

TAX REDUCTION STRATEGIES

Quick Guide

This information is provided by West Coast Trust to help clients stay abreast of estate planning issues. It should not be viewed as legal advice, which can only be provided by your personal attorney.

Let us Introduce Ourselves



Tom McGirr

Ed Duvall

Tom McGirr, Salem Office. 503-399-2901

As an attorney with 34 years of experience working throughout the Willamette Valley, Tom helps business owners and investors create and execute wealth management and estate plans. Tom is well known to local estate planning professionals, is active in Salem Rotary, and on the board of the Salem and Eugene Estate Planning Councils and Marion Polk Food Share.

Ed Duvall, Portland/Vancouver Offices. 503-279-3183

With over 20 years of trust, retirement planning, and portfolio management experience, Ed leads our Portland Wealth Management & Trust team. Clients count on Ed's intimate knowledge of retirement plans to help them rollover and manage their retirement accounts in conjunction with their estate planning.

Table of Contents

<i>Federal Income Tax Planning</i>	2
Deferring income	2
Maximizing itemized deductions	2
Flexible spending accounts	2
Health Savings Accounts	2
Tax credits.....	3
Education tax incentives.....	3
Investment strategies	4
Planning with capital gains and losses	4
Tax Exempt Investing	4
Income shifting.....	4
Business owner tax considerations.....	4
Withholding and estimated taxes	5

Federal Income Tax Planning

Income tax planning is a fundamental part of financial planning. The less money you pay for income taxes, the more money you have working toward achieving other financial goals. Below is an overview of many of the techniques currently available which can be used to minimize your current and future taxes.

Deferring income

Deferring income means reducing your current taxes by postponing the taxability of income until a future year. One easy way to defer income is by maximizing contributions to company retirement savings plans, such as a 401(k) plan, as well as by using other tax-advantaged savings vehicles, including IRAs, annuities, and cash-value life insurance. Some contributions to retirement savings plans can be made on a before-tax basis where you defer income tax on the monies going into the plan. In this case, your contributions won't be taxed until you make withdrawals in the future. The income you earn on these accounts accumulates tax-deferred, which means the earnings on your money are not taxed until you make a withdrawal. Roth IRAs present the opportunity to receive distributions tax-free.

Maximizing itemized deductions

Individuals should itemize deductions if their total itemized deductions exceed the federal standard deduction. Deductions reduce the amount of your income that is subject to tax. The following are categories of itemized deductions:

- **Medical and dental expenses:** This category should include the amount of unreimbursed medical and dental expenses (including prescriptions) not paid by insurance or reimbursed through a flexible spending account. Medical and dental expenses are deductible to the extent they exceed 7.5% of your adjusted gross income. You can also include transportation costs when traveling for medical purposes, including mileage at 19 cents per mile (20 cents in 2007), tolls, and the cost of public transportation.
- **State and local taxes:** The amount of state and local income taxes you paid in the current year may be deducted on your federal income tax return. This includes amounts withheld, estimated payments made in the current year, and any balance due on your prior year's state income tax return paid in the current year.

Other deductible taxes include real estate taxes and certain personal property taxes.

- **Interest expense:** Deductible interest includes home mortgage interest, investment interest, qualified student loan interest, and trade or business interest. Certain restrictions apply.
- **Charitable contributions:** You may deduct contributions and gifts to qualified charities. Contributions may be in cash, property, or out-of-pocket expenses (including mileage at 14 cents per mile) for volunteer work for qualified charities. No deduction is allowed for single contributions of \$250 or more to any one organization unless you have a written receipt from the organization.
- **Miscellaneous deduction expenses:** Tax preparation fees, cost of safe deposit box, etc. are deductible to the extent they exceed 2% of your adjusted gross income.
- **Casualty and theft losses:** Nonbusiness casualty and theft losses are deductible to the extent they exceed \$100 and then only to the extent they exceed 10% of your adjusted gross income. Business casualty and theft losses are fully deductible.

Flexible spending accounts

Many companies provide employees with a variety of benefits such as medical and dental insurance, life insurance, long-term disability, and other health and welfare benefits. To obtain these benefits, employees usually have to pay some portion of the premiums. *Flexible spending accounts* allow you to pay for certain eligible benefits, such as health insurance, and pay for certain eligible expenses, such as unreimbursed medical expenses and daycare expenses, with before-tax dollars. If you pay the premiums on a before-tax basis your cost is reduced, since the money you pay is not subject to federal income tax or Social Security tax. At the end of the year, any unused balances are forfeited.

