who substantially perform all of their services in the Liberty Zone and individuals who substantially perform all of their services in New York City for a business relocated from the Liberty Zone to someplace else within New York City because of the September 11 terrorist attacks.

LOOKING AHEAD

The work opportunity credit expires on December 31, 2003.

Welfare-to-Work Credit

The welfare to work credit is designed to encourage the employment of long-term family assistance recipients. The

LOOKING AHEAD

The welfare-to-work credit expires on December 31, 2003.

credit is 35 percent of the first $10,000 of eligible wages in the first year of employment, plus 50 percent of the first $10,000 of eligible wages in the second year of employment, for a total credit of $8,500 per eligible employee.

Tax Write-Offs for Medical Expenses

The tax law recognizes the ever-increasing cost of health care coverage and the burden this places on companies and self-employed individuals. To alleviate some of this burden, special write-offs apply.

Deduction for Self-Employed Individuals

Self-employed individuals, including sole proprietors, partners, LLC members, and more than 2 percent S corporation shareholders, cannot deduct health insurance from their business income. They can, however, deduct a percentage of their cost as an adjustment to gross income (the deduction can be claimed even if they do not itemize other personal deductions). For 2003, the percentage is 100 percent of the premiums (up from 70 percent in 2002).

There have been proposals in Congress to allow the deduction to reduce business income for purposes of figuring self-employment tax paid by self-employed business owners. Stay alert for possible developments on this matter.

Archer Medical Savings Accounts

Small businesses (those with 50 or fewer employees) and self-employed individuals can cope with their medical expenses on a tax-advantaged basis if they carry a high-deductible insurance policy and save for uncovered expenses through a special savings account. Contributions to the savings account are tax deductible and the account builds up on a tax-deferred basis. Funds can be tapped at any time to pay medical expenses not covered by insurance; withdrawals for this purpose are tax free. Withdrawals for any other purpose are taxable and subject to a 15 percent penalty. The penalty is waived for withdrawals starting at age 65. This arrangement of a high-deductible insurance policy combined with a special savings account is collectively referred to as an Archer medical savings account (MSA).

LIMITS ON DEDUCTIBLES AND OUT-OF-POCKET EXPENSES. In order to qualify for deductible contributions to Archer MSAs, the deductibles and out-of-pocket limitations under the medical policy must fall within set parameters. Changes in the parameters for 2003 due to cost-of-living adjustments may be found in Table 6.4.

As long as the insurance policy conforms to these limits, then deductible contributions to a special savings account can be up to 65 percent of the policy's deductible for self-only coverage or 75 percent for family coverage. (See Example 10.)

TABLE 6.4 Parameters for Archer MSAs

Type of Coverage	Limits on Deductibles	Limit on Out-of-Pocket Expenses
Self-only	$1,700 to $2,500	$3,350
Family	$3,350 to $5,050	$6,150

LOOKING AHEAD

Archer medical savings accounts are set to expire on December 31, 2003. Any business or self-employed individual that starts an Archer MSA before the expiration date can continue to fund it even if the law is not extended once again. The limits on deductibles and out-of-pocket expenses will be adjusted for inflation in 2004.

An employer can make these deductible contributions. Alternatively, if the employer provides the high-deductible policy, employees can make their own deductible contributions.

At present, these medical arrangements have not been very popular; in some states it is difficult to find an insurer willing to write a high-deductible policy and provide

Example 10

In 2003, a self-employed individual carries a policy for her family with a deductible of $4,500 and a limit on out-of-pocket expenses of $6,000. She may contribute up to $3,375 (75% of $4,500) to an Archer MSA.

a savings mechanism as well. However, interest is starting to grow, due in part to the continuing escalation in health insurance costs. It remains to be seen whether Congress again extends this tax break or changes it as has been proposed.

Health Reimbursement Arrangements

A new type of company-sponsored health plan can be used to cut costs for small businesses while providing tax-free medical assistance to employees. Under a health reimbursement arrangement (HRA), a company contributes a fixed dollar amount to an account for each employee. The law does not limit how much may be contributed; typical contributions of companies offering these plans range from $2,000 to $5,000 per employee. The company *saves* money by changing insurance coverage to high-deductible plans that effectively shift more of the cost of medical care to employees, reducing premium costs.

Contributions to HRAs are fully deductible by the company and tax free to employees. Employees may tap into the account to cover unreimbursed medical expenses, again a tax-free event. Unused amounts may be carried forward and used in subsequent years.

Disbursements from HRAs can be made through the use of company-provided debit cards, credit cards, or other electronic media as long as the company has adequate controls in place to assure that disbursements are only for qualified medical costs. Qualified costs may include over-the-counter (nonprescription) medications.

Other Tax Changes

There are other tax changes affecting businesses. Here are some not already covered in this chapter that have general applicability (that is, they are not limited to a certain industry, such as insurance).

Accumulated Earnings Tax

C corporations are discouraged from retaining earnings instead of distributing them to shareholders by means of a tax called the accumulated earnings tax. The reason: The government wants the tax revenues it can realize when shareholders pay tax on the dividends distributed to them from corporate earnings. C corporations that keep accumulations beyond reasonable amounts and a specific exemption ($150,000, or $100,000 for personal service corporations) are subject to this tax.

The tax rate used to be pegged at the highest individual income tax rate (e.g., 38.6 percent in 2002). However, the accumulated earnings tax rate is now just 15 percent, the same rate that would apply if the dividends had been distributed and taxed to shareholders.

Personal Holding Company Penalty

The personal holding company penalty is designed to punish individuals who use their corporations to collect their income so that they can take advantage of the lower corporate tax brackets.

Like the accumulated earnings tax, the personal holding company penalty used to be pegged at the highest individual income tax rate (e.g., 38.6 percent in 2002). However, the personal holding company penalty rate is now just 15 percent, the same rate that would apply if corporate income had been distributed as dividends and taxed to shareholders.

Collapsible Corporation Rules

In the past, individuals tried to use C corporations to convert what would have been ordinary income on inventory sales into capital gains on stock sales. To block this attempt, the collapsible corporation rules were created. If the rules applied, then shareholders were prevented from realizing capital gains on a particular transaction and instead had to report the income at ordinary income rates.

Now, however, Congress no longer believes these rules are necessary; there are other rules that adequately ensure tax at the corporate level. As a result, the collapsible corporation rules have been repealed for tax years after December 31, 2002.

Expiring Provisions

Some benefits (in addition to those previously mentioned in this chapter) that are currently in effect are set to expire at the end of 2003. Congress may extend them, in their present form or with changes, at some future date. Stay alert for extensions to the following expiring provisions.

DONATIONS OF COMPUTERS TO SCHOOLS AND LIBRARIES. C corporations that donate computer equipment and peripherals to schools (grades K–12) and libraries can claim an enhanced charitable contribution deduction. However, this benefit applies only for donations through December 31, 2003.

EXPENSING OF ENVIRONMENTAL REMEDIATION COSTS. Businesses that clean up certain environmental hazards can claim an immediate and full deduction for these costs rather than treating them as a nondeductible capital expenditure. However, this benefit applies only for costs paid or incurred through December 31, 2003.

CHAPTER 7

Estate, Gift, and Generation-Skipping Transfer Tax Relief

Income taxes may not be your only tax concern. If you give away money during your lifetime or at your death, estate, gift, and/or generation-skipping transfer tax (collectively referred to as transfer taxes) issues can arise. Is the money or property you give away or pass on subject to transfer taxes? Is it better to give your property away while you are alive or to wait until death (assuming you can afford to make this choice)? New rules allow you transfer more of your assets to your family and friends—during lifetime or at death—without resulting in a transfer tax.

But the complexities of these transfer tax rules have grown immeasurably as a result of recent law changes. To add further complication, the future of these rules is uncertain. For example, the estate tax is set to be repealed in full in 2010 and then old estate tax rules (those in effect in 2001) are set to reapply starting in 2011 unless Congress takes further action. While President Bush has been pushing for complete repeal of the estate tax, budget considerations (and the need for revenue) may override these efforts.

This chapter covers in detail the new rules for 2003 on estate, gift, and generation-skipping transfers. It also explains how limits on transfers will change in the coming years so you can devise long-range plans.

