tax IMPACT

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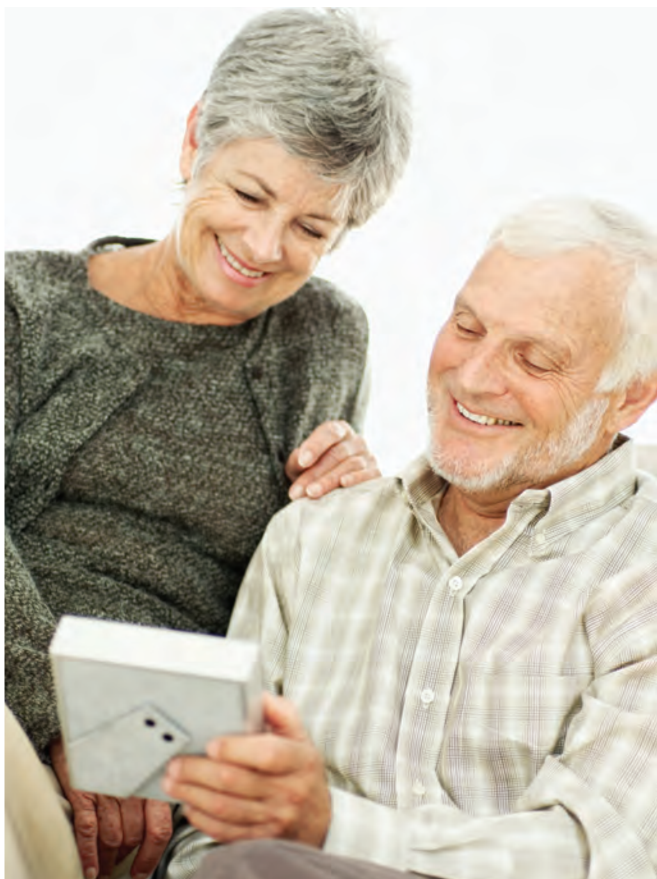
5 common estate planning mistakes

In today's uncertain economic times, estate planning is more important than ever. A carefully crafted estate plan can help you provide for your family's financial security at the lowest possible tax cost. As you design your plan, or review an existing one, be sure you aren't making any of these five common estate planning mistakes.

1. You don't have a gifting plan

Don't underestimate the tax-saving power of the annual gift tax exclusion. For 2009, the exclusion is $13,000 per recipient ($26,000 if you split gifts with your spouse), up from $12,000 last year. If, for example, you and your spouse give away the maximum to five recipients every year for 10 years, you'll have transferred a total of $1.3 million tax free without using any of your $1 million lifetime gift tax exemption. Annual exclusion gifts are more effective because, unlike lifetime exemption gifts, they don't reduce the amount of wealth you can transfer tax free at death.



Keep in mind that there are certain "gifts" that are not deemed to be gifts. For instance, medical expenses and tuition expenses paid on behalf of another aren't considered gifts as long as the payments are made directly to the medical provider or the school.

2. You own your life insurance policy

If you own an insurance policy on your life, nearly half of the proceeds could be lost to estate taxes. However, if you don't own the policy, the proceeds won't be included in your taxable estate. One of the most effective strategies for keeping life insurance out of your estate is to set up an irrevocable life insurance trust (ILIT) to buy and hold the policy. You can even make annual exclusion gifts to the trust to cover some or all of the premium payments.

If you already own your life insurance policy, you can transfer the policy to an ILIT. Watch out for the "three-year rule," which provides that certain assets, including life insurance, transferred within three years of your death are pulled back into your estate and taxed. So it's wise to transfer an existing policy to an ILIT sooner rather than later.

3. You're leaving everything to your spouse

Designating your spouse as your sole beneficiary may seem like a good strategy. After all, the marital deduction allows you to transfer an unlimited amount of wealth to your spouse tax free (as long as he or she is a U.S. citizen). The problem is that it also wastes your estate tax exemption, currently $3.5 million.

Suppose that you and your spouse each have $3.5 million in assets. If you leave everything to your spouse, there's no current estate tax. When your spouse dies, he or she will have an estate worth $7 million (assuming the assets remain intact), resulting in $1.575 million in estate taxes (assuming the current rate of 45%).

