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What You Need To Know About The AMT In 2008

The alternative minimum tax (AMT) simply won't go away. Despite annual "patches" by Congress to bump up the exemption amounts, the dreaded AMT will affect millions of taxpayers in 2008 unless more comprehensive tax relief is enacted. Whether that will happen remains to be seen. At this point, the safest approach is to prepare for the worst and hope for the best.

- Deductions for personal exemptions
- The "bargain element" on incentive stock options (ISOs)
- Interest from "private activity" municipal bonds

After the necessary adjustments have been made, you subtract a personal exemption amount based on your tax filing status. This is where Congress has provided a small dose of tax relief in recent years.

Small Mercies Of The AMT

Exemption Amounts for the AMT have been slowly rising this decade, but they are scheduled to revert to pre-EGTRRA levels in 2008

Filing Status	2000	2001-2002	2003-2005	2006	2007	2008
Joint Filers	$45,000	$49,000	$58,000	$62,550	$66,250	$45,000
Unmarried Filers	$33,750	$35,750	$40,350	$42,500	$44,350	$33,750

Before we discuss how to confront the lingering AMT problem in 2008, let's take a step back to see how it works.

The AMT in a nutshell. The AMT operates in a parallel tax universe. After you run the numbers for your regular tax liability, you're required to work through the complex AMT calculation. You pay whichever of the two taxes is higher.

The starting point for the AMT is your taxable income for regular tax purposes. Then you have to add back certain "tax preference items" that you had originally deducted from income, and make other technical adjustments. We'll spare you the details, but the list of adjustments is as long as your arm. Some common examples of items treated differently under the AMT are:

- State and local income taxes
- Real estate and property taxes
- Large medical and dental expenses
- Miscellaneous expenses (subject to a 2%-of-adjusted gross income floor)

Higher exemption amounts. The annual exemption amounts have been increased through a series of stopgap moves since they were boosted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). But the amounts will revert to the low pre-EGTRRA levels in 2008 if Congress fails to take further action.

For example, until a late temporary fix was enacted, it was estimated that an additional 21 million taxpayers would have been snared by the AMT on their 2007 returns. Currently, the lower levels are still scheduled to kick in for 2008 (see chart).

But that's not the end of the story. The AMT exemption amounts are phased out for high-income taxpayers. The reduction is equal to 25 cents of each dollar of AMT income above $150,000 for joint filers and $112,500 for single filers. And these amounts haven't been adjusted for inflation. As a result, no exemption is available to joint

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It's Growing Season...

Flowers and crops are growing this season...are your investments? We have several ways to help you increase your financial yield.

Talk to us about the flexible investment options available for your Traditional IRA, Roth IRA, or non-qualified investment account.

Another way to make the most of this growing season is to set up an automatic payment to your investment account or increase your current level. Rank your personal financial goals where they belong and pay yourself first!

No matter what your financial goals entail, contact City State Bank Trust & Investments to help you grow into them!

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Key Questions For Those Nearing Retirement

Life may begin at 40, but the countdown to retirement starts at age 55. Now is the time to take stock of your savings, goals, and timetable for moving into a phase of life that may last 30 years. These questions can help you gauge how you're doing.

When do you want to retire? This is a crucial variable. If you're planning to retire early—say, at age 55 instead of 65—you'll not only have to save more, sooner; you'll also need to have the money last an extra decade. On the other hand, if you expect to work well past normal retirement age, that reduces the burden on your nest egg. Another reason to keep working: While you normally can begin penalty-free withdrawals from an employer's qualified retirement plan at age 55, distributions from an IRA before age 59½ may result in a 10% penalty.

How is your money invested? Though there are no guarantees, a portfolio with most holdings in stocks holds the potential to grow more quickly than one emphasizing bonds or cash. But at this point, you won't have much time to recover from market losses and may need to reduce your allocation to equities. That, in turn, could affect when you'll have sufficient savings to leave the work force.

