

NEW WAYS AND PROVEN WAYS TO SAVE TAX

With the third-largest tax cut in U.S. history now in effect, 2003 promises to be a year of significant savings for many taxpayers. Even better, many provisions of the new law will enable individuals and businesses to reduce taxes for years to come. At a time when the economy has given us little to cheer about, this is good news indeed.

In some areas, savings will be automatic and widespread, as tax rates are cut by two percentage points in most brackets. But in other areas, such as investments, careful planning and timing will be required to take full advantage of the changes in the tax code.

While the new law alters the tax environment, it does not change basic tax planning principles or make proven strategies obsolete. You'll still want to think about timing income and deductions, making donations, and claiming all possible credits. But more than ever, you'll want to have a tax plan.

So please review this guide carefully, then consult an advisor for more on ways to reduce taxes and achieve your financial goals.

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The best way to use this guide is to identify those areas that may have the greatest effect on you or your business and discuss them with your tax advisor. The information in this guide is not intended for use without personalized professional assistance. If you need to discuss any issues in this guide, please contact your tax advisor. ©2003 07/03

New Law's Few Changes Carry Enormous Effect

Despite the controversy that preceded its arrival, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) actually contains a somewhat small number of provisions — certainly nothing that compares with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). So does this mean the new law's impact is also minor? Not at all. In fact, JGTRRA opens up a remarkably wide range of tax saving opportunities. But, like its 2001 predecessor,



many of the law's provisions change over the next several years and, unless extended, will apply only for a limited number of years. So immediate attention — and action — is key. Read on for an overview of the act.

INSPIRATION FOR INVESTORS

Dropping capital gains tax rates. The top long-term capital gains rate drops from 20% to 15%. And gains that previously would have been taxed at 10% or 8% are now taxed at 5% and will not be taxed at all in 2008. The rates apply to long-term gains from sales, exchanges and installment payments received on or after May 6, 2003, and before Jan. 1, 2009.

Improving tax treatment of dividend income.

Starting this year and continuing through 2008, for individual shareholders, the tax rate on qualified dividend income from domestic and qualified foreign companies has been reduced to 15% — the same as the new long-term capital gains rate. This rate takes effect retroactively to Jan. 1, 2003, about four months earlier than the new capital gains rates.

BOOSTS FOR BUSINESSES

Bumping up bonus depreciation. JGTRRA builds on the first-year bonus depreciation deduction introduced in the Job Creation and Worker Assistance Act of 2002. Now companies may write off 50% of the cost of qualifying new assets acquired on or after May 6, 2003, and placed in service before Jan. 1, 2005. Property will not be eligible if a binding contract for its acquisition existed before May 6, 2003. But property acquired before that date may still qualify for the previous law's 30% bonus depreciation.

Swelling the Section 179 expensing limit.

Eligible new and used property placed in service during 2003, 2004 and 2005 now qualifies for a \$100,000 deduction (up from the previous \$25,000) in lieu of depreciation.

Plus, the \$200,000 phaseout amount has increased to \$400,000 for qualifying equipment put in service during those same years.



Extending the corporate estimated tax deadline.

The new tax law allows 25% of the amount of any required installment of corporate estimated tax that is otherwise due on Sept. 15, 2003, to be paid by Oct. 1, 2003.

SAVINGS FOR SOME OR ALL

Expanding the 10% bracket. JGTRRA increases the taxable income that falls into the 10% bracket to the first \$14,000 for married couples filing jointly (up from \$12,000) and the first \$7,000 for singles or married persons filing separately (up from \$6,000). The \$10,000 amount for heads of household doesn't change.

Accelerating overall tax rates. Other tax rates above 15% were previously scheduled to drop at least two percentage points by 2006. But the new law accelerates all of those changes to this year. That means, beyond the 15% bracket, regular income tax rates are 25% (down from 27%), 28% (down from 30%), 33% (down from 35%) and 35% (down from 38.6%). But EGTRRA's sunset provision still stands, so all could return to their pre-2001 levels in 2011.



Chart 1
Marriage Penalty Relief

Year	Standard Deduction¹	End of 15% Bracket²
2002	167%	167%
2003 and 2004	200%	200%
2005	174%	180%
2006	184%	187%
2007	187%	193%
2008	190%	200%
2009 and 2010	200%	200%
2011	167%	167%

¹For joint returns as a percentage of deduction for single returns.

²For joint returns as a percentage of end of single bracket.

Source: U.S. Internal Revenue Code

Softening the marriage penalty. The act increases the standard deduction for married couples filing jointly from 167% to 200% of a single filer's deduction. Plus, the 15% tax bracket for joint filers is now also 200% that of singles and will remain so through 2004. These amounts will be in flux for some time because, in 2005, they go back to the percentages under EGTRRA. (See Chart 1.)

Easing the alternative minimum tax (AMT). For 2003 and 2004, the AMT exemption increases from \$49,000 to \$58,000 for joint filers, from \$35,750 to \$40,250 for single filers and from \$24,500 to \$29,000 for married persons who file separately. These amounts expire after 2004, returning the exemptions to pre-2001 levels of \$45,000, \$33,750 and \$22,500, respectively.

Nurturing the Child credit. The credit increases from \$600 to \$1,000 this year. 🏠

Tax Changes Make Savvy Strategies A Must for Investors

Ask many people to define successful investing and they might say, “Why a healthy return, of course.” But true success isn’t what you get, it’s what you keep. And to that end, planning — for income taxes as well as for other factors, such as long-term investment and family goals — is a must. Plus, this year it’s even more important with the new rates affecting dividends and capital gains. Let’s consider some ways to keep more of your gains and suffer less from your losses.