Estate Tax Changes

The old adage about the certainty of death and taxes applies doubly to estate taxes for those of means. Your estate generally can't escape paying a federal estate tax on the assets you own or have an interest in at death if their value exceeds a certain amount. (If you are married, you can arrange it so that the tax may be postponed until the death of whichever spouse dies second, but eventually some transfer tax will be paid if the value of assets remaining at the death of the second spouse exceeds a certain amount.)

Exemption Amount

How rich do you have to be in order to be concerned about the federal estate tax? That figure increases in the coming years. For 2003, there is no federal estate tax if your estate is valued at no more than $1 million (there is no change from 2002). This exemption is accomplished by permitting your estate to claim a credit against the tax liability that effectively exempts $1 million from tax. Thus, in 2003, the tax credit reflecting the $1 million exemption amount is $345,800.

LOOKING AHEAD

In 2004 and 2005, the exemption amount increases to $1.5 million. It increases to $2 million in 2006 and to $3.5 million in 2009. In 2010, there is no exemption amount—there is no need for one since there is no estate tax. However, starting in 2011, unless Congress acts in the interim, the estate tax exemption will drop to $1 million and remain there.

PLANNING. The increase in the exemption amount can affect you in one of two ways: Either you need no longer be concerned with federal estate tax because your assets are below the increased taxable threshold or you can pass on a greater amount without the imposition of federal estate tax.

But do not be too quick to dismiss the federal estate tax out of hand—the size of your estate may be larger than you think. Be sure to consider *all* of your assets, including your IRAs and retirement benefits and inheritances you may come into. By making a thorough inventory of your assets (based on their present value), you will get a better idea of whether you should be planning to reduce federal estate taxes or whether you are home free. Just remember that things can change—you may think you are currently exempt from worrying about the federal estate tax, but if you come into money (for example, an insurance settlement, lottery winnings, or an inheritance), you may then find yourself vulnerable to the federal estate tax. Or if the value of your assets rises (for example, the stock market recovers and boosts the value of your stocks and stock mutual funds held both personally and in retirement accounts), again you may find that the size of your estate is large enough to fall victim to estate tax—or at least the need to plan to minimize or avoid it.

Until now, a common estate planning strategy for married couples with sufficient assets to be subject to the federal estate tax was to set up a credit shelter or bypass trust so that the exemption amount could be fully used in the estate of the first spouse to die. It worked like this: A will provided that a credit shelter trust (also called a bypass trust) would be created with an amount equal to the maximum exemption amount. The surviving spouse would be named as the income beneficiary of that trust, enjoying income for life, with assets of the trust passing at the surviving spouse's death to other named beneficiaries (typically the couple's children). Assets in excess of the exemption amount placed in the trust would pass outright to the surviving spouse. Result: At the death of the first spouse there would be no estate tax. The assets passing directly to the surviving spouse would be shielded by the marital deduction, and the assets passing into the credit shelter trust would be shielded by the exemption amount. At the death of the surviving spouse, the assets in the trust are not included in that spouse's estate; they pass directly (untaxed) to the named beneficiaries.

If your existing will or a trust contains a formula clause for funding a credit shelter or bypass trust based on the “maximum federal exemption amount” or “maximum unified credit,” you may wish to revise these documents. You may be passing on to that trust more than you intended to the detriment of other heirs. For example, if your estate is $1.5 million and you die in 2003 with an old will providing for a credit shelter trust based on the maximum exemption amount, two-thirds of your estate will be in that trust, which may be more than you had envisioned.

Discuss with your tax or legal adviser new ways to limit the amount of assets passing into a credit shelter or bypass trust. For example, you may wish to limit the funding of the trust to a set dollar amount or a percentage of the estate or some combination of these two limits.

Estate Tax Rates

Like federal income taxes, estate tax rates are graduated—the larger your estate, the higher the estate tax rate. In 2003, the top estate tax rate is 49 percent (down from 50 percent in 2002).

Table 7.1 shows the estate tax rates for an individual dying in 2003. Example 1 shows the impact of these rates on a

LOOKING AHEAD

The top estate tax rate declines by one percentage point each year over the next several years (e.g., 48 percent in 2004), until it reaches 45 percent in 2007. It remains at 45 percent until 2010, when the estate tax is repealed entirely. However, starting in 2011, the former top estate tax rate of 55 percent will again apply (unless Congress acts in the interim).

TABLE 7.1 Estate Tax Rates for Those Dying in 2003

Taxable Estate	Tentative Tax
Not over $10,000	18% of such amount
Over $10,000 but not over $20,000	$1,800, plus 20% of the amount over $10,000
Over $20,000 but not over $40,000	$3,800, plus 22% of the amount over $20,000
Over $40,000 but not over $60,000	$8,200, plus 24% of the amount over $40,000
Over $60,000 but not over $80,000	$13,000, plus 26% of the amount over $60,000
Over $80,000 but not over $100,000	$18,200, plus 28% of the amount over $80,000
Over $100,000 but not over $150,000	$23,800, plus 30% of the amount over $100,000
Over $150,000 but not over $250,000	$38,800, plus 32% of the amount over $150,000
Over $250,000 but not over $500,000	$70,800, plus 34% of the amount over $250,000
Over $500,000 but not over $750,000	$155,800, plus 37% of the amount over $500,000
Over $750,000 but not over $1,000,000	$248,300, plus 39% of the amount over $750,000
Over $1,000,000 but not over $1,250,000	$345,800, plus 41% of the amount over $1,000,000
Over $1,250,000 but not over $1,500,000	$448,300, plus 43% of the amount over $1,250,000
Over $1,500,000 but not over $2,000,000	$555,800, plus 45% of the amount over $1,500,000
Over $2,000,000	$780,800, plus 49% of the amount over $2,000,000

Example 1

In 2003, Mrs. Smith dies with an estate valued at $2 million. (Assume there are no deductions.) The tentative tax on her estate is $780,800. Her estate tax liability is $435,000 ($780,800 – $345,800 credit amount) (before application of the state death tax credit, if any).

particular estate. The tentative tax is the tax *before* applying any tax credits, including the credit that reflects the exemption amount discussed earlier and the state death tax credit. These credits may effectively eliminate any estate tax liability.

SPECIAL ESTATE TAX RATES FOR VICTIMS OF TERRORISM AND MILITARY PERSONNEL. More favorable tax rates can be used for estates of anyone dying as a result of the April 19, 1995, Oklahoma City attack; the September 11, 2001, terrorist attacks; or an anthrax incident occurring after September 10, 2001, and before January 1, 2002. They also apply to military personnel who die while serving in a combat zone after September 11, 2001 (such as those who are killed in action or die as a result of wounds, disease, or injury suffered while on active duty during Operation Enduring Freedom in Afghanistan or in Operation Iraqi Freedom).

The maximum estate tax rule under a special table incorporating favorable tax rates for these victims is 20 percent (compared with 49 percent for other decedents in 2003). Table 7.2 shows the special tax rate schedule for estates of terrorist victims. The tentative tax is the amount before applying any credits, such as the credit for the exemption amount and the state death tax credit, which may eliminate any estate tax liability.

These favorable tax rates automatically apply *unless* the executor elects not to have them apply. Unless the executor elects out, the designation "Section 2201" should be written at the top of the estate tax return, Form 706, and the special tax rates should be used. The estate of anyone filing under these special rates should send the estate tax return to the Internal Revenue Service, E&G Department/Stop 824T, 201 W. Rivercenter Blvd., Covington, KY 41011.

State Death Tax Credit

An estate may claim a tax credit for state death taxes paid by the estate. Until 2003, in 37 states and the District of Columbia the state estate tax amount was equal to the federal state death tax credit. This state estate tax is referred to as a "pickup tax" because it picks up the amount of the state death tax credit permitted to be claimed on the federal estate tax return.