What will you get from Social Security? Government payments may make up only a small percentage of your retirement income, but this variable, too, needs to be part of your retirement calculations. How much you receive depends on several factors, including when you were born and when you apply for benefits. Payments could start as early as age 62, but if you begin then, your checks will be smaller. Wait a couple more years (if you were born between 1943 and 1954, full retirement age is 66), and your checks will be larger. If you live a long time, the bigger monthly checks will more than make up for the few years you did not collect up front.

How's your contingency planning? An unexpected job loss or serious illness could hurt your retirement plans, draining savings just when you need to be putting away as much as possible. If you have a cash cushion you can draw on in emergencies, it could stem the damage—but if you don't, build your reserves now. And you may want to invest in long-term care insurance.

How much will you need during retirement? Though rules of thumb suggest you'll need 70% to 80% of your current income to live comfortably after you leave the work force, the amount you should set aside depends on several factors, including the age when you expect to retire, your anticipated housing costs and other living expenses, and how healthy you are. To be effective, your retirement plan needs to take into account many interrelated variables. We can help you evaluate many possible scenarios, and if you're in danger of falling short of your goals, we can work with you to get on track before it's too late. ●

Rolling Over A 401(k) To A Non-Spouse

If you participate in a 401(k) or other employer plan, you have to designate who receives the assets when you die. Typically, you'll name your spouse, though you might also choose a child, grandchild, or favorite niece or nephew. You can also decide to spread the wealth by designating multiple beneficiaries. Yet while the choice is yours, keep in mind that it could have tax implications.

In the not-so-distant past, tax rules clearly favored spousal beneficiaries. Then as now, a spouse could roll over inherited funds tax-free into his or her own IRA, and required minimum distributions (RMDs) would be based on that person's life expectancy. Until a recent rule change, though, anyone other than a spouse who inherited the account had much less palatable choices. Non-spouses had to take an immediate lump-sum distribution, often resulting in a massive tax bill, or empty out the account within five years, which was only slightly less punishing.

But then came the Pension Protection Act of 2006 (PPA). It lets a non-spouse roll over funds from the decedent's account, much as a spouse would, although there are a few extra wrinkles.

Initially, the IRS interpreted the PPA provision to mean that a non-spouse beneficiary who inherited a 401(k) could roll it over only if the plan sponsor agreed to accommodate the transfer. That's not what Congress had intended, though, and the IRS has acknowledged this by indicating that all plan sponsors must provide this option to non-spouse beneficiaries, effective January 1, 2008.

However, calling the post-death transfer of funds a rollover is a bit of a misnomer. It is actually a transfer from one account to another that must remain titled in the name of the decedent. For instance, suppose that Jack Hill inherits an account from

Nine Estate Planning Mistakes To Avoid

Thanks to increased home values, well-funded retirement accounts, and hefty life insurance policies, many retirees today not only have enough money to live comfortably but are also likely to have wealth to distribute at the end of their lives. But it can be tricky making sure your bequest gets where you want it to go. Here are nine common mistakes to avoid.

Assuming you don’t need an estate plan because you don't owe estate tax. With estate tax laws currently in flux, whether your estate is large enough to owe estate taxes may depend on when you die. But even if taxes aren’t an issue, estate planning can ensure your assets are controlled according to your wishes if you’re incapacitated and parceled out appropriately at your death. It can also help to avoid the cost and delay of probate and minimize emotional and financial burdens on your beneficiaries.

Not having a will. Without a will, state law will govern the disposition of your probate estate, with the government deciding who gets what. Depending on your state of residence, if you are survived by a spouse and children, your estate will typically be divided among them even if you had something else in mind. Moreover, assets could be poorly managed and your estate could end up paying more than it should in taxes and legal fees. A will lets you specify who gets what and could help minimize estate taxes.

Not having a letter of instruction. What happens if you change your mind about who gets your favorite jewelry or whether you want to be buried or cremated? You can note these wishes in an addendum to your will called a "letter of instruction." Though not legally binding in all states, this document will at least give your heirs an idea what you want and help them avoid needless conflicts.