Consider dividend-paying stocks. With the introduction of the lower 15% maximum federal tax rate on dividends, dividend-paying stocks became more valuable. But many saw price increases before the tax legislation was even signed into law, perhaps offsetting the tax advantage with an inflated price. Don’t let tax considerations dictate your portfolio allocations, but the law change may serve as a reminder that dividend-paying stocks may have a place in your portfolio.

Reduce turnover. Selling stocks frequently or holding mutual funds with high turnover rates tends to repeatedly create capital gains. Long-term capital gains — gains on assets you have owned more than one year — are taxed at lower rates than regular income. Through May 5, 2003, long-term gain rates were typically 20%. After that date, they are typically 15%. (See Chart 2.)



This means the maximum differential between long- and short-term gain rates is greater than before, at a variance to 20 percentage points (35% vs. 15%). Thus, holding stocks long-term or choosing funds that provide long-term gains could save you more tax dollars than ever. Certain mutual funds have realized and unrealized capital losses that could also save you tax dollars. But funds with high turnover rates could incur high expenses, so consider overall performance when selecting funds.

Chart 2

Capital Gain Regular Tax Rates

Asset Type and Holding Period	Sales Through May 5, 2003	Sales After May 5, 2003
Held 12 months or less	35%	35%
Held more than 12 months	20%	15%
Exceptions to the 20% or 15% rates:		
Collectibles, such as artwork	28%	28%
Gain attributable to depreciation on real property	25%	25%
Assets purchased after Dec. 31, 2000, and held more than 5 years	18%	15%
Qualified small business stock held more than 5 years	14%	14%
Gain that would be taxed at 10% or 15% based on your regular income tax rate	10%	5%
Assets purchased after Dec. 31, 2000, and held more than 5 years that otherwise would be taxed in the 10% or 15% bracket	8%	5%

Source: U.S. Internal Revenue Code

Time capital gains and losses. Recognizing some losses when you already have recognized gains lets you offset them and even claim up to an additional \$3,000 per year. Or, if you already have recognized a capital loss, you have the freedom to recognize capital gains that will be absorbed by the loss, without concern about paying a tax, or opt to carry forward a loss. If you have pre-May 6, 2003, gains still taxed at the old 20% rate, consider offsetting them with losses before year end.

Be creative when selling assets. An installment sale allows you to defer capital gains on most assets other than personal residences or publicly traded securities. You can reduce your overall tax burden by spreading the gain over several years as you receive the proceeds. Or, if you invest in rental real estate, consider a like-kind exchange. You may be able to defer gain over the time you hold the replacement property, though you will reduce your depreciation deductions on that property.



Identify which shares you have sold. Sell high-tax-basis shares when possible to reduce gain or increase your loss and offset other gains. If you bought the same security at different times and prices, you must identify which shares you have sold when you file your tax return or you're deemed to have sold the shares on a first-in, first-out (FIFO) basis. If you hold actual stock certificates, you must surrender the appropriate ones.



Turn bad investments into something good. A failed investment is never a pleasant experience. But you can add a silver lining to this dark cloud by showing that a security or nonbusiness loan is fully worthless. To do so, you must prove that the security has absolutely no value. Be careful: Even if it retains a negligible value, you may not be able to claim it as worthless. One way to eliminate this remaining small value is to sell it through a bona fide sale to an unrelated party for a nominal amount. To take the loss in 2003, you must finalize the sale before year end or abandon the asset or investment. To claim a bad debt on a nonbusiness loan, you must be able to show it became totally worthless by year end and that you have made a reasonable attempt to collect on it.

Weigh the tax impact of bonds. Although interest on U.S. government obligations is taxable on your federal return, such interest generally is exempt on your state and local returns. In contrast, interest on state and local government bonds is excludable on your federal return. If the state or local bonds were issued in your home state, interest also may be excludable on your return for that state. But corporate bond interest is fully taxable for federal and state purposes.

Swap your bonds. With a bond swap, you sell a bond, take a capital loss and then immediately buy another bond of similar quality from a different issuer. The wash sale



rule (see “Avoid the Dirty Consequences of Wash Sales” on page 11) doesn’t apply to such a transaction, because the bonds are not substantially identical. Thus, you achieve a tax loss with virtually no change in economic position.

Beware of “original issue discount” income.

This originates from investments that generate annual interest — even those that don’t annually pay you this interest — such as a bond (except a U.S. savings bond) with original issue discount (OID), where you receive the “interest” as the bond rises toward its maturity price. The IRS contends you earn a portion of that interest annually, and expects you to pay taxes on that interest. So, these investments may be best suited for tax-deferred vehicles such as IRAs and Keogh plans, or investors with sufficient other cash flow to absorb these taxes.

Exercise sound judgment with stock options.

During last decade’s economic boom, stock options became a common means of attracting new employees and compensating key executives. But in today’s more unpredictable times,

these perks' value has also become less certain. Thus, think carefully before exercising (or postponing exercise of) options and before deciding to exercise and buy stock or sell it immediately. Complicated tax rules may substantially add to your tax liability if you act hastily — or be minimized if you plan properly. At the same time, financial risks can be great if you focus solely on getting the best tax treatment.

Use the investment interest expense deduction.

You can deduct investment interest — up to your net investment income for the year — on any money you borrow to buy or carry taxable investments. But you can't include long-term capital gains in your net investment income for investment interest deduction purposes without waiving the favorable 15% or 20% rate and subjecting your gains to your higher ordinary

Tax Action Strategy

Avoid the Dirty Consequences of Wash Sales

An often overlooked provision known as the wash sale rule prevents you from taking a loss on a security if you buy an identical or significantly similar security (or option to buy a security) within 30 days before or after you sell it. If you violate this rule, you can realize a loss only when you sell the replacement security.