You can preserve your exemption and eliminate estate taxes by placing your assets in a credit shelter trust. If properly structured, the trust provides your spouse with income for life — and access to the principal as needed — but the assets aren't included in his or her

Be sure to name contingent beneficiaries

No matter how much effort you put into determining how your wealth will be divided after you're gone, it will be all for naught if your beneficiaries die before you. To avoid having the state design an estate plan for you, name contingent beneficiaries in your will, living trust, life insurance policy, retirement plans and other important documents that require a beneficiary designation.

estate. Plus, your exemptions shield both of your estates from tax.

4. You haven't considered GST taxes

The federal generation-skipping transfer (GST) tax applies at a flat rate (currently 45%) — in addition to any gift or estate taxes — to transfers to people who are more than one generation below you. Note that there are exceptions in the tax code so, under certain circumstances, a transfer to your grandchild might not be subject to the GST tax. For nonfamily members, there is an age test. Someone who is 37½ years or more younger than you is considered to be more than one generation below you.

The GST tax can quickly eat up substantial amounts of wealth, so it's critical to allocate your GST exemption (currently $3.5 million) carefully. If you plan to make gifts to your grandchildren or other "skip" persons or you have a trust that may benefit them in the future, consult your tax advisor about how to allocate your exemption most effectively.

5. You own assets jointly

Many people hold property as joint tenants with rights of survivorship (with a spouse or child, for example) because they think it's a simple way to avoid probate and transfer the property automatically when one owner dies. There are several potential problems with this strategy.

For one thing, it doesn't avoid probate. It merely postpones it until the surviving owner's death. More important, joint ownership has several tax disadvantages. If you and your spouse have estates large enough to trigger estate tax problems, holding most of your property jointly will waste one of your estate tax exemptions. If you're in a community property state, however, you have the opportunity to avoid this problem. You can equalize your estates — for instance, by holding property as tenants in common or by properly titling community property — and use a credit shelter trust to minimize estate taxes. (See "3. You're leaving everything to your spouse" on page 2.)

Make no mistake

Even if your estate plan is mistake-free, review it periodically to be sure it reflects your current personal and financial circumstances as well as any changes in the gift and estate tax laws and regulations. Keep in mind that everyone's situation is different, so the strategies you employ may be different from the ones your loved ones are using. ◎

Taking stock of your inventory accounting method

If your business involves the production, purchase or sale of merchandise, inventory accounting can have a significant effect on your tax bill. In some cases, switching inventory accounting methods from first-in, first-out (FIFO) to last-in, first-out (LIFO) can reduce your taxable income, giving your cash flow a boost. But tax savings aren't the only factor to consider. You should also evaluate the effect the change will have on your financial statements.

LIFO vs. FIFO

A common inventory accounting method for financial statement purposes is the FIFO method. FIFO assumes that merchandise is sold in the order it was acquired or produced. Thus, the cost of goods sold is based on older — and often lower — prices. The LIFO method operates under the opposite assumption: It allocates the most recent costs to the cost of sales.

One last caveat about using LIFO: If your business is structured as a C corporation and you change your structure to an S corporation, you'll have to include a "LIFO recapture amount" in income for the C corporation's last tax year. The recapture amount is the excess of your inventory's value using FIFO over its value using LIFO. You can spread out the tax payments over four years, however, in equal, interest-free installments.

If your inventory costs generally rise over time, LIFO offers a definite tax advantage. By allocating the most recent — and, therefore, higher — costs first, it maximizes your cost of goods sold, which minimizes your taxable income. Keep in mind that LIFO involves more sophisticated record keeping and more complex calculations, so it's more time-consuming and expensive to use than FIFO.

Making the switch

If you're contemplating a switch to LIFO, beware of the IRS's "LIFO conformity rule." It generally requires you to use the same inventory accounting method for tax and financial statement purposes. Switching to LIFO may reduce your tax bill, but it will also depress your earnings and reduce the value of inventories on your balance sheet, which may place you at a disadvantage in comparison to competitors that don't use LIFO. There are various issues to address and forms to complete, so be fully informed and consult your tax advisor before making a switch.

LIFO can create a problem if your inventory levels are declining. As higher inventory costs are used up, you'll need to start dipping into lower-cost "layers" of inventory, triggering taxes on "phantom income" that the LIFO method previously has allowed you to defer. If you use LIFO and this phantom income becomes significant, consider switching to FIFO. It will allow you to spread out the tax on phantom income over a four-year period while giving your balance sheet a boost.