In 2003, the state death tax credit is reduced by 50 percent of the amount otherwise allowed. Thus, the maximum state death tax credit for an adjusted taxable estate over

TABLE 7.2 Estate Tax Rates for Terrorist Victims

Taxable Estate	Tentative Tax
Not over $100,000	None
Over $100,000 but not over $150,000	1% of such amount
Over $150,000 but not over $200,000	$500, plus 2% of the amount over $150,000
Over $200,000 but not over $300,000	$1,500, plus 3% of the amount over $200,000
Over $300,000 but not over $500,000	$4,500, plus 4% of the amount over $300,000
Over $500,000 but not over $700,000	$12,500, plus 5% of the amount over $500,000
Over $700,000 but not over $900,000	$22,500, plus 6% of the amount over $700,000
Over $900,000 but not over $1,100,000	$34,500, plus 7% of the amount over $900,000
Over $1,100,000 but not over $1,600,000	$48,500, plus 8% of the amount over $1,100,000
Over $1,600,000 but not over $2,100,000	$88,500, plus 9% of the amount over $1,600,000
Over $2,100,000 but not over $2,600,000	$133,500, plus 10% of the amount over $2,100,000
Over $2,600,000 but not over $3,100,000	$183,500, plus 11% of the amount over $2,600,000
Over $3,100,000 but not over $3,600,000	$238,500, plus 12% of the amount over $3,100,000
Over $3,600,000 but not over $4,100,000	$298,500, plus 13% of the amount over $3,600,000
Over $4,100,000 but not over $5,100,000	$363,500, plus 14% of the amount over $4,100,000

(Continued)

TABLE 7.2 *(Continued)*

Taxable Estate	Tentative Tax
Over $5,100,000 but not over $6,100,000	$503,500, plus 15% of the amount over $5,100,000
Over $6,100,000 but not over $7,100,000	$653,500, plus 16% of the amount over $6,100,000
Over $7,100,000 but not over $8,100,000	$813,500, plus 17% of the amount over $7,100,000
Over $8,100,000 but not over $9,100,000	$983,500, plus 18% of the amount over $8,100,000
Over $9,100,000 but not over $10,100,000	$1,163,500, plus 19% of the amount over $9,100,000
Over $10,100,000	$1,353,500, plus 20% of the amount over $10,100,000

$10,040,000 is $541,400, plus 8 percent of the amount over $10,040,000.

After 2004, the credit is replaced by a deduction for the actual amount of state death taxes paid by an estate. The value of the deduction is clearly worth less than a credit.

LOOKING AHEAD

In 2004, the credit is further reduced by 75 percent of the amount otherwise allowed (the maximum state death tax credit for an adjusted taxable estate over $10,040,000, is $270,700, plus 4 percent of the amount over $10,040,000). No credit may be claimed after 2004.

The impact of the change in the state death tax credit may be a *higher* total tax burden on estates than before the reduction in federal estate taxes. The reason: Some states do not automatically adopt changes in federal estate tax law so that prior limits apply. (See Example 2.)

STATE RESPONSE TO FEDERAL ESTATE TAX CHANGE IN THE STATE DEATH TAX CREDIT. States that have had estate taxes inextricably linked to the federal estate tax by means of the credit pickup have been set to lose about $23 billion in revenue between 2003 and 2007. Because of their continued need for this (and even more) revenue, many states have already taken action to ensure collection of state death taxes despite the declining (and eventually disappearing) federal estate tax credit for state death taxes.

Example 2

In New York, the federal estate tax law in existence on or before July 22, 1998, continues to govern the state's death taxes. As a result, unless the state legislature takes action, the state's death tax will be a 16 percent federal state death tax credit (the 12 percent in existence for federal tax purposes, plus 4 percent additional state tax). Thus, the combined top federal and state estate tax is 54 percent (50 percent for federal estate tax and an additional 4 percent for New York estate tax).

Eight states (Maine, Massachusetts, Minnesota, Nebraska, North Carolina, Rhode Island, Vermont, and Wisconsin) and the District of Columbia have taken action to preserve their pickup tax by fixing it at the state death tax credit level before enactment of the federal estate tax changes by the 2001 tax act. Five states (Kansas, Maryland, New Jersey, Ohio, and Pennsylvania) have a stand-alone state death tax that incorporates the death tax credit as a supplemental or minimum tax (the state has its own death tax, either an inheritance tax or an estate tax, but the death tax credit is an additional amount).

Thirteen states (Connecticut, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Nebraska, New Hampshire, New Jersey, Oregon, Pennsylvania, and Tennessee) have an inheritance tax (but it is being phased out in New Hampshire in 2003, in Louisiana in 2004, and in Connecticut in 2006).

Other "pickup" states (New York, Virginia, and Washington) have laws that do not change with the federal changes.

To check the estate tax in your state, click on www.retirementliving.com and then on "Taxes State by State."

Miscellaneous Estate Tax Changes

There are a number of changes that can affect the computation of the federal estate tax. Some of these changes are minor or merely technical in nature, but others can have a significant impact on the amount of taxes that will be paid.

LOOKING AHEAD

The limit for special use valuation will continue to be adjusted annually for inflation (regardless of any changes in federal estate tax rates or exemption amounts).

SPECIAL USE VALUATION. If an estate includes a farm or property used in a business, it can be valued at its special use rather than at its highest and best use. However, the reduction in the size of the gross estate through special use valuation cannot exceed a set dollar amount. For 2003, the limit has increased to $840,000 (up from $820,000).

INTEREST ON PORTION OF ESTATE TAX PAYABLE IN INSTALLMENTS. Certain estates can qualify to pay federal estate in installments over 14 years. This payout option is designed to permit estates heavily comprised of business interests to avoid liquidating those interests to pay the taxes.

If the estate is eligible and elects this installment payment option, then a portion of the federal estate tax is subject to a favorable interest rate of only 2 percent. The dollar amount used to determine the 2 percent portion increased in 2003 to $1.12 million (up from $1.1 million in 2002).

LOOKING AHEAD

Like the limit on special use valuation, the dollar limit on the portion of the estate tax payable in installments that qualifies for the favorable interest rate will continue to be indexed annually for inflation.

What Has Not Changed in Estate Taxes

It is important to recognize that certain basic rules of the federal estate tax remain unchanged by the new law. Fundamentals include:

- An unlimited marital deduction for property passing to a surviving spouse.
- An unlimited charitable contribution deduction for property passing to charity.
- A deduction for estate expenses, indebtedness, and certain taxes.
- A deduction for family-owned business interests of up to $675,000 for 2003. Although this deduction is repealed starting in 2004, any recapture of the deduction for dispositions of the interests by the family within 10 years of death continues to apply.
- Alternate valuation date for valuing property included in the estate, which is generally six months after the date of death.
- Special use valuation for valuing farms and business realty.
- The credit for tax on prior transfers. However, starting in 2005, the computation of the credit is changed slightly.

Gift Tax Changes

A quarter of a century ago, the estate and gift taxes became unified—subject to the same tax rates and the same exemption amount. Now they have effectively been decoupled so that different rates and exemption amounts will apply in the coming years.

Lifetime Gift Tax Exemption Amount

You may give away in your lifetime a set amount without any gift tax. For 2003, the gift tax exemption amount, like the estate tax exemption amount, is $1 million. The gift tax exemption will not be further increased; it will not even be indexed for inflation. (In comparison, the estate tax exemption amount in 2004 increases to $1.5 million.)

PLANNING. Those who used up their lifetime gift tax exemption amount before it was increased to $1 million in 2002 can make additional tax-free gifts at this time if they have not already done so. However, because the gift tax is figured on cumulative gifts, the additional tax-free amount is not simply $325,000 (the difference between the new $1 million exemption limit and the old $675,000 limit)—it is $302,907.

GIFTS TO NON-U.S. CITIZEN SPOUSES. While gifts to spouses who are U.S. citizens can be made in any amount—there is no percentage or dollar limit—a dollar limit is imposed on transfers to non-U.S. citizen spouses (including spouses who are permanent

LOOKING AHEAD

The limit on gifts to non-U.S. citizen spouses will continue to be indexed annually for inflation.

U.S. residents). In 2003, the limit increases to $112,000 (up from $110,000 in 2002).

LOOKING AHEAD

The top federal gift tax rate, like the federal estate tax rate, declines by one percentage point each year over the next several years (e.g., 48 percent in 2004), until it reaches 45 percent in 2007. It remains at 45 percent through 2009.

Gift Tax Rates

For 2003, the gift tax rates are the same as the estate tax rates. Thus, the maximum gift tax rate is 49 percent (down from 50 percent in 2002).

In the year in which the estate tax is repealed—2010—the gift tax remains (the gift tax is not repealed along with the estate tax). At that time, the gift tax rates will be changed to marginal rates ranging from 18 percent to 35 percent. The top rate will apply to taxable gifts over $500,000. In effect, the top gift tax rate of 35 percent will be the same as the top individual income tax rate.