Fortunately, there are several ways around the wash sale rule. For example, consider buying securities of a different company in the same industry or shares in a mutual fund that holds securities much like the one you sold. Alternatively, consider doubling up on your investment for a 31-day period before selling the original shares or selling and then waiting 31 days to repurchase.

income tax rate. Similarly, you can count dividends as investment income only if you waive the use of the 15% tax rate.

Maintain a constant awareness of your portfolio. For instance, if you hold taxable bonds for the purpose of generating income and diversifying your overall portfolio, consider holding them in an IRA or qualified retirement plan where there won't be a tax cost. Try to own dividend-paying stocks that qualify for the 15% rate outside of retirement plans so you will benefit from the lower rate. And keep real estate investment trusts (REITs) in your retirement plan if possible, because they don't qualify for the special dividend rate.

Or compare the yield on tax-exempt bonds versus the yield on taxable bonds. Based on the spread and your tax bracket, tax-exempt bonds may be a better choice — though the alternative minimum tax (AMT) must be considered. Don't let taxes prevent you from creating an overall portfolio that suits your financial plan, but try to organize it in the most tax-efficient manner.

Don't forget about the AMT. The new 15% and 5% long-term capital gain and dividend rates also apply for AMT purposes. But the AMT is still a powerful force to be reckoned with. In fact, the lower overall tax rates as well as the special dividend and long-term capital gains rates may actually make it easier to fall into the AMT. So monitor your situation throughout the year, and take action as necessary to either avoid the AMT or make its lower maximum rate work to your advantage. 🏠

Business Victory Calls for Keen Use of New Tax Act and Other Planning

What separates successful companies from less prosperous ones isn't the words in their advertising campaigns or the numbers on their balance sheets, it's the people. And no one is more important than you — the business owner. Here are some ways you, as your company's champion, can use the new tax act and other strategies to ride to victory this year.

Consider business structure.

Businesses may operate under a variety of structures, ranging from sole proprietorship to C corporation. Income taxation and owner liability are the main



factors that differentiate one from another, but there are other factors to consider as well.

For instance, with this year's tax law changes, most new businesses will still lean toward the flow-through taxation of a sole proprietorship, partnership, limited liability company (LLC) or S corporation. Maximum federal tax rates are now identical at 35% for individuals and corporations, taking away one of the advantages of the C corporation. (While individual rates decreased for 2003, corporate rates stayed as they were.) At the same time, double taxation of dividends or sales of a business are less of a factor than in the past because of the new lower rates — though still not an issue to ignore.



When possible, defer income. In potentially high-income years, consider deferring some income to later years. For example, if your business uses the cash method of accounting, you can delay billing notices as you approach year end and pay as many expenses as possible. Or, if you use the accrual method, you can delay shipping products or delivering services until the new tax year. Of course, consider the business risks of these strategies.

Make the most of deductions. Businesses, especially sole proprietorships, often overpay taxes because of missed tax deductions. Unlike separate business entities where all expenditures are accounted for, proprietorship expenses may be commingled with personal expenses, and this can be overlooked. Review your expenses to avoid making the same mistake. Generally, ordinary and necessary expenses incurred while conducting your trade or business are deductible.

Chart 3

Corporate Federal Income Tax Rates

Taxable Income	Tax	% on Excess ¹
\$0	\$0	15%
\$50,000	\$7,500	25%
\$75,000	\$13,750	34%
\$100,000	\$22,250	39%
\$335,000	\$113,900	34%
\$10 million	\$3,400,000	35%
\$15 million	\$5,150,000	38%
\$18,333,333	\$6,416,667	35%

¹ Personal service corporations taxed at flat 35% rate.

Source: U.S. Internal Revenue Code

Claim the executive compensation deduction.

A business is entitled to a deduction for reasonable compensation paid or incurred during the taxable year. Keep this deduction in mind when assessing your company's tax liability. Another effective strategy is using certain types of deferred compensation programs, including tax-advantaged qualified plans — such as pension, profit-sharing and 401(k) plans — and nonqualified plans that can be more creative.

Write off bad debts. Business bad debts are treated as ordinary losses and can be deducted when either partially or wholly worthless. For individuals and certain other entities, the IRS may consider loans made to closely held corporations as investments and, if not repaid, reclassify them as nonbusiness bad debts, which are treated as short-term capital losses. You can carry back net operating losses two years — this amount has returned to its previous number now that the expanded

five-year period brought by the Job Creation and Worker Assistance Act of 2002 has elapsed — or elect to forgo the carryback period and carry forward the loss.

Deduct equipment purchases. Many taxpayers assume that equipment with a useful life well beyond the taxable year must be capitalized. Although this is generally true, an exception exists in the form of a de minimis rule, which allows current deductions for minor expenditures as long as they clearly reflect income. You may also take a current deduction for equipment repairs and maintenance expenses.

Take advantage of depreciation rules.

Careful planning during the year can help you maximize the deduction in the year of purchase.

You generally will want to use the



Modified Accelerated Cost Recovery System (MACRS), instead of the straight-line method, to get a larger deduction in the early years of an asset's life. The IRS generally treats all newly acquired tangible assets other than real estate as being placed in service at the midpoint of the year. This gives you six months of depreciation in the first year. But if you made more than 40% of the year's asset purchases in the fourth quarter, you may be required to use the generally less favorable midquarter convention. You also may be eligible for special "bonus" depreciation. (See "Use the New 'Bonus' Depreciation Deduction.")

Use your vehicle. The new tax law curiously also benefits those who buy midsize to large sport utility vehicles and use them primarily for business purposes. Vehicles



rated above 6,000 pounds, which now include a variety of foreign and domestic models, qualify for the expensing allowance of up to \$100,000, and they aren't subject to the luxury auto limits that otherwise apply to vehicles. The maximum first-year depreciation for the "under three ton" category is now \$10,710.

