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TAX STRATEGIES

VIRGINIA B. MORRIS AND
KENNETH M. MORRIS

TAX STRATEGIES

CONTENTS

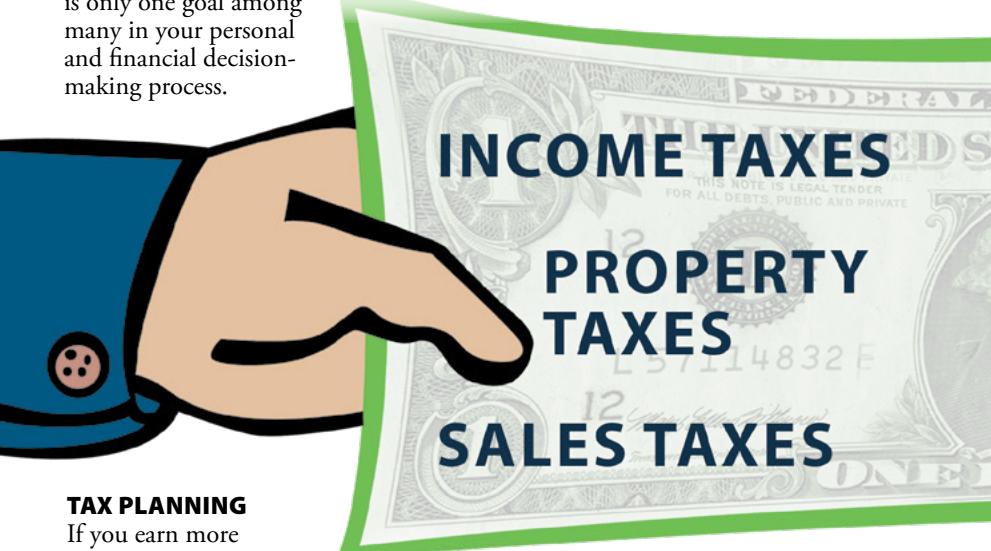
- | | |
|--|---|
| 2 Getting a Grip on Taxes | 18 Tax-Free Earnings for College |
| 4 Adjusting Your Income | 20 Flexible Spending Accounts |
| 6 Tax Benefits | 22 Health Savings Accounts |
| 8 Investing, Tax-Wise | 24 Using Trusts |
| 10 Tax Planning for Investments | 26 Testamentary Taxsavers |
| 12 TaxTime | 28 Gifts |
| 14 IRA Rollovers | 30 And More Gifts |
| 16 Strategies for Paying | 32 Glossary |

Getting a Grip on Taxes

The more you know, the less you'll owe.

Nobody likes paying taxes. Fortunately, you can reduce what you owe without running into trouble with the law. But to succeed, you need a sense of how the tax system works and where the opportunities for saving are.

At the same time, it's equally important to recognize that avoiding taxes is only one goal among many in your personal and financial decision-making process.



TAX PLANNING

If you earn more income, buy a home, marry or divorce, have children, go into private practice, save for retirement, or buy and sell investments, it will affect many of the taxes you owe.

Tax planning is one way to make the system work for you instead of against you. That involves two basic steps:

- Recognizing that your personal and financial decisions have tax consequences
- Making choices that have the potential to reduce or postpone the taxes you owe

For example, if you and your spouse are both earning income, you'll have to decide whether to file a joint income tax return or file separately by weighing the advantages and drawbacks of these alternatives.

Or, if you sell an investment that has increased in value to give you cash to buy a new car, you'll probably have a capital gain that could increase your tax bill. To offset the gain, you might want to sell investments that have lost value. That way, you can deduct your capital losses from your capital gains to reduce or eliminate the amount on which tax is due. But for the strategy to work, you usually must act by December 31 of the year for which the taxes are due.

A BIRD'S EYE VIEW

Your quest for a smaller tax bill would probably be easier if the US tax system were simpler. The complication is that federal, state, and local governments all have taxing power, and each taxing authority focuses on different ways to collect its share of your money.

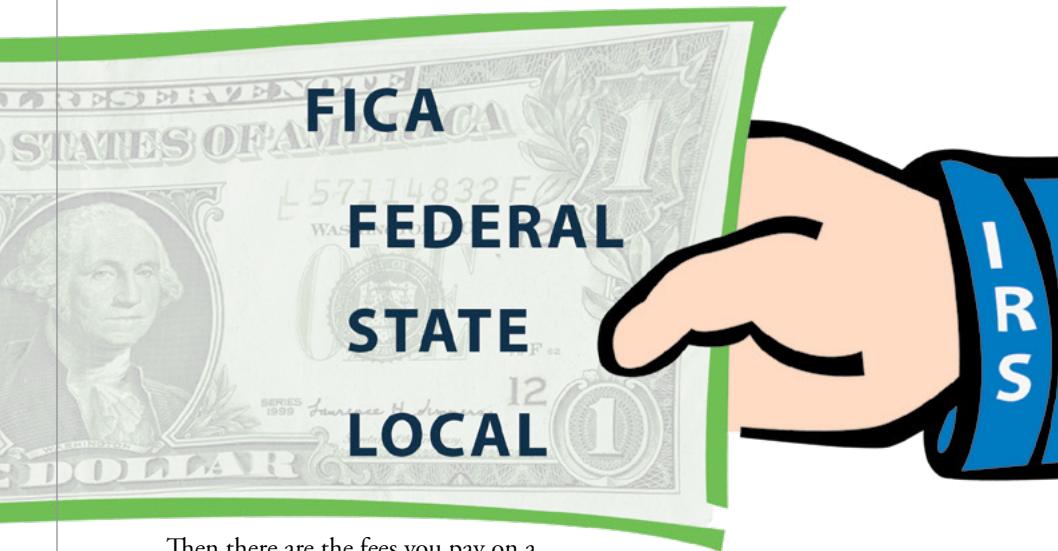
The federal government, all but nine states, and some cities tax your income. While you may be able to avoid state or city income taxes by living somewhere that doesn't impose them, you can't escape federal income tax even by moving out of the country.

All but five states and many local governments charge sales taxes on goods and services you purchase in the state or online for delivery there, though the rates they impose and the items they tax vary from place to place. In addition, the federal government charges excise taxes on a range of sales, from gas and airline tickets to alcohol and tobacco.

In addition, you can expect to pay property taxes, typically on real estate but also on vehicles in some states. Though renters don't pay real estate taxes directly, the cost is imbedded in what the landlord charges. With these taxes, too, rates vary substantially, from state to state and typically within a state.

FICA TAXES

Your employer must also withhold what's required by the Federal Insurance Contribution Act (FICA). That's 6.2% of your earnings up to the annual income cap for Social Security, plus 1.45% with no cap for Medicare. Based on your earnings, you may also owe an additional 0.09% Medicare tax. That's called a **surtax**, because it's a tax on top of another tax.