Annual Gift Tax Exclusion

Without regard to your lifetime exemption amount, each year you can give away a set amount to as many people as you choose without any gift tax and without even having to file a gift tax return. This is called an annual gift tax exclusion.

In 2003, the annual exclusion has *not* been adjusted for inflation from the 2002 limit of $11,000 per beneficiary. This means you can give away $11,000 to as many people as you wish. (See Example 3.)

Married couples can agree to make split gifts, thereby doubling the annual gift tax exclusion. In other words, together they can give any person $22,000 in 2003 even if the gifted money or property is owned by one spouse. However, if split gifts are made, a gift tax return must be filed even though no tax is due.

LOOKING AHEAD

The annual gift tax exclusion may be adjusted for inflation. Any adjustment will be in $1,000 increments.

PLANNING. If you can give away cash or property without any concern that the transfer may impact your standard of living today or in the future, you may wish to adopt a gifting program as a means of benefiting your loved ones today, saving income taxes, and cutting your future estate taxes. Consider these strategies:

Example 3

You have three children and five grandchildren. In 2003, you can give them each $11,000, or a total of $88,000, without any gift tax. Gifts offset by the annual gift tax exclusion do not use up any part of your lifetime exemption amount.

- In addition to the annual gift tax exclusion, you can make direct payments (of any amount) to a school or medical provider for the same beneficiary. For example, you can give your grandchild $11,000 and pay his or her tuition to Harvard of $26,066 by writing a check directly to Harvard.
- You can use gifting for income tax savings within the family. If you are in a high tax bracket while your child or grandchild is in a lower bracket, gifting is a means of shifting income that will be taxed at a lower rate. For ideas on income shifting and kiddie considerations, see Chapters 1 and 3.

Generation-Skipping Transfer Tax Changes

Wealthy individuals whose children don't need an inheritance to improve their standard of living may give their money to their grandchildren. This strategy effectively saves estate tax on one generation (the children's generation) and allows grandchildren to inherit more property on an after-tax basis. However, making a generation-skipping transfer—from grandparent to grandchild—may result in a special transfer tax, called the generation-skipping transfer (GST) tax. The GST tax is intended to collect the revenue lost by avoiding estate tax on the skipped generation. The GST tax is imposed in addition to any other transfer tax (estate or gift tax). The rules on the GST tax for 2003 have changed.

GST Exemption Amount

The exemption amount that can be transferred across the generations without imposition of the GST tax has been adjusted for inflation to $1.12 million in 2003 (up from $1.1 million in 2002). (See Example 4.)

LOOKING AHEAD

Starting in 2004, the GST exemption becomes the same as the estate tax exemption (for example, $1.5 million in 2004 and 2005).

Example 4

Grandma dies in 2003, leaving her $5 million estate as follows: $4 million to her only son and $1 million to be divided by her three grandchildren. Grandma's entire estate (less the exemption amount of $1 million) is subject to federal estate tax. There is no GST tax in this case because the GST to her grandchildren is less than her GST exemption amount of $1.12 million. Thus, if her son leaves the balance of $4 million to his children at death, there is an estate tax savings on the $1 million (plus future appreciation) that has already passed from Grandma to her grandchildren. If the son dies after 2010 when the top estate tax rate returns to 55 percent, this could be a tax savings of as much as $550,000.

LOOKING AHEAD

As the top estate tax rate declines over the coming years as explained earlier, the GST tax rate is reduced accordingly. In 2010, when the federal estate tax is repealed, the GST tax similarly disappears. Then, in 2011, like the federal estate tax, the GST tax reappears—based on the law in effect in 2001. This means that the top GST rate again rises to 55 percent.

GST Tax Rate

The GST tax rate continues to be the highest federal estate tax rate. However, since the top estate tax rate declines in 2003 to 49 percent (from 50 percent in 2002), the GST rate is effectively reduced to 49 percent.

Miscellaneous Tax Changes

Some tax changes do not fit neatly into any of the categories discussed throughout this book. Still, these other changes may provide you with important tax-saving opportunities—or cost you extra taxes—for 2003.

This chapter covers a variety of tax rules that have changed for 2003 as a result of new laws, cost-of-living adjustments, IRS rulings, or court decisions. These changes extend beyond income taxes, applying to employment taxes as well.

Standard Deduction Amounts

Taxpayers who do not itemize their personal deductions can claim a write-off called a standard deduction. Tax law changes and cost-of-living adjustments have combined to boost the standard deduction amount you can claim.

Dollar Amounts

If you do not itemize your personal deductions, you instead claim a standard deduction amount. The dollar amounts of the standard deduction amount for your filing status have increased for 2003 due to cost-of-living adjustments and, in the case of joint filers, new legislation (see Chapter 1). The 2003 standard deduction amounts are in Table 8.1.

ADDITIONAL STANDARD DEDUCTION AMOUNTS. Those age 65 and older and/or blind can claim an additional standard deduction amount if they do not itemize their deductions. For 2003, the additional standard deduction amount for singles is $1,150 ($950 for those who are married filing jointly or surviving spouses).

STANDARD DEDUCTION FOR DEPENDENTS. The standard deduction for dependents is essentially unchanged for 2003. It remains at the greater of $750 or the sum of $250 plus earned in-

TABLE 8.1 **Standard Deduction Amounts**

Filing Status	Standard Deduction
Single	$4,750
Head of household	7,000
Married filing jointly and surviving spouse	9,500
Married filing separately	4,750

come but cannot exceed the regular standard deduction of $4,750 for singles.

LOOKING AHEAD

The standard deduction amounts will again be adjusted for inflation in 2004, so expect to see increases for all taxpayers. The standard deduction amounts for married persons filing joint returns will also be adjusted for inflation, but starting in 2005 the amount will *decline* because it will no longer be double the amount for singles (see Chapter 1).

Strategies for Benefiting from Standard Deduction Increases

If your itemized expenses annually approximate your standard deduction amount, consider bunching your discretionary expenses so that you itemize in one year (when your expenses exceed the standard deduction amount) and claim the standard deduction in the following year. You can alternate this strategy from year to year. (See Example 1.)

Example 1

In 2003, you know that your state income taxes will be $4,500. Assuming you are single, if you make charitable contributions exceeding $2,000 for the year, you will be able to itemize deductions ($6,500 itemized deductions versus $4,750 standard deduction). So make contributions in 2003 that you would ordinarily make over two years (2003 and 2004) to benefit from itemizing in 2003. Then you can claim the standard deduction in the following year. In 2005, again consider boosting your charitable contributions so that your itemized expenses exceed the standard deduction amount at that time.

Reduction of Itemized Deductions

High-income taxpayers lose a portion of certain itemized deductions. For 2003, the point at which you are considered a high-income taxpayer subject to this reduction in your itemized deductions has increased. ***Note:*** The same limit applies to singles as well as married couples filing jointly. Table 8.2 shows the point at which itemized deductions start to be reduced.

LOOKING AHEAD

The AGI threshold will be adjusted for inflation in 2004. The reduction in itemized deductions for high-income taxpayers starts to be phased out in 2006 and is eliminated by 2010.

The reduction generally is 3 percent of AGI over the applicable limit. ***Note:*** The limit on itemized deductions does not impact write-offs for medical expenses, investment interest, gambling losses, and casualty and theft deductions.

Medical Expenses

Sickness and injury can be both personally challenging and financially costly. Even if you have medical insurance, not

TABLE 8.2 Limitations on Itemized Deductions

Filing Status	AGI Over—
Married filing separately	$ 69,750
All other taxpayers	$139,500

all expenses may be covered (and you may pay some or all of the costs of the insurance). The tax law allows you to deduct certain medical costs.

Long-Term Care

The tax law recognizes the extraordinarily high cost of long-term care. Currently, the average annual cost of a nursing home is about $54,000 (and over $100,000 in some parts of the country). However, if you carry long-term care insurance to cover this cost, you may be able to achieve some tax benefit.

DEDUCTION FOR LONG-TERM CARE PREMIUMS. A portion of the annual cost of long-term care insurance is treated as a deductible medical expense. (See Example 2.) The dollar limits on premiums taken into account as medical expenses have increased for 2003, as shown in Table 8.3.