Tax Action Strategy

Use the New "Bonus" Depreciation Deduction

Thanks to the two recent tax law changes, eligible companies can now write off additional "bonus" depreciation for new equipment purchases and certain leasehold improvements. For purchases or improvements made, you may be able to write off 50% of these costs after May 6, 2003, but before Jan. 1, 2005. Thus, your company can immediately write off 50% of a new asset's cost and recover the remaining 50% under regular depreciation schedules.

This figure is increased from the 30% that is allowable as bonus depreciation from Sept. 11, 2001, through Sept. 11, 2004. Taxpayers may elect to claim 30% instead of 50% bonus first-year depreciation for qualifying property, or elect not to claim any bonus depreciation at all.

Expense when you can. The Section 179 expense election allows a current deduction for assets that otherwise would be subject to the normal depreciation rules. Thanks to the new tax law, this amount has now been increased to \$100,000 for 2003 and 2004, and now specifically includes “off-the-shelf” computer software. These increased dollar amounts are inflation-indexed for tax years beginning after 2003, but in 2005 the rules go back to the way they were before JGTRRA. So it may be appropriate to schedule major capital additions in 2003 or 2004 when the greatest tax benefits are available. And if you have more than the maximum \$100,000 limit, choose those assets for expensing that would have had the longest life under the regular depreciation rules.

Manage your inventory for tax savings. You must calculate the dollar amount of inventory you have on hand at year end. If inventory value is low and therefore the cost of merchandise sold is higher, your taxable income will be lower — so the inventory method you choose can significantly affect your taxable income.



Maximize tax credits. They reduce a business's tax liability dollar-for-dollar. Credits available to businesses include Welfare-to-Work, Work Opportunity, Empowerment Zone, and Research and Development.



Hire your kids. As the owner of an unincorporated business, you can hire your children and fully deduct their pay. Otherwise dependent children can earn as much as \$7,800 and pay zero federal income taxes if they use the income to support themselves. The children must perform actual work for wages in line with what you would pay nonfamily employees. And for kids under 18, you won't even owe any Social Security or Medicare taxes.

Benefit from tax breaks for the self-employed.

If you're self-employed, beginning in 2003 you can deduct 100% of your health insurance costs for yourself, your spouse and your dependents. This above-the-line deduction is limited to the income you've earned from your trade or business. You can also deduct above the line half of the self-employment tax you pay on your self-employment income. And you may be able to deduct home office expenses. 🏠

At-a-Glance Tax Strategizer

TAX STRATEGY	HOW IT WORKS
Accelerate or Defer Income	If you expect to be in a higher tax bracket next year, accelerating income into the current year can reduce your taxes because you will be taxed at a lower rate. If you expect to be in a lower tax bracket next year, then the opposite approach — deferring income into the following year — can reduce your taxes. Even if your marginal bracket remains the same, deferring income to a later year generally will be advantageous.
Maximize Above-the-Line Deductions	You can take above-the-line deductions — the income adjustments that determine adjusted gross income (AGI) — in addition to the standard deduction or itemized deductions. And because AGI determines your eligibility for various deductions, exemptions and credits, this strategy can further reduce your taxes.
Maximize Itemized Deductions	Claiming itemized deductions will save you tax if your total itemized deductions exceed the standard deduction. (For 2003, the standard deduction is \$4,750 for single and married filing separately, \$7,000 for head of household, and \$9,500 for married filing jointly.) And, by bunching certain deductible expenses in one year, you may be able to exceed applicable floors.
Claim Every Possible Exemption	Similar to deductions, exemptions reduce the amount of income you pay tax on, so the more exemptions you can claim, the lower your tax bill.
Make the Most of Tax Credits	While adjustments, deductions and exemptions reduce the amount of income subject to tax, tax credits take dollars directly off your tax bill, so they are particularly valuable tax-savings tools.
Plan for the Alternative Minimum Tax (AMT)	If you're subject to the AMT, consider timing the recognition of income and payment of deductible expenses to minimize liability. If you paid the AMT in a previous year, you may be able to claim a credit, depending on which adjustments generated the AMT.

ITEMS TO CONSIDER

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Your gross income includes all forms of income received, such as from wages, salaries and tips; interest; dividends; profits and losses from a business; capital gains and losses (see page 8); rents, royalties, partnerships, S corporations and trusts; unemployment compensation; alimony; Social Security benefits; IRA and pension distributions (see page 29); and refunds of state and local income taxes.

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Possible adjustments include IRA, SEP, SIMPLE or Keogh plan contributions (see page 26); alimony paid; moving expenses; self-employment tax (see page 19); self-employed health insurance (see page 19); penalty on early withdrawal of savings; student loan interest (see page 25); and some higher education expenses (see page 24).

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Possible itemized deductions include interest expense (see page 11 and page 35); foreign, state and local income taxes, and state property taxes (see page 35); charitable contributions (see page 37); casualty and theft losses; gambling losses; and miscellaneous expenses, such as unreimbursed employee expenses, tax preparation fees, investment fees and expenses, safe deposit rental charges, and expenses incurred to protect income or capital.

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For 2003, you are allowed a \$3,050 exemption each for yourself, your spouse, your dependent children and any additional dependents. Possible additional dependents include parents, nieces and nephews, and other relatives whom you may be supporting.

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Possible tax credits include the Child, Adoption, and Dependent Care credits (see page 33); and the Hope and Lifetime Learning credits (see page 22).

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You will be subject to the AMT if your AMT liability exceeds your regular tax liability. AMT liability is determined by adding various tax adjustments back to your taxable income and deducting an exemption depending on filing status: \$40,250 for single and head of household, \$58,000 for married filing jointly. Rates are 26% on the first \$175,000 of AMT income and 28% for income over that amount.