Then there are the fees you pay on a toll road or a bridge, which aren't legally considered a tax but are, for all intents and purposes. And at least part of the cost of registering your car is considered a personal property tax.

PREPAYING WHAT YOU OWE

Since governments need what they collect in income taxes to help cover their operating budgets, they insist you prepay what you owe.

If you have a regular income, your employer **withholds** what's due based on information you provide on IRS Form W-4. What you want to accomplish in completing the form is coming as close as you can to matching the amount that's withheld with what will be due. That way, you can avoid a potential penalty for underpaying and the pointlessness of overpaying.

The only flexibility you have is in the number of allowances you claim: one for yourself and one for each dependent you claim, while allowing for each factor—such as non-salary income—that will impact what you'll owe. More allowances mean less is withheld, increasing your take-home pay. Taking fewer allowances has the opposite effect, more withheld and less in your pocket.

To help you determine the right number of allowances, the IRS

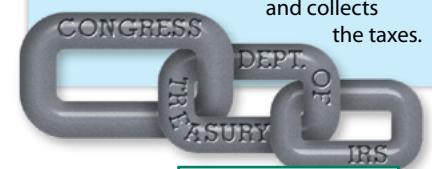
provides a "Deductions and Adjustments Worksheet."

But the worksheet isn't simple and requires detailed information about your finances. It probably pays to ask for help in completing it from your employer or a knowledgeable tax adviser. Remember that you can update the form at any time, especially if you discover on April 15 that you missed your target or if your financial situation changes.

The alternative is to make estimated payments four times a year, which requires more work on your part but is an option if you have self-employment income.

THE CHAIN OF COMMAND

Taxes don't just happen. Congress passes the federal tax laws that make up the Internal Revenue Code (IRC), sets the tax rates, and authorizes the way tax money is spent. The Internal Revenue Service (IRS), which is part of the US Department of the Treasury, interprets the Code through a series of regulations and collects the taxes.



Adjusting Your Income

Fortunately, you don't owe tax on every last nickel.

If you're looking for the bright side of paying income taxes, consider this: Your **taxable income**—the amount of income that's the base for calculating what you owe—is always less than your **total income**, sometimes called your gross income.

That's because the tax law—officially the Internal Revenue Code—lets you deduct certain amounts from your total income in figuring your taxable income. And you may also be able to subtract credits to reduce your actual tax.



WORKING THE NUMBERS



1 The process of finding the tax you owe begins with totaling your income. You add up all your earned and unearned income, including basic things like your salary, interest, and dividends. Your income may also include a list of things that might not occur to you, such as sick pay and unemployment. The IRS provides a fairly exhaustive list in the instructions that come with tax forms and in Publication 17, "Your Federal Income Tax."

2 The next step in finding your taxable income—which determines the tax you owe—is calculating your **adjusted gross income (AGI)** by subtracting your **adjustments to income**, or certain specific expenses listed on tax Form 1040.

Among the adjustments that may be relevant to you are interest on student loans, contributions to deductible IRAs, or deductible health savings accounts (HSAs).

FILING STATUS

Your **filing status** is the other factor that determines how much income tax you owe in any year. In fact, filing status is the major reason that people with similar incomes owe different amounts.

When you're supporting yourself—which means you get less than half of your support from someone else—you choose your filing status from among the five that are available, based



SOME FREE LUNCH

A few—but not many—sources of income aren't taxed if you're on the receiving end, including gifts, tuition scholarships and some fellowships, tax-exempt interest from municipal bonds, and child support payments.



TAXING THE UNEARNED

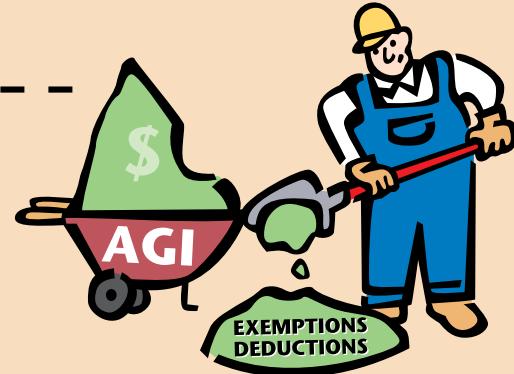
Remember, you also owe tax on **unearned income** from your savings and investment accounts, which you report on schedules B and D.

If you sell investments for more than you paid for them, you owe **capital gains tax** on your profit. Long-term gains on most assets you own for more than a year before you sell them are taxed at a lower rate than short-term gains or earned income. But they're still taxed.

If you're paid interest on a savings account, certificate of deposit (CD), or bond, you owe tax on that amount even

if you leave the interest in your account to compound. The same is true for dividends you receive on stocks or mutual funds, whether or not you reinvest those earnings. The good news is that the tax on most dividends is figured at the long-term capital gains rate.

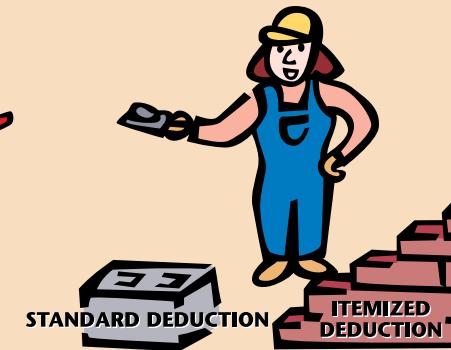
Banks, brokerage firms, mutual fund companies, and other financial institutions typically don't withhold income tax on the interest or dividends they pay you. If it's substantial, you can either increase the amount you have withheld from your earned income or pay estimated taxes.



3 Next, you subtract **deductions** from your AGI to find your taxable income.

Deductions are designed to reduce your taxable income and so the amount of tax you owe. The standard deduction you can take depends on the way you file your return—as single, married filing jointly, married filing separately, or head of household. People who are 65 or older and those that are legally blind qualify for a higher deductible.

In some years, there are exceptions to the general rules on deductions, so it always pays to check if you qualify for additional savings that would reduce your taxable income. For example, you can deduct any financial losses you suffered as result of a federally declared disaster, such as a fire, tornado, hurricane, or flood.



4 You can take either the **standard deduction**, an amount that covers certain personal expenses, or you can **itemize**, or list, your deductions and take that amount if it's higher than the standard. Most people don't bother itemizing, but if you have mortgage interest and real estate taxes, charitable contributions, or certain other expenses, itemizing may pay off in lower taxes.

But the only medical expenses you can deduct are amounts you paid out of pocket during the year, that were not covered by insurance, and that are more than 7.5% of your AGI.

on your actual living situation, or, more precisely, your situation as the IRS defines it.

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Widow or widower with dependent child

When you do have a choice, such as filing joint or separate returns when you're married, you'll usually owe less tax if you do the conventional thing and file jointly. Plus, filing separately makes you ineligible for a number of tax-related benefits, like being able to convert a traditional IRA to a Roth IRA.

