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CLIENT'S tax & financial UPDATE

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A tax, business, and financial planning newsletter for our clients and friends

Practical Ways to Shelter Your Income from Taxes

Despite all the publicity to the contrary, tax shelters are alive and well. Here are some of the best ways to shelter your income from Uncle Sam.

Real Estate Shelters

If your Adjusted Gross Income (AGI) is $100,000 or less, you can deduct up to $25,000 in losses for rental property which you actively manage. However, the $25,000 loss deduction for rental property is phased out if your AGI is between $100,001 and $150,000. If your AGI is more than $150,000, you cannot deduct any portion of your rental real estate losses (assuming you have no passive income).

The shelter strategy. If you plan properly, you don't have to give up your deductions even if your income is more than $150,000. You can shelter income from taxes if you use your real estate for personal purposes instead of using it as rental property. No matter how high your income, your property taxes will be fully deductible. And your mortgage interest deduction will be allowed to the first $1 million in acquisition debt and $100,000 in home equity debt.

How to use the shelter strategy. In the past, you could save taxes if you rented your vacation home and used it yourself for 14 days or less per year. If you kept within the 14 day limit, your property qualified as rental property and you could take the appropriate deductions. Using the opposite strategy may, however, save taxes.

If your AGI is over $150,000, consider using the property yourself for more than 14 days a year and treat it as your second residence instead of as rental property. This will allow you to deduct real estate taxes and mortgage interest payments.

It's important to assess your individual

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*tax*POINTS

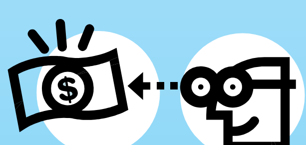
LIFE INSURANCE LOOPHOLES

***Loophole:* Life insurance proceeds are income tax free.** This is true even if only a few premium payments were made. However, life insurance premiums are not tax deductible.

Life insurance proceeds are partly or totally estate tax free if the policy (or part of it) is owned by the beneficiary, not the insured. ***Better:*** Use an irrevocable life insurance trust (ILIT) as the policy owner. If children or other individuals own the policy, it becomes available to an ex-spouse or unintended strangers in the event of divorce or a lawsuit against the child. The proceeds are estate tax free if you have no control over the policy. ***Caution:*** Making your estate the beneficiary subjects the proceeds to tax.

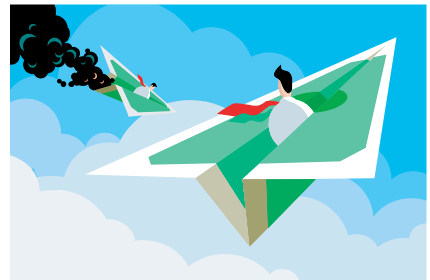
***Loophole:* Employer-paid group term insurance premiums are tax free** up to $50,000 of life insurance. Premiums paid for policies over that are taxable at reduced rates determined by IRS tables.

***Loophole:* Whole life insurance creates a tax-free buildup of cash value** that offsets premiums in later years. When paid as part of the life insurance proceeds, it is not taxed…nor when borrowed from the policy…when withdrawn, it is tax free to the extent of total premiums paid.



The Danger of Investing a Life Insurance Loan

It's sometimes possible to borrow money against the cash value of a life insurance policy at an interest rate that's lower than you can earn from a bank time deposit. For example, you might be able to borrow against your life insurance at a 3% interest rate and use the money to invest in a bank CD that pays 4%. Although this may appear to be a sure money-maker, it is not.



When you borrow against a life insurance policy, the entire proceeds from the policy (the face value less the outstanding loan balance) are considered part of your estate since borrowing against a life insurance policy creates an incident of ownership. That means if you die before you repay the loan, estate taxes could wipe out all of your profits. On the other hand, if you do not have an incident of ownership, the proceeds from the insurance that are paid directly to your beneficiary are excluded from your estate.

When You Can Deduct Personal Legal Fees

When incurred by a business, legal fees are generally deductible as an ordinary business expense. However, legal fees for personal matters are deductible as miscellaneous itemized deductions only if they are incurred for the following services:

- The collection or production of income.
- The management of income producing property.
- The resolution of tax matters such as tax determination, collection or refund.

In addition, there are certain personal matters for which legal fees may be deductible. Some of these include the following.

Executor's commission. An executor who incurs legal fees to obtain taxable income can claim a deduction.

Probate. Legal fees paid for probate by an estate are deductible on the estate tax return, but strong substantiation of the legal time involved is necessary.

Social Security. Legal fees incurred to collect Social Security benefits are deductible to the extent that the Social Security benefits are taxable. For example, if one-half of the benefits are taxable, then one-half of the legal fees are deductible.

Alimony. Legal fees incurred for the receipt of alimony are deductible. To support this deduction, your attorney must give you an itemized bill that shows how the legal fees were allocated to tax and to non-tax matters.

Personal injury suits. If damages are awarded for lost wages, the portion of the legal fees attributable to recovery of the wages is deductible.