Families and Students Have Many Tax-Smart Options

Families endure much together. But one thing they needn't tolerate is unnecessarily high tax liability. Nor should they suffer excessive financial duress because of a college education. Read on for some tips on how families can lower their tax bills — now more than ever with the higher Child credit — and mitigate school costs. (Some of these suggestions may help the students themselves, too.)

Shift income to children. In 2003, you and your spouse together can gift up to \$22,000 of assets annually free of federal gift tax to each of your

Tax Action Strategy

Teach Yourself About Education Credits

When those kids hit college, you may be able to claim a Hope credit for the first two years of post-secondary education. For qualified tuition and related expenses required for enrollment on at least a half-time basis, the maximum credit, now adjusted annually for inflation, is \$1,500 per student for 2003.

Similarly, you may be eligible for the Lifetime Learning credit of up to \$2,000 per taxpayer for an unlimited number of years of postsecondary, graduate and certain other education expenses. If your child pays his or her own qualified expenses and you don't claim him or her as a dependent, your child may be able to claim the Hope or Lifetime Learning credit on his or her return.

children or grandchildren. For children under age 14, unearned income beyond \$1,500 will be taxed at their parents' marginal rate — so the income tax benefit of shifting income to them is limited. But for children ages 14 and older, all of their income (earned and unearned) will be taxed at their own, generally lower marginal rates.

Take advantage of tax credits. You may be able to claim the \$1,000 Child credit for each child under 17. And you may also be eligible for the Dependent Care credit, which is worth at least 20% of qualifying expenses. If you adopt, you may be able to take the maximum Adoption credit or the adoption assistance program income exclusion of \$10,160 per eligible child. Note that your alternative minimum tax (AMT) liability does not reduce any of these credits. Also remember that these credits include restrictions and phase out if your income is above a certain level. (See Chart 4.)

Chart 4

2003 Family and Education Tax Break Phaseouts

Tax Break	Adjusted Gross Income Phaseout Ranges	
	Single Filers	Joint Filers
Adoption credit	\$152,390 – \$192,390	\$152,390 – \$192,390
Hope credit	\$41,000 – \$51,000	\$83,000 – \$103,000
Lifetime Learning credit	\$41,000 – \$51,000	\$83,000 – \$103,000
Student loan interest deduction	\$50,000 – \$65,000	\$100,000 – \$130,000
ESA contribution	\$95,000 – \$110,000	\$190,000 – \$220,000

Source: U.S. Internal Revenue Code

Grab education-expense deductions. Speaking of college, you may be able to deduct above the line a portion of qualified higher education expenses. The expenses are defined the same as for the Hope credit. (See “Teach Yourself About Education Credits” on page 22.) In 2003, taxpayers with AGIs not exceeding \$65,000 for singles and \$130,000 for joint filers will be eligible for a maximum annual deduction of \$3,000 in 2003, rising to \$4,000 in 2004. Further, you may exclude from income qualified employer-provided education assistance, including for graduate-level courses.



Consider a Section 529 plan.

Also known as qualified tuition programs, these state-sponsored plans enable parents or grandparents to either secure current tuition rates with a prepaid tuition program or create tax-free savings accounts to fund college expenses. Considerable income tax advantages may follow. Your contribution may qualify for the \$11,000 annual gift tax exclusion (\$22,000 for gifts by married couples). In fact, only for 529 plan contributions, you can elect to use annual exclusions for five years all at once (for example, a \$55,000 contribution or a \$110,000 joint gift). Distributions used to pay qualified higher education expenses will be free of federal income taxes though possibly subject to individual state taxes. (This provision will expire in 2010 unless Congress extends it.) Last year, the definition of “qualified tuition program” expanded to include certain prepaid tuition programs established and maintained by eligible private education institutions.

Deduct student loan interest. You may be able to deduct up to \$2,500 of interest above the line. Last year, the first-60-months limit was eliminated and AGI phaseout ranges rose. They are now adjusted annually for inflation. (See Chart 4 on page 23.)

Cover more education costs with Coverdell ESAs. Previously known as education IRAs, Coverdell education savings accounts (ESAs) offer some key advantages. Subject to certain income limitations (see Chart 4 on page 23), in 2003 you can contribute \$2,000 annually to such a plan to benefit a child under 18. The contribution is not deductible, but distributions of earnings will be tax-free if used to pay for the beneficiary's qualified education expenses, including not only postsecondary expenses, but also elementary and secondary school expenses. And you may both claim the Hope or Lifetime Learning credit (see "Teach Yourself About Education Credits" on page 22) and take tax-free ESA distributions as long as you don't use the ESA funds to pay the same expenses for which you claim the credit. The deadline for contributions is the due date of the income tax return for the year of contributions — April 15 of the following year.

Add to your child's tax-smart savings with a Roth IRA. Roth IRAs are perfect for teenagers in low tax brackets with many years to let their accounts grow tax free. The dollar limit for minors is the same as for adults under 50: the lesser of \$3,000 or 100% of earned income from a legitimate job reported on their tax returns. (This amount will rise in 2005 and again in 2008 — see Chart 5 on page 27.) ❏

Retirement Can Bring Tax Savings Today And Tomorrow

Thinking about retirement should put a smile on your face. But like many, you may find yourself frowning instead at the many planning challenges involved. Never fear — many options exist that can help you enjoy tax savings not just during retirement, but right here and now.

Contribute to a traditional IRA, Keogh or SEP.

You may be able to take an above-the-line deduction for traditional IRA contributions up to \$3,000 or 100% of earned income, whichever is less. Taxpayers age 50 and up can also make “catch-up contributions” of up to \$500. The contribution limit will increase in future years. (See Chart 5.) You may also be able to deduct contributions to a Keogh or single-employee Simplified Employee Pension (SEP). Earnings in all three plans accumulate tax deferred. This year, annual contribution limits for defined contribution Keogh plans remain at \$40,000. The benefit limit for defined benefit Keogh plans also stays put at \$160,000, as does the \$40,000 limit on single-employee SEP contributions.