Tax Benefits

Finding different routes to tax savings can be a reason to celebrate.

Among important ways to capitalize on the tax savings that are built into the federal system are subtracting all of the

tax credits for which you're eligible and taking advantage of the various benefits that come with homeownership.

MAKING THE MOST OF CREDITS

There are several substantial tax credits you may be eligible to take, especially early in your career. Because you subtract credits from the tax due, they reduce the amount you would otherwise owe dollar for dollar. What's more, some credits are **refundable**, which means that if the credit is larger than what you owe, the

IRS pays you the amount that remains after your tax is paid.

Most credits have AGI limits and other restrictions, which limit who qualifies to claim them. And what's available can vary from year to year, but it can be worth the trouble of checking out those that may benefit you—perhaps some of the ones in this list.



The **child tax credit** lets you subtract up to \$2,000 for each qualifying dependent child. The credit is fully refundable.

The refundable **child and dependent care tax credit** lets you subtract up to 50% of the amount you spend on childcare or care for an incapacitated spouse or parent so that you can work. The cap is up to \$4,000 for one qualifying dependent and up to \$8,000 for two or more. But you need to check the age and other restrictions.

YOUR HOME AS A TAX SAVER

You may be more likely to think of the taxes you pay because you own a home than the tax benefits you may realize from owning it. But think again. You may want to rethink this.

As a homeowner you can deduct the annual interest you pay on mortgage loan debt on a primary or secondary residence, with the cap based on the year you bought the property. On

The **adoption credit** covers up to \$14,400 in adoption costs per child, though it does not apply if you adopt your spouse's child.

There are two green energy credits. With the **plug-in electric-drive motor vehicle credit**, you could qualify for up to \$7,500 depending on the specific vehicle you buy, and with the **residential energy credit**, you can deduct up about a quarter of the cost of solar energy systems, though this credit is scheduled to expire in 2024.



a home purchased on December 16, 2017, or after, the cap is \$750,000. For a purchase before that date, or a purchase for which you had a

binding contract by January 1, 2018, that closed before April 1, 2018, the cap is \$1 million.

Interest on a home equity loan is also deductible, provided you used the money to build or substantially improve a home you own or to buy a qualified home. The same cap, of \$750,000 and



\$1 million respectively, apply to a mortgage loan. Further, if you have both a mortgage loan and a home equity loan, the interest that's deductible on the home equity loan may be reduced if the combined value of the loans exceeds \$750,000 or \$1 million.

You can also deduct up to \$10,000 you paid in state property taxes, or a combination of property and either state and local income taxes or sales taxes.

HOME SALES TAX SAVINGS

If you sell your home for more than you paid to buy it, plus the expense of the **capital improvements** you made while you lived there, and the cost of selling, you have a taxable **capital gain**.

First, what's a capital improvement? Basically, it's work on a property that increases its value or prolongs its life. Among other things, additions, renovations, room conversions, roof replacements, and similar permanent changes count. However, repairs or replacements of defective appliances, interior and exterior painting, and other maintenance do not.

The costs of selling include the commission you pay a real estate agent, repairs and improvements to foster a sale, a buyer's warranty, attorney's fees, and closing costs—roughly 10% of the selling price.

These numbers, backed up by good records, are important because the higher the purchase price plus improvements plus selling costs, the less the gain. And there's a bonus. You can reduce that gain further by subtracting \$250,000 if you file as a single taxpayer or \$500,000 if you file jointly as a married couple. The tax you owe is calculated on the remaining balance.

If you've owned the house for more than a year, the long-term rate is either 15% or 20%, depending on your income. If it was less than a year, it's a short-term gain and taxed at the same rate you pay on your ordinary income. And, if you sell at a capital loss, the loss is not deductible.

To find out more, check out IRS Publication 523, "Selling Your Home."

FIGURING GAIN

\$ 850,000	Purchase price
+ 125,000	Capital improvements
= \$ 975,000	Cost basis
\$ 1,295,000	Sales price
- 60,000	Fix up costs
- 12,950	Cost of selling
= \$ 1,177,050	Adjusted sales price
- 975,000	Cost basis
= \$ 202,050	Capital gain
- 250,000	Tax credit
= \$ 0	Taxable gain

SHIFTING AND BUNCHING

Two approaches to reducing your tax bill share similar strategies for handling the timing of income and of expenses in the December and January timeframe.

The objective of **shifting** is paying income tax at a lower rate on certain non-salary income—think signing bonus, capital gain, real estate closing, or other amounts with timing you can control. If your rate is lower this year than you expect it to be next, you arrange for these payments to be finalized in December rather than January.

If you expect it to be lower next year, you arrange for January payments. There are rules that limit your ability to shift income in this way, so you should be sure to seek professional advice.

Bunching, on the other hand, involves consolidating expenses, such as uncovered dental work or medical expenses, into one year rather than scheduling them over two years. In that way, it may be more likely that you could reach the threshold for deductibility—currently 8.5% of AGI for medical expenses.

Investing, Tax-Wise

Be tax-smart. Take advantage of ways to pay less.

Inflation nibbles away at your investment earnings over the years, but taxes can take big bites every year. The solution isn't out of reach: You can include some tax-saving strategies in your overall financial plan.

Three strategies you'll want to emphasize are

- Making tax deferred investments
- Choosing some tax-exempt investments
- Emphasizing tax efficient investments in your taxable investment portfolio