Using Prior Tax Returns to Get a Refund

Taking time to review some of your previous tax returns could produce a tax refund if you find that you paid extra tax dollars because you overlooked something when you filed. Check the returns you filed in 2006 and thereafter because you can amend a return within three years of the date you filed it or within two years from the date you actually paid your taxes, whichever is later.

What to look for

There are several common oversights you should look for. Filing an amended return for any of them could result in a refund.

- **Not taking all the deductions you deserved.** One example that is often overlooked is the deduction for investment interest. You might find others that you should have taken in the past by comparing previous returns with your 2008 return. If you did omit a deduction, it might be worth amending an earlier return.
- **Claiming the standard deduction instead of itemizing deductions.** Some taxpayers claim the standard deduction because they wait until the last minute and don't have the time to itemize their deductions. Others claim the standard deduction because they don't have the necessary information to itemize their deductions when the filing deadline arrives. Regardless of your reason, if you claimed the standard deduction, you should check to see whether you would have saved money by itemizing your deductions. If you claimed the standard deduction in any of the previous years, reviewing it against a checklist of possible itemized deductions is a good way to see what you might have overlooked.
- **Forgetting to take tax credits.** It's not unusual for taxpayers to overlook certain tax credits such as the child care credit, the earned income credit, adoption credit, and education credits. Make sure you took all the credits you deserved on your previous returns.

- **Overlooking exemptions.** The most commonly overlooked exemption is for parents who did not live with you during the year, but otherwise qualify as dependents because of contributions you make toward their support.
- **Electing the wrong filing status.** Married couples who file separately usually pay higher taxes than if they file jointly. You can amend your return if filing jointly would have lowered your taxes.
- **Paying too much Social Security.** If you had more than one employer in a particular year, you may have paid too much Social Security. The maximum you must pay varies from year to year, but your old returns will indicate the correct maximum amount.
- **Omitting the home office deduction for the business use of a home.** An individual's trade or business must meet specific tests to take a deduction for the business use of a home.

It's Time to Update Your Will

Since the enactment of new tax laws, many estate plans have become outdated. If you don't review your estate plan and update your will, your heirs could lose many important benefits and might be forced to pay unnecessary estate taxes. Regardless of changes in the tax law, you should review your will regularly because your financial and personal situation might have changed.

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Ways to Shelter Your Income

situation to see whether using the property as a second residence or treating it as rental property will save you taxes.

Self-Employment Deductions

You can usually take miscellaneous deductions only to the extent that they exceed 2% of your AGI. But many of these same expenses are 100% deductible business expenses if you report self-employment income on Schedule C. By deducting any expenses that are associated with your self-employment income as business expenses, you avoid the 2% floor for miscellaneous deductions. Items such as interest expense, travel costs, publications, and tax preparation fees can be fully deductible on Schedule C as long as you can attribute them to your (or your spouse's) self-employment income.

Life Insurance Shelters

You can take advantage of most whole-life insurance policies to shelter income because some of your premium payment is used to buy insurance and some of it is used as an investment. Your return on the investment portion of your premium accumulates tax-free and taxes are deferred until you cash in the policy. Furthermore, if you die before you cash in the policy and your spouse or your children are the beneficiaries, the accumulated investment earnings are completely free of income tax.

You can no longer defer taxes on investment income from single premium annuities or from life insurance policies for which you pay a single large premium. However, some life insurance policies are now available for which you make seven equal premium payments for a period of seven years. The IRS does not consider these policies as modified endowment contracts and they can be used to shelter income.

If during your lifetime, you receive money - either from a distribution or a loan - from a life insurance policy which is considered a modified endowment contract, it is generally treated as income and is subject to income tax.

Tax-Exempt Bond Shelters

Income from tax-exempt municipal bonds is not subject to federal income tax. Current short term treasury yields, however, may give you a better after-tax yield than some municipal bonds.

Loan Interest Deductions

Interest on consumer loans is not deductible. However, don't make the mistake of classifying all your loans as consumer loans. In some cases, loan interest for tax shelters, investments, and education may be up to 100% deductible, even if the loan is taken against an unsecured line of credit.

How you spend the loan determines its classification and the amount of interest which is deductible. By keeping track of the loan proceeds from the date you receive them until the date you spend them, you can determine the portion of the interest which is fully deductible rather than subject to the limit on consumer loans. For example, if you use the loan proceeds to make an investment, the interest may be fully deductible.

How To Delegate Successfully

Delegating responsibility is one of the keys to good management. Here are some principles to follow for effective delegation.

- Delegate early, never at the last minute.
- Make certain that the person to whom you delegate a task wants to do the task.
- Make it clear whether the delegation is permanent or temporary.
- Always delegate total tasks, not portions of them.
- When you delegate a task, delegate the authority and responsibility that go along with it.
- Once you delegate, don't interfere, but make it clear that you are available for advice and assistance.
- When you delegate a complex task, demonstrate it clearly, and have staff members repeat what you did until it's clear they understand the task.
- Review and evaluate the results and discuss them with the staff member.
- Acknowledge good performance and make sure that all criticism is constructive.