Consider a Roth IRA. Like a traditional IRA, this may allow you to make annual contributions of the lesser of \$3,000 (reduced by contributions to all your other IRAs annually) or your compensation for the year, plus a catch-up contribution of \$500 if you are age 50 or over. The contribution limits will increase in future years. (See Chart 5.)

Chart 5

Retirement Plan Contribution Limit Increases

Year	401(k)s, 403(b)s, 457s and SEPs	For Taxpayers 50 and Over
2003	\$12,000	\$14,000
2004	\$13,000	\$16,000
2005	\$14,000	\$18,000
2006	\$15,000	\$20,000
2007	\$15,000	\$20,000
2008	\$15,000	\$20,000

Year	Traditional And Roth IRAs	For Taxpayers 50 and Over
2003	\$3,000	\$3,500
2004	\$3,000	\$3,500
2005	\$4,000	\$4,500
2006	\$4,000	\$5,000
2007	\$4,000	\$5,000
2008	\$5,000	\$6,000

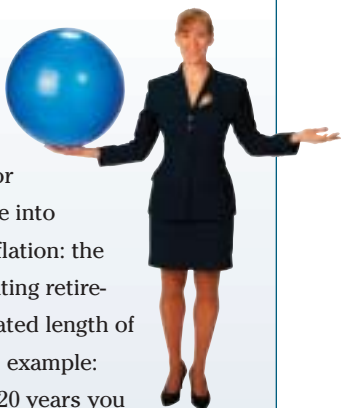
Year	SIMPLEs	For Taxpayers 50 and Over
2003	\$8,000	\$9,000
2004	\$9,000	\$10,500
2005	\$10,000	\$12,000
2006	\$10,000	\$12,500
2007	\$10,000	\$12,500
2008	\$10,000	\$12,500

Source: U.S. Internal Revenue Code

You can't deduct contributions, but you can take qualified distributions tax free.

Anticipate inflation's effect. If your retirement is many years in the future, considering how inflation will affect your retirement living expenses is especially important. After all, as measured by fluctuations in the U.S. Consumer

Price Index, inflation averaged 4% annually throughout much of the latter 20th century even if it is a bit lower today. For best results, you must take into account two periods of inflation: the time you will be accumulating retirement funds and the estimated length of your retirement. Here's an example: Assuming a rate of 4%, in 20 years you would need \$109,556 to make today's \$50,000 purchases. In contrast, those same purchases in five years would cost only \$60,833. The difference in these two figures speaks directly to the importance of anticipating inflation's effect on your retirement plan. Knowing exactly how much the cost of living will increase is impossible, but past inflation rates can help you generate a likely



Tax Action Strategy

Maximize Contributions to Employer-Sponsored Plans

You may be able to make pretax contributions to your 401(k), 403(b) or 457, or salary-reduction SEP plan up to the legal limit — \$12,000 for 2003 (\$1,000 more than in 2002). Plus, your employer may match some of your contributions — also pretax. And plan assets grow tax deferred.

Similarly, under a Savings Incentive Match Plan for Employees (SIMPLE), you may be able to elect to have your employer contribute up to \$8,000 of your salary rather than pay you cash (also \$1,000 more than in 2002). You exclude the contribution from income, and again assets grow tax deferred.

Contribution limits for 401(k)s, 403(b)s and SIMPLEs will gradually rise over the rest of this decade. And taxpayers age 50 and up can make additional “catch-up” contributions to these plans. (See Chart 5 on page 27.)

estimate. Equally important, life expectancies are increasing, and a longer retirement period means you'll need more assets built up so that your money can survive as long as you do.

Plan for retirement account withdrawals. With a few exceptions, withdrawals made before age 59½ are subject to a 10% penalty, but once you reach 70½, you must withdraw the minimum required amount or face a 50% penalty. New distribution rules for IRAs and other similar plans were finalized in early 2002. As a result, calculating the required minimum distribution is now easier. The rules also generally enable beneficiaries to withdraw IRA balances over their life expectancies so funds can grow tax deferred longer. And the rules enable your heirs to do a considerable amount of postdeath planning. Deciding whether to take distributions before 70½ or more than the minimum after that age depends on how much you will receive from other income sources, your life expectancy and other factors. Generally, maximizing tax-deferred growth provides more savings if you can afford to leave the funds in the plan — even if it means depleting other investment accounts.

Create a lump-sum strategy. When you retire (or change jobs), you may receive a lump-sum distribution from your employer's retirement plan. Consider rolling over the distribution to an IRA within 60 days. (Ideally, transfer by direct rollover to the IRA and avoid any income tax withholding issues.) Doing so will avoid current income tax (and potential penalties) while allowing the assets to continue to grow tax deferred. 🏠

Don't Neglect Estate Planning In Your Tax Strategy

Although other tasks may seem to take precedence, never neglect your estate plan. Remember, this arrangement isn't for you — it's for your family and other beneficiaries. So failing to carefully and regularly update your estate plan could mean depriving your loved ones of money you want them to have. Let's look at some key strategies to consider.

Consider exemptions and tax rates. During your life or at death, you can pass up to the exemption amount free of gift and estate taxes. If your taxable estate is equal to or less than the exemption and you haven't already used any of the exemption on lifetime gifts, no federal estate tax will be due when you die. But if your estate exceeds this amount, it will be subject to estate tax.

This year, the estate tax exemption is \$1 million and scheduled to gradually increase until it reaches \$3.5 million in 2009 and disappears in 2010, when the estate and generation-skipping transfer (GST) taxes are repealed. Also, before being eliminated in 2010, the top estate tax rate will gradually decrease to 45% by 2007. (See Chart 6.)