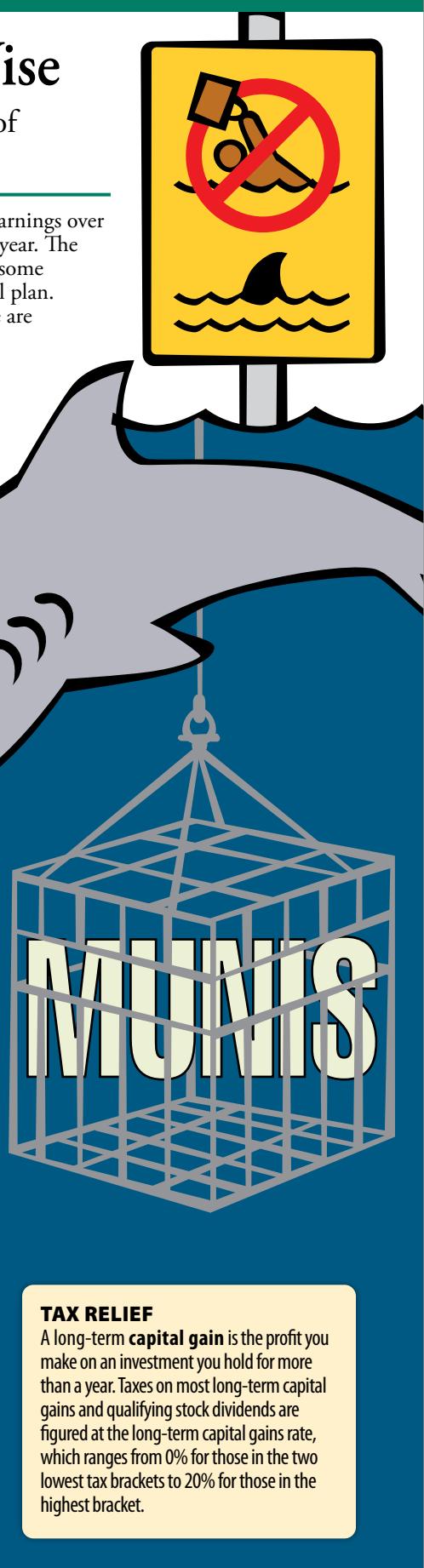
TAX-DEFERRED INVESTING

One of the most effective ways to reduce your current tax obligations is to invest the money you've earmarked for long-term goals using tax-deferred accounts. When you do, income taxes on any investment earnings in the account are postponed, or deferred.

With a traditional tax-deferred retirement savings account, such as a 401(k) or 403(b), your contributions to the plan are also tax-deferred, reducing your current tax bill. You may also qualify to deduct your contributions to a tax-deferred individual retirement account (IRA). Both types of plans have required minimum distributions (RMDs) starting for the year you turn 72, and those distributions—better known as withdrawals—are taxed at the same rate as your ordinary income.

If your employer offers a Roth version of the 401(k) or 403(b), contributions are taxed but RMDs are exempt from tax if you're at least 59 ½ and your account has been open at least five years. With Roth IRAs, if you qualify to contribute, there are no RMDs and withdrawals are tax-exempt.

There are also tax-advantaged accounts for education savings and healthcare savings. In both cases, withdrawals are tax-exempt if you use the money to pay eligible expenses.



TAX RELIEF

A long-term **capital gain** is the profit you make on an investment you hold for more than a year. Taxes on most long-term capital gains and qualifying stock dividends are figured at the long-term capital gains rate, which ranges from 0% for those in the two lowest tax brackets to 20% for those in the highest bracket.

TAX-EXEMPT INVESTING

One way to pay less in income taxes is to invest in tax-exempt **municipal bonds**, or **munis**. They're bonds issued by states, or local governments, usually to raise money for building or improvement projects or to pay for day-to-day operating expenses.

Munis usually pay less interest than comparable taxable corporate or Treasury bonds, but you usually don't owe federal tax on your earnings. However, they may be vulnerable to the alternative minimum tax (AMT), and any capital gains may be taxed. Your

earnings are often exempt from state tax if the bonds are issued in the state where you live.

Tax-exempt investments can make a lot of sense, especially if you're in the higher tax brackets or if you live in a state with high income tax rates.

You want to be careful, however, about buying tax-exempt bonds in a tax-deferred account. All earnings in these accounts are taxed when they're withdrawn, at the same rate you pay on your ordinary income. And since tax-exempt bonds generally pay interest at a lower rate, you also earn less.

BITING BACK AT TAXES

One of the least effective tax strategies is having too much withheld from your earned income. If you get a big refund when you file your return, don't think of it as a bonus. Think of it as a tax-free loan you've made to Uncle Sam. You can solve the problem easily by revising your W-4.

TAX EFFICIENCY

When you make investments that are neither tax-deferred nor tax-exempt, you can still limit the tax you owe by seeking tax efficient investments. What tax efficiency means in this context is that an investment provides smaller taxable earnings or capital gains than other investments with similar characteristics while at the same time providing the same or potentially stronger returns.

For example, an index mutual fund that invests in large US companies is typically more efficient than an actively managed mutual fund that makes similar investments. One of the chief reasons is that an index fund has a much lower turnover rate, which is a measure of how frequently the fund changes its portfolio. An index fund's portfolio contains the components of the index it tracks, and those components change infrequently—sometimes just once a year or less. An actively managed fund, seeking to beat the index performance may have a turnover rate approaching 100%. Any capital gains it realizes are passed along to investors, increasing their taxable income.

Similarly, exchange traded funds (ETFs) tend to be more tax efficient than actively managed mutual funds making similar investments because mutual funds must repurchase any

shares an investor wishes to sell, while an ETF has no similar obligation. If the mutual fund sells assets that have appreciated in value to meet its obligation to buy, any profits it makes on the sales, including costly short-term gains, are passed along to investors. That includes what are known as phantom gains, which are fund earnings on which you may owe tax but which were acquired before you purchased your shares.

EFFICIENCY PLUS

If you hold an investment for more than a year before you sell—which you can almost always manage to do—you'll owe tax on any increase in value at the lower long-term capital gains rate. If you sell sooner, taxes are due at the same rate you pay on your ordinary income.

Most domestic stock dividends are taxed at the same lower long-term capital gains rate, which is determined by your tax bracket.

If you own an investment that's worth less than you paid for it, you can sell, take the loss, and use that amount to offset capital gains.

Tax Planning for Investments

Don't overlook the tax consequences when figuring the return on your investments.

Taxes are a vital part of any investment decision. But remember that taxes are only a part of an overall investment strategy. Financial advisers recommend that you make investment choices not solely on tax avoidance—but on what you can expect to earn, the level of risk you're willing to take, and the diversification of your portfolio.

CAPITAL GAINS

A **capital asset** is any property you can buy or sell. That includes securities, your home and other real estate, jewelry, cars, and collectibles. A **capital gain** is your profit when you sell an asset for more than it cost you. You have a **capital loss**, on the other hand, if you sell the asset for less than it cost.

Capital gains are usually taxable. Capital losses are deductible only if you've held the item for investment and not for personal use. So you'll need complete records for all of your transactions and expenses. See IRS Publication 550, "Investment Income and Expenses," for the details. You can download or view a copy at the IRS website, www.irs.gov.

FIGURING GAIN

You figure gain or loss by subtracting your **basis** from the proceeds of a sale. Basis is the price paid for the item, plus the expense of buying, holding, and selling it. For example, the commissions and costs of an investment transaction are subtracted from the proceeds of a sale when you figure a gain or loss. If you received the item as a gift, your basis is the same as the giver's was. If you inherit an asset, your basis is the market value on the date of the giver's death. See IRS Publication 551, "Basis of Assets."

PROCEEDS The amount you get when you sell your asset

BASIS The original cost of the asset, plus the cost of buying, holding, and selling it

= GAIN OR LOSS

Here's how you would figure a capital gain:

\$ 22,000	Gross proceeds from the sale of stock
- 20,000	Amount you paid for the stock
- 385	Broker's commission and fees on sale
= \$ 1,615	Your capital gain

A capital gain is the profit produced by selling investments or real estate for more than their cost.