Simplifying LIFO

One of the biggest challenges in using LIFO is the need to measure changes in inventory costs. If you currently use LIFO, you may be able to enjoy additional savings by electing to use the inventory price index computation (IPIC) method. It may enable you to reduce administrative costs — and it might even generate greater tax benefits — if you rely on government indexes to calculate LIFO values rather than developing an internal index.

Switching to LIFO may reduce your tax bill, but it will also depress your earnings and reduce the value of inventories on your balance sheet, which may place you at a disadvantage in comparison to competitors that don't use LIFO.

In addition to simplifying LIFO computations, IPIC may increase your tax savings because government indexes often reflect greater inflation than internal data will. Also, you may be able to complete your calculations sooner by using an index published before your year end.

A big impact

The method you use to account for inventory can have a big impact on your tax bill and financial statements. It's a good idea to review the method periodically to ensure that it provides the best fit with your current financial situation. ◎

Stay tuned to tax law changes and reduce your tax bite

With recent economic downturns and important pieces of tax legislation being passed over the past year, you may be wondering what changes you need to make now to protect yourself in the future. Keeping abreast of tax law changes and tax-saving strategies is one way you can protect your assets. Let's look at some key changes made from the new laws: the homebuyer tax break, charitable IRA rollovers and the sales tax deduction.

Interest-free home loans

A new tax break is the so-called "first-time homebuyer credit," a moniker that's somewhat misleading because the incentive isn't a true tax credit and isn't strictly limited to first-time homebuyers. Available for qualifying homes purchased after April 8, 2008, and before July 1, 2009, the credit must be repaid over 15 years — so it's more like an interest-free home loan from Uncle Sam.

The act defines the "first-time homebuyer" as someone who hasn't owned a principal residence during the previous three years. Those who qualify can claim a credit equal to 10% of the purchase price, up to $7,500 (half that amount for married filing separately). The credit begins to phase out, however, when adjusted gross income (AGI) reaches $75,000 ($150,000 for joint filers) and is eliminated for taxpayers with an AGI that exceeds $95,000 ($170,000 for joint filers).

You may not qualify, but perhaps your children — or grandchildren — will. The combination of this credit and lower home prices may make now a great time to give them some money they can use toward a down payment. Plus, the increase in the annual gift tax exclusion to $13,000 this year means you can give a child $1,000 more tax free than you could have last year ($2,000 more if you and your spouse split the gift) without dipping into your $1 million lifetime gift tax exemption. If you and your spouse jointly make the maximum annual exclusion gifts to both your child and his or her spouse, they will have $52,000 for a down payment — an amount that may put them in a better position to qualify for a mortgage in a tight credit market.

Charitable IRA rollovers

This tax break — which had expired at the end of 2007 — has been extended through 2009. The charitable IRA rollover (technically called a "qualified charitable distribution") allows individuals age 70½ or older to transfer up to $100,000 directly from an IRA to a qualified charity without triggering income taxes on the distribution. The rollover even counts toward the taxpayer's required minimum distributions (RMDs) for the year.

"What's the big deal?" you might ask. "Can't you achieve the same result by taking a taxable distribution from your IRA, donating the funds to charity and then claiming an offsetting charitable deduction?" For many people, that's true. However, this strategy won't work if you're constrained by the 50%-of-AGI limit on charitable deductions. A charitable IRA rollover may also provide a tax advantage if your AGI is high enough to reduce your itemized deductions or other benefits, or if you live in a state that doesn't allow charitable deductions for state income tax purposes.

Making a large donation from your IRA under either method provides additional benefits. For example, it will reduce the amount of your future RMDs, because

the amount of your annual RMD is equal to the size of your IRA divided by a factor based on your age. This may even help you stay in a lower tax bracket. Also, the donated IRA assets are removed from your taxable estate. And, of course, you benefit your favorite charity — which may be particularly grateful at a time when both donations and income from endowments are down and many charities are struggling.

There are a number of requirements for making a charitable rollover. For instance, certain charitable entities don't qualify, including donor-advised funds, supporting organizations and private foundations. Also, you must comply with several requirements, including transferring the funds directly from the IRA to the charity and substantiating your donation with the same type of documentation required for other charitable gifts.

Sales tax deduction

The option to deduct state and local *sales* taxes in lieu of state and local income taxes has been extended. Most people will still be better off deducting income taxes, but if you live in a state with no income tax, the sales tax deduction will likely benefit you. The deduction also may benefit those who:

- Reside in states that tax only interest and dividends,
- Reside in states where sales tax rates are significantly higher than income tax rates,
- Have income that isn't subject to state income tax, such as retirement plan distributions, Social Security benefits or U.S. government bond interest,
- Frequently cross borders to shop in neighboring states, or
- Buy expensive items such as boats or luxury cars.