Leaving your entire estate to your spouse. While many couples leave all assets to one another, that’s not always the best strategy. You may want some property to pass directly to children from a previous marriage, or to go into a trust to make use of both spouses’ estate tax exemptions. Trusts, which come in many varieties, may help you fine-tune your estate plan, are typically less vulnerable than wills to legal challenges, and can provide asset protection.

Owning all assets jointly. Most couples own property jointly, with rights of survivorship—meaning that upon the death of one spouse, the jointly owned property automatically passes to the surviving spouse, avoiding probate. But this may not be the best choice in all situations. For example, owning property separately could make it possible to fund a trust and take better advantage of the estate tax exemption.

Not considering annual gifts. Using yearly gifts to distribute your estate while you’re living can be immensely satisfying, and it takes advantage of an annual gift tax exclusion that allows you to make tax-free gifts each year of up to $12,000 each to an unlimited number of recipients. (If you give with your spouse, the limit is $24,000.) You can use your $1 million lifetime gift tax exclusion to make even larger gifts. And any gift now avoids potential estate taxes later.

Failing to consider the benefits of charitable contributions. Fulfilling your philanthropic goals can also have many tax benefits. Your estate can take a deduction for gifts—including cash, personal property, real estate, and certain investments—made to charitable organizations upon your death. (Charitable gifts during your lifetime are also deductible, and reduce the size of your taxable estate.) Other options to consider are a charitable remainder trust that pays a lifetime income to you and distributes remaining assets to a charity at your death, or a charitable lead trust, which reverses the equation, paying the charity now and your heirs when you die. And you might use life insurance to “compensate” family members for the part of their inheritance that goes to charity, if you are insurable and inclined to do so.

Keeping life insurance in your taxable estate. Life insurance benefits aren’t taxed as income but they do go into your estate and could increase your heirs’ estate taxes. A better option may be to have your policy owned by an irrevocable life insurance trust that can pass along proceeds without tax liability.

Failing to update estate strategies periodically. Everyone’s circumstances change. Your wealth may increase or decrease, new children may be born while others reach adulthood, and you could be widowed or divorced and remarry, adding the complications of a second family. Regular reviews can make sure your estate plan keeps up. ●

his aunt Jill. The name on the IRA should read, “Jack Hill as beneficiary of Jill Hill.” In contrast, if Jack had been Jill’s spouse, the IRA could have been titled as if he had owned it all along.

More significantly, the asset switch must be a direct “trustee-to-trustee” transfer. A non-spouse beneficiary can’t touch the funds or take 60 days to redeposit them in an IRA the way a spousal beneficiary could. Also unlike a spousal heir, a non-spouse can’t move the cash into an existing IRA. The funds must be deposited in a new IRA set up for this purpose. Finally, a non-spouse beneficiary can’t wait until age 70½ to begin taking RMDs. This option is still available only to spousal beneficiaries.

Despite these restrictions, non-spouse beneficiaries get a huge lift from the PPA. For example, if you’ve named your 50-year-old child as a beneficiary, he or she should be able to stretch out withdrawals from the account based on a life expectancy of 34 years, according to IRS-approved tables. That’s a whole lot better than a forced five-year withdrawal.

The exact calculation depends on whether the IRA owner had started receiving RMDs before death. This is a complex area of tax law. But we are here to help you ensure that your heirs get the full benefit of your generosity. ●

Use FLPs To Transfer Assets And Cut Estate Taxes

Despite recent court rulings, the family limited partnership—or FLP, pronounced "Flip"—remains a useful tool for wealthy individuals. Yet with the Internal Revenue Service on the lookout for abuse, you must proceed with caution and good legal advice.

For a typical FLP, you set up a limited partnership and transfer income-producing assets—perhaps a business interest or investment real estate—into the partnership. Those who contribute assets are named either the general partner (GP) or limited partners (LPs). The GP has control over assets and distributions, but for exactly that reason, his GP interest is subject to estate tax—and so he shouldn't contribute the majority of the assets, and may want to consider a different estate planning vehicle altogether.