LONG- AND SHORT-TERM GAINS

If you hold an asset for 12 months or less, any increase or **appreciation** in its value will result in a **short-term gain**. These gains are taxed as ordinary income, at your regular tax rate. But if you own an asset for more than a year before you sell at a profit, you have a **long-term capital gain**. Those gains are taxed at a maximum rate of 15% for most taxpayers, but 20% for those in the highest

income bracket. If your regular tax rate is 10% or 12%, long-term capital gains are taxed at 0%.

You could owe a net investment income tax of 3.8% as a Medicare contribution surtax if your modified adjusted gross income (MAGI) is more than \$200,000 and you're a single tax filer or more than \$250,000 if you're married and file jointly.

DEDUCTING CAPITAL LOSSES

If you lose money on an investment, you may be able to deduct your losses. You can combine your capital gains and capital losses to offset, or reduce, the gains on which you owe tax. Or you may wipe out all your gains and have a net loss.

If you have a net loss, you may use it to reduce your taxable income, but there's a cap of \$3,000 per year. If your loss is greater than that amount, you can carry over the excess and deduct it in later years.

Specific rules apply to figuring losses on investments you receive as gifts. You may want to consult your tax adviser to be sure you report them correctly.

THE LONG AND THE SHORT OF IT

An investor in the 35% tax bracket sells stock for a capital gain of \$20,000. She saves \$4,000 if she has a long-term gain on stock held more than one year.

SELL ON OR BEFORE 12 MONTHS
\$20,000 taxed at 35%
= \$7,000 TAX DUE

SELL AFTER 12 MONTHS
\$20,000 taxed at 15%
= \$3,000 TAX DUE

HOLDING STOCKS DEFERS CAPITAL GAINS TAXES

While you're holding an investment, you don't pay tax on any increase in value. The market price of a stock you bought for \$5 a share may climb to \$50, but the tax on that capital gain is deferred until you sell the stock and collect the proceeds. If you sell when you've held stock for more than a year, you owe tax at the capital gains rate, which is always lower than your ordinary income tax rate.

For this reason, you might pick stocks for their long-term growth potential as well as for regular dividends they might pay. You pay tax on most dividends as they are paid, at your long-term capital gains tax rate.



THE GAIN OF GIVING

If you donate appreciated property, such as stock or a house that you've held for over a year, to a recognized charitable organization, you may deduct the market value and avoid capital gains tax on the appreciation. If a stock's value has dropped, you can sell it, take the capital loss and donate the proceeds of the sale. However, all appreciated property may not be equal in the eyes of your beneficiary. While publicly traded securities are generally welcome, assets that can't be converted easily to cash or require expensive maintenance may not be.

PASSIVE INCOME
Passive income or losses come from businesses in which you aren't an active participant. These include limited partnerships, rental real estate, and other business ventures that you don't help manage.

Losses from passive investments may be used to offset only income from similar ventures. The losses cannot shelter other income. That is, they can't be used to offset active income, such as wages and salaries, or portfolio income, such as interest, dividends, and capital gains. Losses you can't use may be deducted only when the passive investment is sold or disposed of in a taxable transaction. A gift is not a taxable transaction.

RETIREMENT INCOME

You'll also want to plan ahead so that when you begin to take income from your retirement accounts you'll be able to keep your taxes as low as possible.

One factor, of course, is that once you reach 72, you'll have to take annual

required minimum distributions (RMDs) from your tax deferred employer plans and IRAs, and these amounts are fully taxable. If you have large account balances, you may

want to ask your financial adviser about managing your withdrawals to spread out the tax burden.

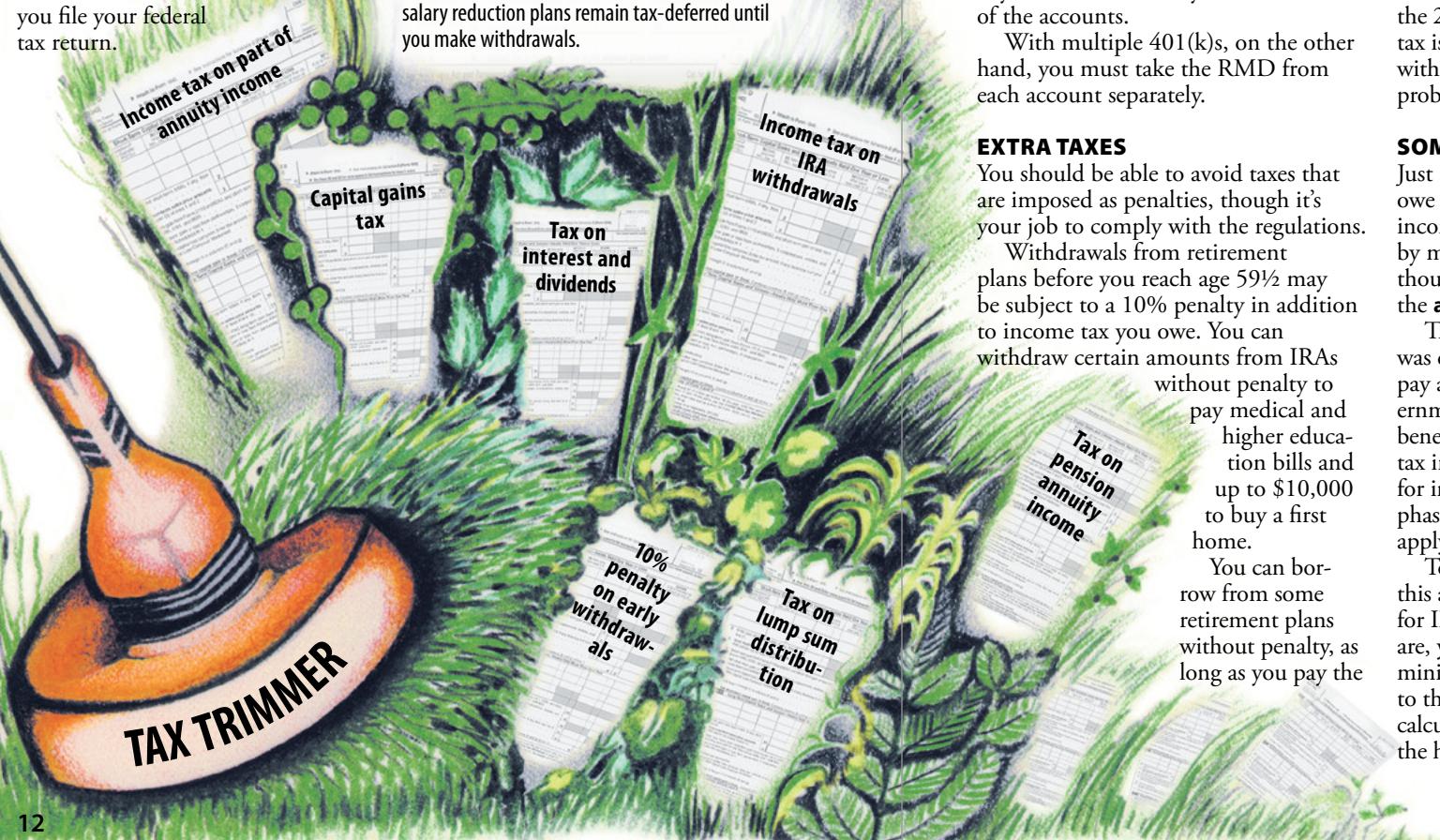
However, if you've contributed to a Roth account or rolled over assets to a Roth IRA, you can take tax-free withdrawals at any time. Interest on municipal bonds is tax free as well. And, if qualified dividends and distributions that you hold in a taxable account make up a portion of your retirement income, at least that portion will be taxed at a lower rate than your ordinary income. Part of your challenge is deciding the order in which you'll draw on your assets to provide the income you need in the most tax-efficient way.