Make lifetime gifts. Gifts you make during your lifetime are subject to federal gift tax. The top gift tax rate will gradually decrease until it

reaches 35% in 2010 — the same as the highest income tax rate at that time. (See Chart 6.) The exemption will no longer keep pace with the estate tax exemption and will remain at \$1 million through 2010 under current law. Fortunately, you can exclude gifts of up to \$11,000 per recipient each year. This exclusion increases to \$22,000 per recipient if your spouse elects gift splitting.

To use the annual exclusion, the law requires you to give recipients a present interest in the property. This usually means the recipient must have complete access to the funds. If you would like more control, consider a Crummey trust, where the gift will qualify for the annual

Chart 6
**Transfer Tax Exemption
 Increases and Rate Reductions**

Year	Estate¹ and GST Tax Exemption²	Highest Estate, GST And Gift Tax Rates
2003	\$1 million ³	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	(repealed)	35% (gift tax only)
2011	\$1 million ⁴	55% ⁵

¹ Less any gift tax exemption already used.

² The gift tax exemption is \$1 million for all years.

³ The GST tax exemption is \$1.12 million.

⁴ The GST tax exemption is adjusted for inflation.

⁵ The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates/gifts over \$10 million.

Source: U.S. Internal Revenue Code

Tax Action Strategy

Plan for Family Business Interests

If you are a family business owner, transferring business ownership can preserve your business and accumulated wealth — if planned properly. For instance, consider tax breaks such as the family business exemption, estate tax deferral and valuation discounts. Or protect yourself with Section 303 redemptions and well-structured buy-sell agreements.

exclusion (because of a temporary right of withdrawal) even though the recipient doesn't have access to the gifted assets after the withdrawal right expires.

Determine which property to gift. Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make. To minimize estate taxes, gift property with the greatest future appreciation potential. To minimize income taxes, gift property that hasn't appreciated significantly since you've owned it, because your basis in the property generally carries over to the recipient, who will owe taxes on any gain when he or she sells it.

While the estate tax is in effect, it may make sense to wait to transfer highly appreciated assets until your death, because the basis will be stepped up and the capital gains tax can be avoided. For property that has declined in value, your best bet is to sell the property to take advantage of the tax loss. You may then gift the sale proceeds.

Take advantage of the unlimited marital deduction and each spouse's exemption.

Your estate generally can deduct the value of all assets that pass in a qualified manner — either outright or in trust — from you to your spouse during your lifetime or at your death, provided your spouse is a U.S. citizen. But if your combined estates are greater than the exemption amount, simply using the full marital deduction to avoid taxes on the first spouse's death could result in needless tax liability on the surviving spouse's death. Use of a credit shelter trust in your estate plan can help minimize the estate tax by using both spouses' exemptions.

Keep an eye on the GST tax. The GST tax was designed to limit an individual's ability to transfer wealth to successive generations without incurring a gift or estate tax at each generation. It is, and will remain, equal to the top estate tax rate. Fortunately, the GST tax exemption will become equal to the increasing estate tax exemption beginning Jan. 1, 2004, until the GST tax is repealed in 2010. Annual exclusion gifts to skipped generations generally are exempt from the GST tax.

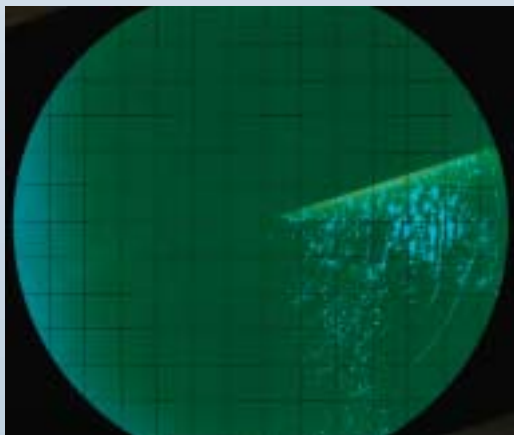
Create trusts. Using trusts in a gift or estate plan can provide significant tax savings while preserving some control over what happens to the transferred assets. Common arrangements include credit shelter trusts, qualified terminable interest property (QTIP) trusts, qualified personal residence trusts (QPRTs), grantor-retained annuity trusts (GRATs) and grantor-retained unitrusts (GRUTs). ❧

Seeing the Big Picture And Bright New Changes Will Lighten Your Liability

Although successful tax planning undoubtedly requires a keen eye for detail, it also calls for the ability to step back and see the big picture. In other words, you need to paint with a broad stroke, taking into account the areas of your life — not to mention the bright new tax law changes — that may offer ways to lighten up your liability. Read on for some particularly picturesque examples.

Avail yourself of the drop in overall tax rates.

This year's tax law accelerates the rate reductions promised by the 2001 act. The top rate has dropped to 35% with the lower brackets now at 33%, 28%, 25%, 15% and 10%. In response, consider lowering your paycheck's withholding amount and using those extra dollars to invest in an IRA or 401(k). By doing so, you'll still enjoy the tax cut and create a new deduction for yourself.



Tax Action Strategy

Pay Off Nondeductible Interest

You may be able to maximize your interest deduction by paying off nondeductible interest — such as that on credit cards or auto loans — with money from a deductible class, such as a home equity loan. If you're paying off credit cards, you likely also will benefit by paying interest at much lower rates.

Maximize home-related deductions. If you use a mortgage to finance the purchase of your home, you likely can deduct related points or prepaid interest. But be careful if you refinance your mortgage — only the amount that does not exceed the current outstanding principal balance will qualify as qualified mortgage debt unless you will make improvements to the residence, though the excess may qualify as home equity debt, and refinancing points will have to be amortized over the loan's term. Don't forget to deduct your property taxes, including vacation properties, too.