Take into account the tax consequences when deciding whether to make a large purchase this year or next — as of this writing, the sales tax deduction hasn't been extended past 2009. Even if it is extended, it may make sense to bunch large purchases into one year if it will cause your sales tax deduction to exceed your income tax deduction. Similarly, you may benefit by shifting state income tax payments between years. For example, if you're making a large purchase this year, you might pay your fourth-quarter 2009 estimated state *income* tax payment after, rather than before, year end, so that you can deduct it in 2010 while deducting sales tax in 2009.

Generally, the best way to maximize your sales tax deduction is to save your receipts.

Also consider the alternative minimum tax (AMT). Just like the deduction for state and local income taxes, the sales tax deduction can't be taken for AMT purposes. So if you have to pay the AMT, you'll lose some or all of the benefit of the deduction.

Generally, the best way to maximize your sales tax deduction is to save your receipts. If you haven't saved them throughout the year, however, you can use IRS tables to estimate your sales taxes. Sales tax paid on large-ticket items such as vehicles, boats, airplanes, home construction, remodeling or refurnishing may be deducted in addition to the table amount.

Keep taxes top of mind

Recent tax law changes have created several opportunities for reducing your 2009 tax bill, including many not mentioned here. More changes may have been made after this issue went to press, and additional ones are likely to occur in the coming months. Even if you've just filed your individual income tax return, it's wise to be thinking about next year's tax deadline and to contact your tax advisor for information on the latest tax law changes. Otherwise, you may miss out on many tax-saving strategies. ◎

tax TIPS

Accelerated depreciation for building improvements

If your business is planning to make improvements to its physical space this year, you may qualify for accelerated depreciation deductions. Last October's Emergency Economic Stabilization Act of 2008 (EESA), also known as the "bailout" act, extended accelerated depreciation for leasehold and restaurant improvements through 2009 and also extended this benefit to certain retail properties. Qualifying property can be depreciated over 15 years instead of the usual 39-year recovery period for commercial real estate.

The 15-year recovery period is available for structural or other real-property improvements made to an interior portion of a nonresidential building by a lessor, lessee or sublessee "under or pursuant to a lease." To qualify:

- The space must be occupied exclusively by the lessee,
- The building must be more than three years old, and
- The improvements must be placed in service by the end of 2009.

The tax break isn't available for space leased to a related party (such as a family member or another company that the lessor controls).

The bailout also extended through 2009 similar tax benefits for improvements to qualified restaurant property and expanded these benefits to qualified retail property. Essentially, this provision allows qualifying restaurant and retail businesses to take advantage of the 15-year recovery period even if their buildings are owner occupied.

Qualified leasehold improvements don't include any expenditures you make to enlarge the building or change its internal structural framework, structural components benefiting a common area, elevator or escalator. Other limits and exceptions may apply. ◎

Are you a trader or an investor?

The short answer is, "If you have to ask, you probably aren't." People who buy and sell a lot of stock often attempt to classify themselves as traders rather than investors. Traders have several tax advantages, including the ability to deduct losses as ordinary rather than capital losses and fully deduct their investment expenses.

A recent U.S. Tax Court case illustrates how difficult it is to achieve trader status. In *Holsinger et al v. Commissioner* the court ruled that a couple who set up a trading company and made nearly 700 trades over a two-year period were not traders. As a result, they owed approximately $98,000 in taxes.

The court explained that, to be considered a trader, your trading activity must be substantial and you must try to profit from short-term swings in the market. The couple traded on 63 days one year and 110 days the next. The court concluded that it was "doubtful whether the trades were conducted with the frequency, continuity and regularity indicative of a business." ◎

Dipping into retirement savings comes at a high price

In today's tough economic times, it may be tempting to dip into your IRA or 401(k) account, if your plan allows it. Remember that you'll have to pay income taxes and, if you're under age 59½, penalties on the money withdrawn — though penalties may be waived if you use the funds from your IRA for qualifying expenses, including certain medical, college and housing expenses. It's also important to consider the loss of tax-deferred growth on the funds you withdraw. Even borrowing against your 401(k) account usually slows the growth of your retirement savings. ◎

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