Tax Time

Income taxes, like weeds, can be hard to get under control.

Despite the major changes that retirement is likely to bring, you won't be able to escape taxes entirely if you have income from an employer plan, an IRA, investments, or Social Security. The irony, of course, is that if you owe tax, it means you have a larger income and so may actually be more financially secure.

There are some tax breaks, though, after retirement. When you stop working, you stop paying taxes for Social Security and Medicare. That can add several thousand dollars to your bottom line. If you earn a pension in one state but move to another, you don't have to pay taxes on the pension income to the state where you earned it. (But you will be a taxpayer in the state where you live.) When you reach 65, you may also qualify for a larger standard deduction when you file your federal tax return.



TAXING RULES

Most retirement income is taxed, based on the type of income it is. Here's an overview of federal rules that apply:

Annuity income: A portion of each annuity payment is considered a return of principal and is not taxed unless it was purchased with pretax dollars. Earnings are taxed at your regular rate.

Capital gains: Profits from the sale of stock, mutual funds, your home, and many other investments are taxed at your long-term capital gains rate, provided you have held the investments for the required period.

Interest income is taxed at your regular rate.

Dividends from qualifying stocks and mutual fund distributions of those dividends are taxed at your long-term capital gains rate.

IRA distributions: All earnings in a traditional IRA and any contribution for which you took a tax deduction are taxed at your regular rate when you withdraw the money. Withdrawals of nondeductible contributions you made are not subject to tax. Additionally, income from a Roth IRA is not taxed if you are at least 59½ and your account has been open five years or more.

Lump sum distributions from pensions, 401(k)s, and other salary-reduction plans are taxed at your regular rate.

Pension annuity income is taxed at your regular rate.

Rollovers from pensions, 401(k)s, and other salary reduction plans remain tax-deferred until you make withdrawals.

STRATEGIC PLANNING

When you're ready to start taking money out of your IRAs and employer sponsored retirement savings plan, you need a strategy to meet the legal requirements while ending up with the smallest tax bill that you can. Your success will depend in large part on decisions you made when you were still part of the workforce.

If you invested in only tax-deferred accounts, after you turn 72 you must take at least your required minimum distribution (RMD) from those accounts. That could be a substantial taxable amount if you had contributed regularly to your accounts and chose well-performing investments.

But if some or all of your retirement assets were in Roth accounts, you could take your RMDs from an employer plan or withdraw from an IRA without owing any tax, provided you were at least 59 ½ and your account had been open at least five years.

If you have more than one IRA, one benefit is being able to decide which one or ones to draw on first. One advantage IRAs have over employer accounts is that you calculate the total you must take out from each account, but you may take the entire withdrawal from any one account or any combination of the accounts.

With multiple 401(k)s, on the other hand, you must take the RMD from each account separately.

EXTRA TAXES

You should be able to avoid taxes that are imposed as penalties, though it's your job to comply with the regulations.

Withdrawals from retirement plans before you reach age 59½ may be subject to a 10% penalty in addition to income tax you owe. You can withdraw certain amounts from IRAs without penalty to pay medical and higher education bills and up to \$10,000 to buy a first home.

You can borrow from some retirement plans without penalty, as long as you pay the

DON'T FORGET ABOUT ESTATE TAXES

While the amount that's exempt state tax changes from time to time, and you can't predict what the law will be at the time you die, you can use a well-designed estate plan to provide as generously as possible for your heirs. It's wise to consult an experienced professional to be sure you'll achieve this goal.

amount back within five years. But if you don't repay, you may face the 10% penalty as well as the taxes due.

There's a 50% penalty due each year on any amount you should withdraw from your traditional IRA but fail to take after you turn 72. There's also a 6% annual penalty for excess IRA contributions in your account.

You might also owe a penalty if you do an indirect IRA rollover from a qualified plan. The plan will withhold 20% of the total toward your tax bill. If you deposit the total amount including the 20% into an IRA, you can reclaim the 20% when you file your income tax return for the year. The problem is that you must put the total amount—including the 20% you didn't get—into the IRA. If you don't deposit it all, even if it's because you don't have the money, the 20% is considered a withdrawal, so tax is due and potentially a 10% early withdrawal penalty. You can avoid the problem by doing a direct rollover.

SOME INCOME IS TAX FREE

Just as you can minimize the tax you owe by choosing the way you take income, you can avoid tax altogether by making tax-exempt investments—though you may be vulnerable to the **alternative minimum tax (AMT)**.

The AMT is a separate tax system that was designed to ensure that all taxpayers pay a minimum amount of tax. The government's approach is to limit certain tax benefits to find the alternative minimum tax income (AMTI), allow exemptions for individuals whose AMTI is under the phaseout level for their filing status, and apply the AMT tax rates to the balance.

To find out if you may be subject to this alternative, you use the instructions for IRS Form 1040 or 1040SR. If you are, you must calculate your tentative minimum tax. You compare that amount to the amount you have separately calculated as your regular tax and owe the higher amount.

IRA Rollovers

Rollovers are a hop, skip, and a jump from an employer's retirement plan.



When you leave your job or retire, you can roll over the value of the assets in your employer sponsored retirement plan to an **individual retirement**

account (IRA), keeping the tax-deferred status of your assets intact. To begin the process, you choose a financial services company to be the custodian of your account. Most companies that offer IRAs provide a range of investment alternatives, so you should have no trouble finding one that offers the types of investments you want to make. In fact, you may already have an account with the custodian you choose, or you may select a new one.

The best approach to moving the money is almost always a **direct rollover**, or movement, of assets from your employer's plan to the IRA. While the time it takes to complete the process varies, your chief responsibilities are to be sure you've provided the information the custodian needs to initiate the rollover, to follow up to be sure it has been completed, and to choose your new investments.

WHY A ROLLOVER?

There are potential advantages in moving your retirement plan money to an IRA. You generally have more

investment choices, more flexibility in managing withdrawals, and more options in choosing beneficiaries. But there are also potential drawbacks. The fees could be higher with an IRA, and IRAs have no loan provisions.