Important: Self-employed individuals who pay this cost can deduct 100 percent of the portion of such cost

Example 2

In 2003, when you are 65 years old, your annual premium for a long-term care policy is $2,600. You may include $2,510 as a medical expense along with your other deductible medical expenses. The total of your medical expenses is deductible to the extent it exceeds 7.5 percent of your AGI.

TABLE 8.3 Dollar Limits for Long-Term Care Premiums

Your Age by Year-End	Deductible Portion of Premium
40 or less	$ 250
41 to 50	470
51 to 60	940
61 to 70	2,510
Over 70	3,130

otherwise deductible in 2003 as an adjustment to gross income (up from 70 percent in 2002).

EXCLUSION FOR BENEFITS PAID FROM LONG-TERM CARE POLICIES. Payments from long-term care policies are excludable to the extent they cover long-term care costs. If you receive a daily dollar payment without regard to costs, your exclusion is limited to $220 per day (up from $210 in 2002).

This same daily dollar limit applies to accelerated death benefits paid from a life insurance policy to an insured who is chronically ill (there is no limit on payments to an insured who is terminally ill).

LOANS TO CONTINUING CARE FACILITIES. If you pay a large entry fee to a continuing care facility that is refundable, it may be viewed as an interest-free loan that generates “interest income” to you—the amount that you should have charged under the below market interest rules based on the applicable federal rate of interest. However, loans up to a certain dollar amount are exempt from the below market interest rules. For 2003 this amount is $151,000 (up from $148,800 in 2002).

This exemption from the interest-free loan rules applies only if you or your spouse is at least age 65 by the end of the year and the continuing care contract provides you with a separate living unit, meals, and routine medical care (and skilled nursing home care at no additional substantial charge if such care becomes necessary).

LOOKING AHEAD

In 2004, the dollar limits on annual long-term care insurance treated as deductible medical expenses will again be increased for inflation. The nursing home loan amount also will be adjusted for inflation.

Medical Transportation

If you travel to and from the doctor's office, pharmacy, or physical therapist, you can deduct your transportation costs. If you ride public transportation or take a taxi, you can deduct your actual out-of-pocket costs. If you use your car for this purpose, you do not have to figure your actual expenses; instead you can deduct a standard mileage rate. For 2003 the standard mileage rate for medical travel is 12 cents per mile (down from 13 cents per mile in 2002).

Important: In order to deduct your medical travel costs you must keep records on the miles you drive for this purpose. Note your odometer reading for each medical-related trip you take in your car.

Weight Loss Programs

The cost of a weight loss program for someone diagnosed with obesity is fully deductible. However, the cost of special foods for someone who is obese and the cost of weight loss programs simply to maintain general good health or for cosmetic purposes are not deductible.

Surgery to remove loose skin following substantial weight loss is also a deductible medical expense (and not treated as nondeductible cosmetic surgery). The reason: The surgery also relates to the disease of obesity.

Cosmetic Surgery

Generally, no deduction is allowed for cosmetic surgery and similar procedures. But cosmetic surgery performed to correct a deformity related to an injury, disease, or congenital abnormality or to meaningfully promote the proper function of the body or to prevent or treat an illness or disease is a deductible medical expense.

The IRS has ruled that breast reconstruction surgery following a mastectomy and vision correction surgery both qualify for deductibility. However, cosmetic surgery undertaken merely to improve one's appearance does not qualify. Thus, teeth whitening procedures do not qualify as a deductible medical expense.

Over-the-Counter Treatments

The law limits deductibility of medicine and drugs to insulin and prescription drugs. Even if a treatment is recommended by a doctor, over-the-counter medications are not deductible, including medications once prescribed only by prescription that are now sold over the counter (although they may be reimbursed through a health flexible spending arrangement or other similar plan).

However, the costs of over-the-counter treatments, which include nonprescription equipment, supplies, and diagnostic devices, are deductible. For example, the costs of bandages, crutches, thermometers, and blood sugar tests are deductible medical expenses.

Health Care Credit for Displaced Workers

Certain displaced workers may be eligible for a refundable tax credit to pay for health insurance coverage. The credit is 65 percent of premium costs, with no dollar limit.

Eligible workers include workers who qualify for trade adjustment assistance as well as those age 55 or older who are not eligible for Medicare but are receiving payments from the Pension Benefit Guaranty Corporation (PBGC).

The credit can be used only to cover COBRA (Consolidated Omnibus Budget Reconciliation Act of 1986) or obtain coverage under a spouse's employer's plan or a state-sponsored insurance program. The credit may not be used to pay for individual coverage unless the worker has such coverage for at least 30 days prior to losing his or her job.

The federal government has set up a mechanism to allow the credit to be used to pay for health coverage directly (rather than paying for health coverage and then receiving the credit when filing a return).

Other Medical Expense Changes

Changes to business-related medical expenses, including a discussion of Archer medical savings accounts and the above-the-line deduction for health insurance of self-employed individuals, are discussed in Chapter 6.

Moving Expenses

If you make a job-related move that meets time and distance tests, you can deduct your out-of-pocket costs as a deduction from gross income. For purposes of this deduction, if you use your car to move household goods and/or your family, you can deduct your related expenses. Instead of figuring your actual costs, you can deduct a standard mileage rate. For 2003 the standard mileage rate for move-related travel is 12 cents per mile (down from 13 cents per mile in 2002).

Transportation Fringe Benefits

Employer-paid transportation fringe benefits can be received tax free by most employees. The dollar limit for these benefits is expressed as monthly amounts. Table 8.4 shows the limits for 2003.

If you receive a benefit in excess of this dollar limit (for example, monthly parking valued at $200 per month), only the excess is taxable.

TABLE 8.4 2003 Limits on Transportation Fringe Benefits

Type of Transportation Benefit	Monthly Dollar Limit
Free parking	$190
Transit passes*	100
Van pooling*	100

*The monthly dollar limit is a combined amount if you receive both types of benefits.

LOOKING AHEAD

The dollar limits on these transportation fringe benefits may be adjusted for inflation after 2003.

Note: Partners, LLC members, more than 2 percent S corporation shareholders, and independent contractors can receive transit passes and van pooling worth up to $21 per month; if the benefit's value is more, then the entire benefit is taxable. These individuals cannot receive commuter parking benefits tax free unless the benefits are *de minimis*.

Home Sales

If you sell your home, you may be able to avoid tax on your profit. The law allows you to exclude up to $250,000 of gain ($500,000 on a joint return) if you owned and used your home for two out of five years before the date of sale.

But what happens if you are forced to sell before satisfying the two-year period? The law allows you to prorate the exclusion for the period of use if the sale is necessitated by a change in employment (such as relocation that meets the deductible moving expense test of at least 50 miles), health reasons (such as a doctor-recommended change of climate), or unforeseen circumstances.

"Unforeseen circumstances" include (but are not limited to):

- The home is destroyed, including destruction through acts of terrorism or war.
- The homeowner or a member of the household dies or goes on unemployment benefits.
- The homeowner becomes unable to pay the housing costs and basic living expenses because of a change in employment or self-employment status (for example, a homeowner loses her job and the only job to be had is one paying substantially lower wages).
- There is a divorce or breakup of a permanent relationship of the home's co-owners. (See Example 3.)
- The homeowner has multiple births resulting from the same pregnancy.

Estimated Taxes

You must pay your tax liability for the year throughout the year—through withholding from wages or certain other payments—or by making your tax payments in installments. The amount of your payments should be sufficient to avoid underpayment penalties.

Example 3

You and your domestic partner, who bought a home jointly in November 2002 for $240,000, separate. Your partner moves out and you cannot afford the upkeep yourself, so you sell the home in November 2003 for $290,000. Your exclusion is limited to $125,000 (one-half of the $250,000 exclusion). Thus, you can fully exclude your gain of $25,000 ($290,000 – $240,000 × 50%, which is your share).

Calculating Your Estimated Taxes

For 2003, your estimated taxes—through withholding, estimated tax payments, or a combination of both—to avoid penalty must be at least 90 percent of the tax due for 2003 or 100 percent of the tax shown on your 2002 return. (See Example 4.) These are called "safe harbors" because if you fix your estimated taxes according to these amounts, you

Example 4

In 2002 your adjusted gross income was $85,000 and your tax liability was $14,000. In 2003 your income increases and you anticipate owing $20,000. To avoid estimated tax penalties for 2003, your payments through withholding and estimated taxes must be at least $14,000 (100 percent of last year's tax liability) since this is less than $18,000 (90 percent of 2003 tax liability).

can escape penalties even if your liability for the year turns out to be greater than you had planned.