Health Savings Accounts

Effective in 2004, a new savings option became available to help individuals pay for their health-care needs. The Health Savings Account (HSA) permits eligible individuals who are not enrolled in Medicare to save for "qualified" medical health expenses on a tax-free basis. (Note that qualified expenses include

the cost of many non-prescription drugs). These accounts may be offered through employers. However, any insurance company or bank can offer HSAs to eligible individuals as well.

These plans are only available to individuals with high-deductible health plans — i.e., plans with a deductible of at least \$1,100 for individuals (\$1,100 in 2007) and \$2,200 for families (\$2,200 in 2007). Contributions are limited to \$2,900 for individuals (\$2,850 in 2007), and \$5,800 for families (\$5,650 in 2007) regardless of income, and additional “catch-up” contributions may be available to those age 55 or older. Contributions are tax-deductible, and distributions, when used for a qualified medical expense, are tax-free. If expenses are not qualified, then the distribution may be treated as taxable income, and a penalty may also apply.

However, when used as intended, HSAs can grow tax-free, and unused balances can roll over from year to year. These accounts are also portable, and may be used across different jobs. These are all potential advantages of using the Health Savings Account when compared with the Flexible Spending Account.

There are additional details and restrictions that must be considered. Check with your adviser or account sponsor regarding your eligibility to use the HSA.

Tax credits

Tax credits, unlike deductions, reduce tax liability dollar for dollar by the amount of the available credit. There are various tax credits benefiting many different types of taxpayers including families with young children, the elderly, the disabled, and those with students attending college. Some examples are shown below. Consult your tax adviser to determine which credits may be available to you.

- **Child and dependent care credit:** A credit is allowed for a portion of qualified child or dependent care expenses that are paid in order for the taxpayer to work. The maximum amount of child care expenses that can be considered is \$3,000 for one child or dependent, or \$6,000 for two or more. The credit ranges from 20% to 35% of eligible child care expenses.
- **Earned income credit:** A credit is available to certain low-income taxpayers who have earned income. The maximum credit is up to \$438 (\$428 in 2007) for a taxpayer with no children and who has earned income less than \$12,880 (\$12,590 in 2007), and \$2,917 (\$2,853 in 2007) for a taxpayer with one child and

earned income less than \$33,995 (\$33,241 in 2007). For a taxpayer with two or more children and earned income less than \$38,646 (\$37,783 in 2007), the maximum credit is \$4,824 (\$4,716 in 2007).

- **Saver's Credit:** This credit is available to certain taxpayers who contribute to their employer's retirement plans and who have adjusted gross income levels under \$53,000 joint (\$52,000 in 2007) or \$26,500 (single) (\$26,000 in 2007). The maximum credit available is \$1,000. By contributing to a retirement plan and claiming this credit, the taxpayer reduces the amount of tax due to the IRS.

Education tax incentives

Two income tax credits (the HOPE Scholarship credit and the Lifetime Learning credit) are provided to help defray qualified tuition and fees, (not room and board or books). The HOPE Scholarship credit may be elected only for a student's first two years of post-secondary education. The HOPE credit equals 100% of the first \$1,200 (\$1,100 in 2007) plus 50% of the second \$1,200 (\$1,100 in 2007) of qualified education expenses paid during a taxable year, making the maximum credit \$1,800 for each qualifying student (\$1,650 in 2007).

The Lifetime Learning credit equals 20% of the first \$10,000 of qualified education expense. The Lifetime Learning credit is calculated on a per family (taxpayer and his or her dependents), rather than a per student basis, making the maximum family credit \$2,000 in 2008. Both credits are phased out for joint filers with modified adjusted gross income between \$96,000 and \$116,000 (\$94,000 and \$114,000 in 2007).

While the HOPE credit applies to only the first two years of undergraduate education, the Lifetime Learning credit is available for any course work at a qualified education institution that improves job skills. Eligible taxpayers may elect to exclude from income amounts withdrawn from an Education Savings Account that are used to pay qualified education expenses for a student. HOPE and Lifetime Learning tax credits can be claimed in the same year as Education Savings Account distributions, as long as the ESA distribution is not used to pay for the same costs used to claim the education credit.

Taxpayers may also exclude from income amounts withdrawn from a Qualified Tuition Plan, or QTP (e.g. a '529' plan) that are used to pay for qualified higher education expenses for a student. HOPE and

Lifetime Learning tax credits can be claimed in the same year as QTP distributions, as long as the QTP distribution is not used to pay for the same costs used to claim the education credit. Individuals can contribute to both QTPs and ESAs on behalf of the same beneficiary.