Making wise moves

You can make the most of the opportunity to roll over your retirement assets if you know what you can accomplish by moving your money and the most effective ways to meet those goals.

1 FOLLOW THE RULES
You may handle a rollover yourself rather than with a direct transfer. But you take on more responsibility and face potential problems that don't arise with the direct approach.

The one advantage of an indirect rollover may be that you have short-term access to cash for 60 days between taking money out of one account and putting it in another. However, if you miss the 60-day deadline, your money is no longer tax deferred and you owe income tax plus a potential 10% tax penalty if you're younger than 59½.



The decision will depend in part on:

- How much you have to convert
- Current and anticipated tax rates
- Your age
- The time until you plan to withdraw

As with other Roth accounts, you must keep an account with transferred funds open for at least five years and be 59½ before you can withdraw tax-free earnings. If you're not confident you'll wait that long, it's probably not smart to convert, pay the tax, and withdraw early, only to face more taxes (and potentially a tax penalty).

The long-term advantage of a Roth IRA, in addition to providing tax-free income, is that no withdrawals are required while you are alive. This allows you to take advantage of the IRA's tax-deferred growth potential as long as you don't need the money.

CONSIDER ANOTHER ROLLOVER
If you take a new job where the employer offers a retirement savings plan that accepts rollovers from IRAs or other

employer plans, you may choose to move your money into the new plan. You are allowed to move money from one type of plan—say a 403(b)—to another type—such as a 401(k), if the plan accepts rollovers. That increases your flexibility, and allows you to consolidate your retirement assets. One of the things to consider is the quality of the new plan's offerings, and whether you believe they will help you meet your objectives as well as investments you select for your IRA.

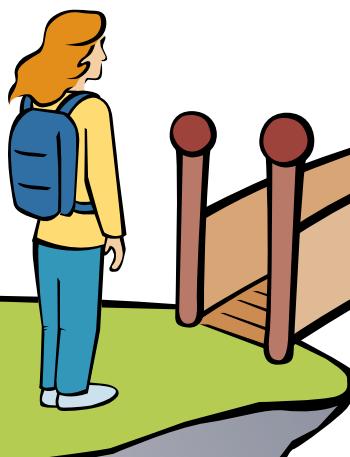
PUT AWAY PENSION PAYOUTS

You can put all or part of your lump sum pension payout in a rollover IRA. If you receive the payout in a series of payments over a period of less than ten years, you can put some or all of those payments into a rollover IRA too.

Strategies for Paying

A number of resources can help you pay for your child's education.

If you've accumulated less than you hoped by the time your child is ready to enroll, you can be confident that there are a number of other ways to help fill the gap. More than 80% of undergraduates receive some form of financial aid each academic year from a variety of different sources: federal and state governments, colleges and universities, and a vast number of private organizations, nonprofits, and religious groups, among others.



SCHOLARSHIPS AND AWARDS

Scholarships are the gold standard of financial aid. The money they provide never has to be repaid, and, because it's a gift, it's not taxable income.

Broadly speaking, scholarships fall into two categories. Some are merit-based, given in recognition of something the recipient has achieved that the grantor considers important. The achievement could be, and often is, academic. But students win merit-based scholarships for a wide range of talents, skills, and abilities—often ones that a college or university sees as important enough to justify offering an incentive that might encourage the student to enroll.

Others are need-based. These scholarships recognize the academic accomplishments of students who, without financial aid, would be unable to afford enrolling. Colleges and universities have specific policies governing how need-based scholarships are offered, something you can investigate by contacting a school's financial aid office.

In fact, that office at each of the schools your student may be interested in attending is the best place to start your scholarship search. You should also check with the high school guidance office, government agencies, and the US Department of Labor's FREE scholarship search tool. But be careful of scams. You should never pay a provider to find scholarships.

MEETING DEADLINES

Most scholarships have application deadlines, which may be a year or more

before the student plans to enroll. That means investigating what's available during the junior year in high school and being ready to apply for at least some of those you're eligible for as early as the summer between junior and senior years. Don't hesitate to make multiple applications as long as you meet the qualifications. You can never tell which ones will be successful.

Generally you apply for the scholarships offered by individual colleges and universities when you apply to those schools for admission, usually in the fall of senior year. Applying early can work in your favor, especially if there is a limited pool available.

You will want to check not only how much money each scholarship you're offered will provide but whether it will apply just one year or for each year you're enrolled full-time. Scholarships with the longer time frame are obviously preferable, as they reduce your financial concerns. Usually these longer-term scholarships require maintaining a specific grade point average.

For help evaluating the aid you're offered, check "Understand Your Financial Aid Offer" on the Consumer Financial Protection Bureau website (www.consumerfinance.gov/paying-for-college).

LOWERING THE COST

There are other ways to reduce the cost of higher education without reducing its quality. The costs at various institutions vary substantially, especially the cost of tuition. So it's smart to look at a range



TUITION GIFT EXCLUSION

Grandparents who pay a child's college tuition qualify for a special gift tax exemption if they write a check (or authorize an electronic transfer) directly to the school. Since the money doesn't go to the student, the IRS doesn't consider it a gift even if it's more than the \$16,000 tax-exempt amount that normally applies. The only downside is that the payment may reduce the student's eligibility for financial aid.

of schools, public and private, that might be a good fit.

You may also want to investigate some of these other approaches:

- Credits earned at local colleges during the summer can reduce the number of semesters required for a degree. Be sure, first, that the credits can be transferred.
- Two years at a local community college before transferring to a four-year school can help lower overall costs.
- High grades on Advanced Placement (AP) exams could count for college credit, reducing the time required to complete a degree.
- Living off-campus can be less expensive and sometimes more pleasant than school housing, provided it's close enough to keep transportation costs reasonable.

TAX CREDITS

As long as you, your spouse, or independent child is enrolled in a qualifying program, you may be able to use one of two tax credits:

- The **American Opportunity Tax Credit (AOC)**, which replaced the Hope Tax Credit, lets students or their parents subtract up to \$2,500 each year from the income tax they owe, provided they paid that amount in tuition, fees, and textbooks. The credit is available for four years of undergraduate or graduate education provided the student is enrolled at least half-time in a degree-granting program or other recognized education credential. Up to 40% of the credit may be refundable—or sent to you as a payment—if the credit reduces the amount of tax you owe to less than \$0. Qualifying expenses include tuition, fees, and course materials. If more than one

dependent qualifies, you may claim the AOC for each one.

- The **Lifetime Learning Credit** allows you to deduct up to 20% of the first \$10,000 you spend on qualifying education expenses per year. The study doesn't have to lead to a degree and there's no limit to the number of years it may be claimed.