The 100 percent prior-year safe harbor cannot be used if you are considered a "high-income taxpayer." You fall in this category if, in 2002, your adjusted gross income exceeded $150,000 ($75,000 if you were married and filed separate returns). In this case, the prior-year safe harbor means paying 110 percent of your 2002 liability (it had been 112 percent of 2001 liability for purposes of 2002 estimated taxes). (See Example 5.)

The IRS has ruled that taxpayers can rely on the prior-year safe harbor to avoid estimated tax penalties even if the return for the prior year is filed late. As long as the prior year is a full 12 months and a return for the prior year is eventually filed, then the prior-year safe harbor can be used.

PLANNING. In view of the tax changes enacted in 2003, including tax rate reductions on ordinary income, capital

Example 5

Your adjusted gross income in 2002 was $160,000, your tax liability last year was $40,000, and your 2003 liability is expected to be $50,000. In this instance, since you are considered a high-income taxpayer, you must pay through withholding and estimated tax at least $44,000 (110% of $40,000) since this is less than $45,000 (90% of $50,000).

gains, and dividends as well as an increased child tax credit, you may be able to reduce your estimated tax payments. Taxpayers who may be affected include:

- Self-employed individuals and owners of pass-through entities who pay individual income tax on their share of business profits.
- Investors who realize capital gains or receive dividends.

Withholding

The withholding tables on your wages changed on July 1, 2003, to reflect the cuts in the tax rates above 15 percent, the expansion of the 10 percent bracket for taxpayers other than heads of households, and the increase in the 15 percent tax bracket for married couples filing joint returns. You do not have to take any action to benefit from the new wage withholding changes.

PLANNING. You may wish to change withholding allowances—to have more or less withheld from your pay—depending on your circumstances. To do so for the remainder of 2003 or for 2004, you must file a new Form W-4 with your employer. Otherwise the employer will figure your withholding based on whatever allowances you have been claiming.

FICA, Self-Employment Tax, and Social Security Benefits

Social Security and Medicare taxes are paid by working individuals so that they can collect retirement benefits at some future time. Employees pay their share of these taxes (called FICA) on their compensation, while self-employed individuals pay both the employee and employer share of these taxes (called self-employment tax) on their net earnings from self-employment.

FICA

The tax rates on the Social Security and Medicare portions of FICA tax for employers and employees remain unchanged for 2003. The Social Security tax rate is 6.2 percent and the Medicare tax rate is 1.45 percent.

However, the wage base limit on which the Social Security portion of the tax is figured is limited to $87,000 (up from $84,900 in 2002). There is no wage base limit for the Medicare portion of the tax. (See Example 6.)

Self-Employment Tax

Self-employed individuals pay the employer and employee share of FICA. Thus, they pay a Social Security tax rate of 12.4 percent and a Medicare tax rate of 2.9 percent. One-half of this tax is deductible as an adjustment to gross income.

Example 6

In 2003, you receive a salary of $88,000 from X Corporation. You pay $5,394 in Social Security tax ($87,000 × 6.2%) and $1,276 in Medicare tax ($88,000 × 1.45%) for a total FICA payment of $6,670.

The basis on which the Social Security portion of the self-employment tax is figured—net earnings from self-employment—also is set at $87,000 (up from $84,900 in 2002). As in the case of FICA, there is no limit on net earnings from self-employment for the Medicare portion of self-employment tax.

Social Security Benefits

Recipients under the age of 65 lose a portion of their Social Security benefits if earnings from a job or self-employment exceed a set dollar amount. For 2003, that dollar limit is fixed at $11,520 (up from $11,280 in 2002). For every two dollars of excess earnings, benefits are reduced by one dollar.

Those over the age of 65 do not have any reduction in benefits, regardless of their earnings. However, in the year of the 65th birthday, benefits can be reduced if earnings *before* that date exceed a set amount. The monthly limit for 2003 is $2,560 (up from $2,500 in 2002). For every three dollars of excess earnings, benefits are reduced by one dollar.

LOOKING AHEAD

The wage base limit for the Social Security portion of FICA and self-employment tax is set to increase. Current projections put that figure in excess of $90,000 for 2004.

Caution

You continue to pay Social Security taxes on your earnings from a job or self-employment, regardless of age—even if you are collecting benefits.

Note that the age 65 threshold at which point Social Security benefits are not reduced regardless of earnings remains constant even though the normal retirement age starts to increase in 2003. Thus, someone born in 1938 has a normal retirement age of 65 years, two months (which is attained in 2003 or 2004, depending on the month of birth). Still, if benefits start *on* one's 65th birthday, there is no reduction of Social Security benefits regardless of earnings.

Withholding on Social Security Benefits

If you are collecting benefits, you may opt to have federal income tax withheld from your benefits. Doing so may avoid the need to pay estimated taxes on investment income, which is not subject to withholding.

Due to the decline in the income tax rates, the withholding rates on Social Security benefits in 2003 are 7 percent, 10 percent, 15 percent, or 25 percent, at the taxpayer's option (the highest rate is down from 27 percent).

Tax Relief for Personnel in Operation Iraqi Freedom

Members of the armed forces, including reserve members, serving in the Arabian Peninsula areas qualify for the combat zone exclusion. For enlisted members and warrant officers, all military pay each month of service within the zone (including any hospitalization following combat) is excludable from income. For commissioned officers, the exclusion is limited to $5,882.70 (up from $5,532.90 in 2002).

In addition, certain deadlines are extended to 180 days after the last day in the combat zone (or any continuous hospitalization outside the United States for combat zone injuries). These include deadlines to file returns, make refund claims, and fund IRAs. The extensions also apply to spouses of combat zone personnel. For further details, click on “Armed Forces Benefits” at www.irs.gov.

State-by-State College Savings Plans

All plans accept accounts for both residents and nonresidents unless otherwise noted.

State	Fund Manager	Phone	Comment
Alabama	Van Kempen Asset Management	866-529-2228	Nonresidents through broker only
Alaska	T. Rowe Price T. Rowe Price and Manulife Financial	866-521-1894 866-222-7498	 Broker only (in and out of state)
Arizona	College Savings Bank Securities Management and Research	800-888-2723 888-667-3239	
Arkansas	Mercury Advisors	877-442-6553 615-416-4116	Broker only (out of state)

(Continued)

State	Fund Manager	Phone	Comment
California	TIAA-CREF	877-728-4338	
Colorado	Citigroup Asset Management	800-478-5651 888-572-4652 (out of state)	
Connecticut	TIAA-CREF	888-779-CHET	
Delaware	Fidelity Investments	800-544-1655	
District of Columbia	Calvert Asset Management Co.	800-987-4859	Nonresidents through broker only
Florida	Florida Prepaid College Board	800-552-4723	
Georgia	TIAA-CREF	877-424-4377	
Hawaii	Delaware Investments	866-529-3343	Nonresidents through broker only
Idaho	TIAA-CREF	866-433-2533	
Illinois	Citigroup Asset Management	877-432-7444	
Indiana	One Group Investments	866-400-7526	
Iowa	State treasurer and Vanguard	888-672-9116	
Kansas	American Century	800-579-2203	
Kentucky	TIAA-CREF	877-598-7878	
Louisiana	Louisiana state treasurer	800-259-5626	Louisiana residents only
Maine	Merrill Lynch	877-463-9843	
Maryland	T. Rowe Price	888-463-4723	
Massachusetts	Fidelity Investments	800-544-2776	