If you're married, though, you could have your spouse contribute all of the investment assets as a limited partner, while as GP you still get to make partnership decisions. Future transfers of assets to children or grandchildren will come from your spouse's shares.

Partnership earnings are paid out to the limited partners, who are taxed on the income. Assuming they're in lower brackets than you are, less money ends up going to the IRS. And if you handle things properly, the assets transferred to the FLP are removed from your taxable estate.

The asset transfer to the FLP is a potentially taxable gift, but you can minimize liability with your annual gift tax exclusion and lifetime exemption. Under the annual exclusion, you may make gifts valued at up to $12,000 per year ($24,000 if your spouse also gives) to each recipient. You could use these amounts over several years for a tax-free transfer of assets into the FLP. Plus, everyone is entitled to an additional $1 million or so (this number changes frequently) in untaxed gifts over a lifetime, and that exemption can cover gifts exceeding the annual exclusion. Potentially even better, the value of FLP interests can be discounted by as much as 30% for estate and gift tax purposes, because limited partners can't easily sell their shares. However, to be completely safe, you may want to keep annual gifts below the $12,000 threshold, because there's a chance the valuation discount could be audited later and disallowed.

Keep in mind, too, that the IRS is inherently suspicious of such arrangements, and if an FLP doesn't pass muster, all assets could end up back in your taxable estate. That's what happened in a landmark case in which Albert Strangi, an elderly entrepreneur, transferred most of his assets to an FLP and named his adult children as GPs together with him. He claimed quite generous discounts on the value of the transferred partnership interests, and distributions from the FLP were used solely to pay Strangi's personal expenses. The Fifth Circuit Court of Appeals eventually ruled that the FLP assets must be counted in Strangi's estate.

Despite the Strangi case, however, FLPs may offer potential benefits for your estate. We can work with your tax advisors to structure a partnership that strictly follows IRS rules. ●

About The AMT In 2008

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filers with an AMT income over $382,000 and single filers over $273,500.

When the AMT calculation is complete, you apply the AMT rate to the net amount. The AMT rate is 26 percent for the first $175,000 of AMT income and 28 percent for AMT income above $175,000.

What's ahead in '08? Unless Congress wipes out the AMT once and for all, high-income taxpayers will face a monumental challenge in 2008. It's best to start planning early to minimize your AMT liability . Make an estimate of where you'll stand at the end of the year, and if you're facing a major AMT liability, consider the following steps for reducing the tax.

- **Avoid prepaying state and local taxes.** Absent the AMT, that's a good way to bolster deductions at year-end. But this strategy backfires if you're subject to the AMT because these taxes aren't deductible for AMT purposes. Prepay enough for your regular tax liability to equal AMT liability.
- **Shy away from investments in private activity bonds.** These are municipal bonds that are used to finance private activities such as certain housing projects and hospitals. Income from these bonds is subject to federal taxes if you pay the AMT. Other municipal bonds are tax-free regardless, so make sure that's what you have in your portfolio. When evaluating munis, specify "AMT free" bonds.
- **Stagger the exercise of Incentive Stock Options.** The "bargain element"—the difference between the option's fair market value and exercise price—is an AMT tax preference, so time such income carefully. Look to postpone exercising ISOs to 2009.
- **Postpone other extra income that might limit your exemption amount.** If you expect to realize a big capital gain from a real estate sale, selling the property on an installment basis will spread out the taxable income over several years. Alternatively, wait until next year to complete the sale and then deal with AMT complications. Better yet, explore the possibility of a tax-free exchange under tax section 1031.
- **Reduce taxable income.** This is the starting point for calculating AMT so try utilizing techniques to reduce your taxable income like increasing pre-tax 401(k) contributions or charitable donations.
- **Consider accelerating more income into 2008.** This may sound crazy, but if you know you're going to pay AMT and you're normally in the 33% or 35% tax bracket, moving up extra income means it would be taxed at 28%, the AMT's top rate. ●

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