Investment strategies

Planning with capital gains and losses

The top capital gains tax rate for individual taxpayers is 15% for investments held for more than 12 months (long-term). For taxpayers in the 15% or lower regular tax bracket, the rate is 5%. Short-term capital gains (investments held 12 months or less) are taxed as ordinary income.

When you have an active portfolio of investments outside of a tax-deferred retirement account, consider some of the following planning tips to minimize the amount of tax you will pay on capital gains generated during the year. Keep in mind that you should not base a buy or sell investment decision solely on tax minimization; make sure it makes economic sense and is part of your overall investing strategy.

- If you have **recognized** short-term capital gains and you were considering selling an asset that will generate a long-term or short-term capital loss, you can use the loss to offset the gain by selling the asset. This may eliminate the short-term gain which would have been subject to tax at ordinary rates.
- If you have a capital loss or a capital loss carryforward and you were considering selling an asset that will generate a short-term capital gain, you can use the loss to offset the gain by selling the asset. This may eliminate the short-term gain which would have been subject to tax at ordinary rates.
- Keep in mind the capital gains tax rates and the related holding periods when doing your tax planning.

Tax Exempt Investing

In constructing the income-generating portion of your portfolio, investing in tax-exempt vehicles (such as municipal bonds) can be used as a tax-saving strategy. When evaluating investments, you should compare the after-tax yields you are earning. You must look at a taxable investment on an after-tax basis in order to compare it with a tax-exempt obligation. You may also need to factor in state taxes when making your investment decisions.

If you decide to utilize tax-exempt investments, keep the following points in mind:

1. Due to lower yields, you generally have to be in one of the higher marginal federal income tax brackets for municipals to make sense.
2. Don't invest in tax-exempt municipals within a tax-deferred retirement plan. The money in your retirement account is already tax-advantaged.
3. Occasionally, municipal funds declare a capital gain which will be taxable.

Income shifting

Shifting assets into a child's name often minimizes your overall household tax burden. However, for children under age 18, the amount of unearned income which may be taxed at the child's federal income tax rate is limited. In 2008, the limit is \$1,800 per child annually (\$1,700 in 2007). (This dollar threshold is adjusted annually for inflation.) Earnings in excess of this amount are taxed at the parents' marginal federal income tax rate. (This is often referred to as the "kiddie tax.") Once the child reaches age 18, all income is taxed at the child's tax rate. Keep in mind that assets shifted into your child's name to reduce your income taxes may be subject to gift taxes, and often later reduce the amount of financial aid for which you are eligible.

Business owner tax considerations

Self-employed individuals may establish tax-advantaged retirement plans with contributions based on net earnings from self-employment. Tax-advantaged plans include Keogh plans, Simplified Employee Pensions (SEPs), and Savings Incentive Match Plan for Employees — SIMPLE Plans. See your tax adviser for information on retirement plans and other tax-savings retirement vehicles.

Self-employed individuals are currently entitled to deduct up to 100% of the amount paid for health insurance coverage for themselves, their spouses and dependents during the tax year. The deduction is limited to the net earnings from the trade or business for which the insurance coverage was established, minus the deduction for one-half of the self-employment tax and any Keogh, SIMPLE, and SEP deductions.

IMPORTANT NOTE: You cannot take a self-employed health insurance deduction for any month or part of a month that you were eligible to participate in an employer-sponsored health plan.

Other tax issues to keep in mind for a self-employed individual include:

- If your net earnings from self-employment exceed \$400, you will be liable for self-employment taxes. If you make estimated income tax payments, be sure to consider the self-employment tax*.
- If you have employees, you must obtain a separate federal tax identification number and fulfill employment tax responsibilities.
- A deduction may be available for certain expenses incurred in maintaining a portion of your home as an office. You must meet certain restrictive tests for your home office to qualify for deductions.

* The self-employment tax is a social security and Medicare tax. It is similar to the social security and Medicare taxes that are withheld from the pay of most wage earners. In 2007 and 2008, the tax rate is 15.3% on the first \$102,000 (2007: \$97,500) of combined wages, tips and net earnings, and 2.9% on earnings above this limit.

Consult your tax adviser for tax issues relating to self-employed business owners.

Withholding and estimated taxes

Paying too much or too little in taxes during the year can make budgeting difficult. If you received a large tax refund last year, this money could have been invested instead, helping you achieve your financial goals during the year. Project how much tax you expect to owe and be sure to have at least 90% of that amount withheld during the year. Another option is to consider using one of the safe harbor methods of making estimated federal income tax payments. You should consult with a professional adviser to determine which tax payment methods are most advantageous to you, and to consider any state requirements that may apply.

IMPORTANT NOTE: Overpayments of tax are basically interest-free loans to the government.