State	Fund Manager	Phone	Comment
Michigan	TIAA-CREF	877-861-MESP	
Minnesota	TIAA-CREF	877-338-4646	
Mississippi	TIAA-CREF	800-486-3670	
Missouri	TIAA-CREF	888-414-6678	
Montana	College Savings Bank	800-888-2723	
Nebraska	Union Bank & Trust	888-993-3746	
	Union Bank and AIM	877-246-7526	Broker only (in and out of state)
	TD Waterhouse	877-408-4644	
Nevada	Strong Capital Management	800-752-6342 877-529-5295	Broker only (in and out of state)
New Hampshire	Fidelity Investments	800-522-7297 800-544-1722	Broker only (in and out of state)
New Jersey	Franklin Templeton	877-4NJBEST 800-223-2141	Residents only
New Mexico	Schoolhouse Capital	877-EDPLANS	
	Schoolhouse Capital and Oppenheim	866-529-7283	Broker only (in and out of state)
	Schoolhouse Capital and NY Life Investment Mgt.	866-529-7367	Broker only (in and out of state)
	Schoolhouse Capital	877-277-4838	Broker only (in and out of state)
New York	TIAA-CREF	877-697-2837	
North Carolina	College Foundation, Inc.	800-600-3453	Residents and those employed in state
	College Foundation and J&W Seligman	800-600-3453	Broker only

(Continued)

State	Fund Manager	Phone	Comment
North Dakota	Morgan Stanley	866-728-3529	
Ohio	Putnam Putnam	800- AFFORD IT 800-225-1581	Residents only Nonresidents only
Oklahoma	TIAA-CREF	877-654-7284	
Oregon	Strong Capital Management, Inc.	866-772-8464	
Pennsylvania	Delaware Investments	800-440-4000	Nonresidents through broker only
Rhode Island	Alliance Capital	888-324-5057	Nonresidents through broker only
South Carolina	Banc of America Advisors, LLC	800-244-5674 800-765-2668	 Nonresidents through broker only
South Dakota	PIMCO Funds	866-529-7462	Nonresidents through broker only
Tennessee	TIAA-CREF	888-486-BEST	
Texas	Enterprise Capital Management, Inc.	800-445-4723	Nonresidents through broker only
Utah	State agency	800-418-2551	
Vermont	TIAA-CREF	800-637-5860	
Virginia	Virginia College Savings Plan and American Funds	800-421-4120 888-567-0540	Broker only (in and out of state)
Washington			No savings plan

State	Fund Manager	Phone	Comment
West Virginia	Hartford Life	866-574-3542	Nonresidents through broker only
Wisconsin	Strong Capital	888-338-3789	
	Management, Inc.	866-677-6933	Broker only (in and out of state)
Wyoming	Mercury Advisors	877-529-2655	Nonresidents through broker only

Glossary

A

above-the-line deductions Deductions subtracted from gross income to arrive at adjusted gross income (AGI).

adjusted basis The basis of property reduced by any allowable adjustments such as first-year expensing and depreciation.

adjusted gross income (AGI) Gross income less allowable adjustments, such as deductions for IRA contributions, alimony payments, and one-half of self-employment tax. AGI determines eligibility for various tax benefits (e.g., certain itemized deductions, making IRA contributions if you're a plan participant, deducting $25,000 rental loss allowance, and converting a traditional IRA to a Roth IRA).

alternative minimum tax (AMT) A tax triggered if certain tax benefits reduce your regular income tax below the tax computed on Form 6251 for AMT purposes.

Archer medical savings account (MSA) A type of medical plan combining high-deductible medical insurance with an IRA-type savings account to pay unreimbursed medical expenses.

B

basis Generally, the amount paid for property. You need to know your basis to figure gain or loss on a sale or, in the case of business or investment property, the depreciation that can be claimed.

bonus depreciation An additional 30 percent depreciation allowance for the first year business property is acquired and placed in service before May 6, 2003; 50 percent for property acquired and placed in service after May 5, 2003, and before January 1, 2005.

C

capital gains rates Special tax rates imposed on sales or exchanges resulting in long-term capital gains.

carryback A tax technique for receiving a refund of taxes in prior years by applying a deduction or credit from a current year to a prior tax year. For example, a business net operating loss incurred in 2003 may be carried back for two years.

carryforward A tax technique of applying a loss or credit from a current year to a later tax year. For example, a business net operating loss incurred in 2003 may be carried forward for 20 years.

cash method of accounting Reporting income when actually or constructively received and deducting expenses when paid.

charitable organizations Tax-exempt organizations to which contributions can be made on a tax-deductible basis. Charitable organizations may *not* be treated as designated beneficiaries of IRAs or qualified retirement plan benefits.

child For tax purposes, different definitions apply for different purposes (with as many as five different definitions covered in this book).

child and dependent care credit A credit of up to 35 percent of certain care expenses incurred to allow you to work.

child tax credit A credit in 2003 of up to $1,000 per eligible child (under the age of 17) if your income does not exceed certain limits.

conservation easement A right given to a charitable organization or government body to use land for recreation, the preservation of open space, or as plant or wildlife refuges.

constructive receipt A tax rule that taxes income that is not actually received by you but that you may draw upon.

continuing care facilities A living arrangement that provides a separate living unit, meals, and routine medical care.

cost-of-living adjustment An increase in a tax item due to the rate of inflation.

Coverdell education savings account (ESA) A special savings account to fund certain education expenses (formerly called an education IRA).

credit A tax credit that reduces tax liability on a dollar-for-dollar basis.

D

deductions Items directly reducing income for tax purposes. Personal deductions, such as medical expenses, are allowed only if you itemize them on Schedule A. Other deductions, such as alimony and student loan interest, are subtracted from gross income (even if other deductions aren't itemized).

deferred compensation A portion of earnings withheld by an employer (or put into a retirement plan) for distributions to the employee at a later date. If certain requirements are met, the deferred amounts are not currently taxable but are taxed when received at that later time (typically retirement).

defined benefit plan A retirement plan that pays fixed benefits based on actuarial projections.

defined contribution plan A retirement plan that pays benefits based on contributions to individual accounts, plus accumulated earnings. Contributions generally are based on a percentage of salary or net earnings from self-employment.

dependency exemption A fixed deduction allowed to every taxpayer, except anyone who may be claimed as a dependent on another taxpayer's return. Extra dependency exemptions are allowed for a spouse on a joint return and for each qualifying dependent.

dependent A person supported by another person. If certain tests are met, a dependency exemption may be claimed for the dependent.

designated beneficiary A person (or trust) in existence on September 30 of the year following the death of an IRA owner or employee who is named in an IRA or qualified retirement plan to receive distributions.

dividends Payments by corporations to shareholders from earnings and profits ("qualified" dividends are taxed at capital gains rates).

E

earned income Compensation for performing work. You must have earned income to make an IRA contribution or claim the earned income credit.

earned income credit A tax credit allowed to a taxpayer with earned income (or AGI) below certain thresholds.

education credit A credit for paying certain qualified higher education costs. There are two types: the Hope credit and the lifetime learning credit.

educator For purposes of the deduction for educator expenses, educators are teachers, aides, counselors, and principals in grades K–12 who work at least 900 hours during the school year.

elective deferral A portion of an employee's salary withheld and contributed to a 401(k) or other retirement plan. These amounts are not currently taxed as salary.

estate tax A tax imposed on the value of a decedent's taxable estate, after deductions and credits.

estimated tax Advance payment of current tax liability based either on wage withholding or on installment payments of estimated tax liability. Payments must meet certain requirements to avoid underpayment penalty.

exemption For AMT purposes it is an amount subtracted from alternative minimum taxable income. For estate, gift, and generation-skipping transfer tax purposes, it is an amount that is translated into a credit to offset the applicable tax. *See also* **dependency exemption.**

F

fair market value What a willing buyer would pay to a willing seller when neither is under any compulsion to buy or sell.

fellowship *See* **scholarship.**

first-year expensing A deduction up to a set dollar limit for the cost of business equipment placed in service in the year. This deduction is also called a Section 179 deduction.

529 plan *See* **qualified tuition plan.**

flexible spending arrangement (FSA) A salary reduction plan that allows employees to pay for medical coverage or dependent care expenses on a pretax basis.

foreign child A child who is not a U.S. citizen or resident at the time adoption efforts commence.

foreign earned income exclusion In 2003, up to $80,000 of foreign earned income is exempt from tax if a foreign residence or physical presence test is met.

401(k) plan A deferred pay plan authorized by Section 401(k) of the Internal Revenue Code under which a percentage of an employee's salary is withheld (called an elective deferral) and placed in a qualified retirement plan. Income on the elective deferrals accumulates on a tax-deferred basis until withdrawn by the employee (generally when he or she retires or leaves the company).