Make the most of moving. Are you planning to sell your home and move in the near future? If so, remember that as often as every two years you can exclude up to \$250,000 (\$500,000 if you're married filing jointly) of the gain you realize on the sale or exchange of your principal residence as long as you meet certain tests.

Take advantage of rental rules. If you rent a portion of your home or vacation home for less than 15 days, you need not report the income. Converting your residence from personal to rental use may allow you to obtain

the advantages of a tax-free exchange. The loss on the sale of a personal residence is not deductible. But if you sell the home after converting it to rental use, the loss is deductible because it is now a business and not a personal asset. Additional rules, including basis in converted property, apply.



Worry less about the marriage penalty. The marriage penalty occurs when a couple's joint tax liability is greater than what each would pay as single filers. But this year you have less to fear from this disparity because married couples' joint standard deduction has risen to \$9,500 and the 15% bracket has expanded. So, at least from a tax perspective, the cost of marriage has gone down. But bear in mind this provision expires after 2004 and these amounts go back to the 2001 law's figures.

Consider filing separately. When both spouses have substantial income, and one has significant itemized deductions that are subject to a floor, filing separately may provide an overall tax savings.

Maximize charitable giving. Donating cash or other assets to charity is a great way to do good while lowering your tax bill. Because charitable contributions are generally fully deductible, the more you donate to charity, the more tax benefit you receive — as long as your itemized deductions exceed the standard deduction and you don't surpass the limits. (See Chart 7.) Or if you wish to give larger, more regular amounts, consider more sophisticated charitable vehicles such as private foundations and donor-advised funds.

Donate appreciated assets. You can take a charitable deduction equal to the current fair market value and avoid paying tax on the long-term capital gain you would incur if you sold the property. For instance, instead of giving cash, donate appreciated publicly traded securities you have held for more than one year. Along with getting a tax deduction for the securities' full fair market value, you'll steer clear of paying capital

Chart 7

Charitable Contribution Income Tax Deduction Limits

Contribution Recipient	AGI Limits	
	Cash and Ordinary Income Property	Appreciated Capital Gain Property FMV ¹
Public charities	50%	30%
Operating private foundations	50%	30%
Nonoperating private foundations	30% ²	20% ²

¹Fair market value.

²You can increase the ceiling amount under certain circumstances.

Source: U.S. Internal Revenue Code

gains tax on the appreciation. Beware: The deduction amount is subject to tighter limitations than cash contributions. (See Chart 7 on page 37.)

Set up a gift annuity. With a gift annuity, you contribute an asset to a charity that agrees to make annual payments back to you (and/or another beneficiary) either for a specified number of years or — more typically — until death. You can take an income tax deduction for the value of the donated amount minus the present value of the payments back to you or your family. If the charity sells the asset, neither you nor the charity must pay capital gains tax on the proceeds. But you will owe some tax when you receive payments.



Create a CRT or CLT. A charitable remainder trust (CRT) works similarly to a gift annuity. You create a trust during your life or by will at your death to pay, for a given period, income to you or beneficiaries you select. At the end of that period, the trust's remaining assets pass to one or more charitable organizations. Because you're making a partial charitable donation, you or your estate receives a deduction for a portion of the trust's value. Even with the 2010 estate tax repeal (see page 30), this will still be an attractive strategy because of the income tax advantages. A CLT is basically a reverse CRT: The charity receives income for a set period and your beneficiaries receive what remains at the end of the trust term. 🏠

Preserve Peace of Mind With an Overall Wealth Management Plan

Failing to plan effectively, whether for income taxes (which underwent significant changes this year because of the new law, and will continue changing in the immediate future), a college education or retirement, tends to create surprises — unpleasant ones. That's why you shouldn't confront such challenges only on rare occasions. Instead, you must establish and regularly review an overall wealth management plan. Doing so enables you to bid adieu to those unpleasant surprises, which might be brought on by things such as a neglected succession strategy or insufficient insurance. Besides tax planning, here are some other critical elements of an overall wealth management plan.

Investing. Earlier in this guide, we discussed some of the tax aspects of investing, but you need to consider many other factors to create a strategy that will make your money work as hard as you do. Your financial professional can help you determine your investment horizon, find a comfortable risk level, and allocate your assets accordingly among stocks, mutual funds, bonds, cash and cash equivalents, real estate, life insurance, and other investments.

Protecting assets. In our ever-litigious society, asset protection planning is more important than ever. Being prepared to shield yourself from financial claims is critical. The key is that plans must be executed *before* claims arise.

Potential strategies to discuss with your financial professional include transferring assets to your spouse; family limited partnerships; insurance; Delaware, Alaska or offshore trusts; and even your retirement plan.

Succession planning. All business owners should create a strategy to sell their companies or pass them on to their children or other family members. Otherwise, taxes can greatly diminish the value of these businesses when the owners die — perhaps even forcing a family to sell the company. If you're a business owner, you too must integrate an exit strategy into your estate plan to protect your assets and your company's ongoing success. Your financial professional can help you choose the best insurance, determine how you can maximize valuation discounts, develop a buy-sell agreement and see whether an employee stock ownership plan (ESOP) could work for you.

Choosing life insurance. Along with protecting your family's financial future, life insurance can provide liquidity to pay estate taxes, equalize assets passing to children who are not involved in a family business, and pass leveraged funds to succeeding generations free of estate tax. In other words, a well-conceived life insurance policy can act as a bulwark against estate taxes, illiquidity and investment shortcomings. Of course, life insurance takes many forms — including term, whole life, universal and variable life. You may also own it through an irrevocable life insurance trust, which can help keep a policy's proceeds out of your (and your spouse's) taxable estate. 🏰