G

generation-skipping transfer (GST) tax A tax on a transfer that skips a generation (e.g., from grandparent to grandchild) in excess of an exemption amount ($1.12 million in 2003).

gift tax Gifts in 2003 in excess of $11,000 per donee annual exclusion are subject to gift tax, but the tax may be offset by a person's lifetime gift tax exemption amount.

gross income The total amount of income received from all sources before exclusions and deductions.

H

head of household Generally, an unmarried person who maintains a household for one or more dependents and is allowed to compute income tax based on head of household rates (which are more favorable than single person rates).

health reimbursement arrangement (HRA) An employer-funded account that can be tapped tax free to pay for medical expenses.

high-income taxpayers Taxpayers with AGI over a set limit who are subject to certain phaseouts or reductions in benefits. They are also subject to a different estimated tax safe harbor.

home sale exclusion A portion of gain on the sale of a main home that can be received tax free if certain conditions are met.

hybrid car Car powered by both gas and electricity; hybrid cars are eligible for a special $2,000 deduction.

I

incentive stock option (ISO) Option meeting tax law tests that defer regular income tax on the option transaction until the obtained stock is sold (but the exercise of ISOs may give rise to AMT).

inclusion amount In the case of cars leased for business, an amount that must be added back to income for cars that initially have a fair market value over a set dollar amount.

income shifting A tax technique designed to shift income among family members from one who is in a higher tax bracket to another in a lower tax bracket.

indexing *See* **cost-of-living adjustment.**

individual retirement account (IRA) A retirement account to which a limited contribution is permitted annually from earned income (or alimony), but deductions are restricted for active participants in qualified retirement plans who earn over set amounts.

installment sale A sale of property that allows for tax deferment if at least one payment is received after the year in which the sale occurs. The installment method does not apply to year-end sales of publicly traded securities. Dealers may not use the installment method. Investors with very large installment balances could face a special tax.

irrevocable trust Trust that cannot be changed by the creator once it comes into existence.

itemized deductions Items, such as medical expenses, home mortgage interest, and state and local taxes, that are claimed as write-offs on Schedule A of Form 1040 in lieu of claiming the standard deduction. Itemized deductions are subtracted from AGI to arrive at taxable income. The amount of itemized deductions is subject to a reduction when AGI exceeds certain limits.

J

joint return A return filed by a married couple reporting their combined income and deductions. Joint return status generally provides tax savings over filing separate returns for married couples.

K

kiddie tax The tax on investment income in excess of $1,500 in 2003 of a child under age 14, based on the parents' top marginal tax rate and computed on Form 8615.

L

Liberty Zone Generally the area in New York City below Canal Street that was affected by the September 11 terrorist attack.

long-term capital gain or loss Gain or loss on the sale or exchange of a capital asset held more than one year.

luxury car Car costing more than a certain amount; luxury cars are subject to dollar limits on depreciation, trigger inclusion amounts if leased, and result in excise taxes.

M

marital deduction An estate and gift tax deduction for assets passing to a spouse. In the case of a spouse who is a U.S. citizen, it allows for completely tax-free transfers.

marriage penalty The additional tax paid by a married couple that would not be owed if they had remained single.

miscellaneous itemized deductions Generally itemized deductions for job and investment expenses subject to a limit of 2 percent of AGI.

modified adjusted gross income (MAGI) This is generally adjusted gross income increased by certain items (e.g., tax-free foreign earned income). MAGI is used to determine the phaseouts for certain deductions and credits.

moving expenses Certain expenses of moving to a new job location are deductible if distance and time tests are met.

N

net operating loss (NOL) A business loss that exceeds current income may be carried back against income of prior years and carried forward as a deduction from future income until eliminated.

O

ordinary income Income other than capital gains.

ordinary loss A loss other than a capital loss.

P

personal exemption A deduction of $3,050 in 2003 that every taxpayer may claim for himself or herself (other than someone who can be claimed as a dependent of another taxpayer).

placed in service The time when a depreciable asset is ready to be used in business. The date fixes the beginning of the depreciation period or eligibility for first-year expensing.

probate estate Property held in a decedent's name passing by will (or under the terms of state laws of intestacy).

profit-sharing plan A defined contribution plan under which the amount contributed to employees' accounts is based on a percentage of the employer's profits.

Q

qualified plan A retirement plan that meets tax law tests and allows tax deferment and tax-free accumulation of income until benefits are withdrawn. Pensions, profit sharing, SEPs, and SIMPLEs are qualified plans.

qualified tuition plan A higher education savings plan sponsored by a state or private institution.

qualifying widow or widower A filing status entitling the taxpayer with a dependent to use joint tax rates (and the standard deduction for joint filers) for up to two years after the death of a spouse.

R

refundable tax credit A credit that entitles you to receive a refund even if the amount exceeds your tax for the year.

required minimum distribution (RMD) Annual withdrawal from an IRA or a qualified plan designed to avoid a 50 percent penalty.

retirement savings contributions credit A credit for elective deferrals or IRA contributions that may be claimed by a person with income below a set limit (in addition to any other tax benefit related to the elective deferrals or IRA contributions).

revocable trust A trust that may be changed or terminated by its creator (e.g., a living trust). Such trusts generally do not provide any income tax savings to the creator.

rollover A tax-free reinvestment of a distribution from a qualified retirement plan or IRA into another plan or IRA within 60 days.

Roth IRA A nondeductible IRA that allows for tax-free accumulation of earnings.

S

salary reduction agreement Consent to have an employer withhold a portion of wages that will be contributed to a qualified retirement plan or flexible spending arrangement. Such amounts are not currently taxed as wages.

savings incentive match plan for employees (SIMPLE) A type of retirement plan funded by elective deferrals and employer matching contributions.

scholarship A grant to a degree candidate receiving tax-free treatment if used for tuition and course-related expenses.

Section 179 deduction *See* **first-year expensing.**

Section 457 plan A deferred compensation plan set up by a state or local government or a tax-exempt organization that allows tax-free deferrals of salary.

self-employed person An individual who operates a business or profession as a proprietor or independent contractor and reports self-employment income on Schedule C.

self-employment tax Social Security and Medicare taxes paid by a self-employed person. The Social Security portion is 12.4 percent of net earnings from self-employment up to $87,000 in 2003. The Medicare portion is 2.9 percent of all net earnings from self-employment. One-half of the total self-employment tax is deductible.

separate returns Returns filed by married persons who do not file a joint return. Filing separately may save taxes where each spouse has separate deductions, but certain tax benefits require joint filing.

short-term capital gain or loss Gain or loss on the sale or exchange of a capital asset held one year or less.

simplified employee pension (SEP) plan An IRA-type plan set up by an employer or self-employed person rather than an employee.

single The filing status of a person who is unmarried on December 31 of the year for which a return is filed.

special-needs child For purposes of a Coverdell ESA, this is a child who needs more time to complete his or her education because of a physical, mental, or emotional condition. For purposes of the adoption credit, this is a child under age 18 who is physically or mentally incapable of self-care.

standard deduction A fixed deduction allowed to those who do not itemized deductions. The amount depends on filing status, age, and whether a person is blind.

standard mileage rate A fixed rate set by the IRS for deducting auto expenses in lieu of deducting actual costs.

T

taxable income Net income after claiming all deductions (including personal exemptions).

tax bracket In 2003, there are six individual federal income tax brackets—10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent.

tax-free exchange A trade of property that defers the recognition of gain until the property received in the transaction is later disposed of (but only if qualified property is involved).

tax preference items Items that may subject a taxpayer to the alternative minimum tax (AMT).

terrorist victim Person injured or killed in or as a result of the Oklahoma City bombing on October 19, 1995; the attacks on September 11, 2001; or anthrax incidents occurring after September 10, 2001, and before January 1, 2002.

trust An arrangement under which one person transfers legal ownership of assets to another person or corporation (the trustee) for the benefit of one or more parties (beneficiaries).

U

unearned income Investment income or other income that is *not* derived from performing work for pay.

V

vesting The process of accruing an interest in contributions that are treated as earned. Employee contributions are always 100 percent vested. Employer contributions may be immediately vested or vested over a set schedule.

W

withholding An amount taken from income as a prepayment of tax liability for the year. In the case of wages, the employer withholds part of every wage payment for this purpose.

Index