These credits, which you subtract directly from the taxes you owe, can be claimed as long as your income meets the requirements. Congress establishes those amounts each year, with full credit available to those taxpayers whose modified adjusted gross income is less than the cap. You can find the amount for any year you might be eligible on the IRS website, www.irs.gov.

To use either credit, you must report the total tuition and fees paid for the year, in addition to any scholarships, grants, and untaxed income you use to pay these costs. You report these figures, which your child's school will list on a 1098-T receipt in January of each year, on IRS Form 8863 when you file your taxes for the previous year.

CLAIMING CREDITS

If you have more than one child you may or may not be able to claim more than one credit. The AOC applies per child, which means if you have two children who qualify, you can claim the credit twice. On the other hand, the Lifetime Learning credit applies per household, which means you can only claim one credit per year, no matter how many of your children attend school.

Tax-Free Earnings for College

Certain plans make investing for college a little easier—on your mind and on your wallet.

The good news about investing for college is that it's encouraged by the tax code. That means that as long as you stick to the rules, you and your child can enjoy the benefits of tax-free earnings. A number of investment programs, such as Coverdell education savings accounts (ESAs), 529 savings plans, and 529 prepaid tuition plans, let you take advantage of this provision. That can mean having between 15% and 35% more money to spend, depending on your tax bracket.

HOW IT WORKS

ESAs and 529 plans let you, the account owner, set up investment accounts for a **beneficiary**, or recipient, that you designate.

Within these investment plans, your earnings and any capital gains accumulate **tax deferred**, which means you put off paying taxes until your money is withdrawn. And you can withdraw your money **tax free**, or free of federal and sometimes state income taxes, as long as your beneficiary uses the money to pay for **qualified education expenses**, which may include tuition, books, fees, room and board, and more.

If you spend the money in your ESA or 529 plan on non-qualified expenses, you can expect to pay the consequences. Not only will you owe taxes on any earnings included in the amount you withdraw, but you'll have to pay the federal tax penalty—10% of your withdrawn earnings. Plus, certain states may impose an additional 10% penalty, bringing the potential fee as high as 20% of the amount you withdraw.

Contributions to tax-free accounts must usually be made in cash. You can't move investments you already own into the account. You must sell them and invest the proceeds. This could mean you'd owe capital gains taxes on any profit.

Comparing Plans

Each tax-free investment plan operates a little differently, offering its own pros and cons. The first step toward choosing the plan or plans that work best for you is learning more about their advantages and limitations.



GIFT TAXES

When you contribute money to an account in another person's name, your contribution is considered a gift. You can give up to \$16,000 per year—or \$80,000 once in five years to a 529 savings plan—before you may have to file a gift tax report and potentially pay gift taxes. But gift rules apply per donor and per beneficiary.

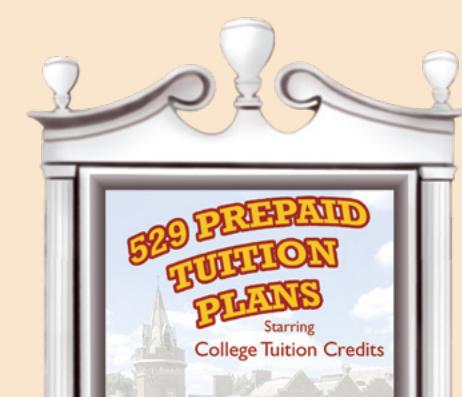
So, in one year you could contribute \$16,000 to one child's 529 account, and then contribute another \$16,000 to another child's account without making a taxable gift. Or, you and other relatives could each contribute \$16,000 a year to one child's account. Remember, though, that ESAs limit contributions to \$2,000 a year.

PUTTING IT TOGETHER

When you consider how much college can cost, it makes sense for you to invest as much as you can afford—and to do so early. In fact, you can open more than one account and take advantage of the tax benefits of different plans. For example, if you reach the \$2,000 annual

contribution limit with your child's ESA, you can also open a 529 savings plan.

Other family members and friends can contribute to these accounts or open additional accounts as well. Just be sure that their contributions fall within the limits set by ESAs, since the \$2,000 cap applies per beneficiary, not per giver.



	Coverdell education savings accounts (ESAs)	529 savings plans	529 prepaid tuition plans
How it works	You invest your account assets in any combination of products available through the financial institution you choose as custodian of your account	You contribute to an account that's typically invested in age- or risk-based investment tracks, which are provided by your plan manager	Your contributions purchase tuition credits at current rates, and the plan invests your contributions to meet future college costs
Pros	<ul style="list-style-type: none"> Accounts available through most financial services companies Investment flexibility Qualified withdrawals cover grades K through 12, as well as college and graduate school 	<ul style="list-style-type: none"> Over 100 plans available to choose from Contribution limits can be more than \$300,000 per account Beneficiaries can be named in multiple accounts Covers K-12, college, graduate school 	<ul style="list-style-type: none"> In some cases, including the private college plan, investments are guaranteed to cover future tuition credits
Cons	<ul style="list-style-type: none"> Eligibility for making contributions phases out once AGI exceeds \$95,000 (or \$190,000 if you're married and filing a joint return) Beneficiary must be under 18 to receive contributions Beneficiary can only accept \$2,000 in contributions per year Beneficiary must make all withdrawals prior to turning 30 	<ul style="list-style-type: none"> Less investment flexibility due to pre-determined investment tracks Some plans have higher-than-average fees that affect investment return 	<ul style="list-style-type: none"> Qualified education expenses include only tuition and mandatory fees at participating colleges and universities Eligibility sometimes restricted by state residency requirements

ALL IN THE FAMILY

You can switch the beneficiary of your ESA or 529 plan, as long as your new beneficiary is a member of the same family, as defined by the tax code. That includes the beneficiary's spouse, child, grandchild, stepchild, sibling, stepsibling, parent, grandparent, stepparent, niece, nephew, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law—or any of these relatives' spouses—as well as any first cousins.



Flexible Spending Accounts

You can reduce your tax bill by using certain healthcare accounts.

It's not as easy to anticipate your future healthcare costs as it is to estimate typical retirement or college education expenses. And there aren't as many tax-advantaged plans that let you benefit from planning ahead. But you may have access through your employer to a flexible spending arrangement, popularly known as a flexible spending account (FSA) that can reduce your taxes while helping to cover your medical and dental expenses.

With an FSA, you can elect to have pretax income deposited in a designated account from which you can withdraw tax free to pay for qualified services and products for yourself, your spouse, and your dependents.

FLEXIBLE SPENDING ACCOUNTS

An FSA is a tax-advantaged employee benefit, often part of a package described as a cafeteria plan because you can choose among the offerings to meet your specific needs.

An FSA lets you defer a fixed amount of pretax income—capped at \$2,850 a year in 2022—to pay qualifying out-of-pocket medical and dental expenses. Because the amount you contributed is not reported as income, the contribution reduces your current federal income tax and state taxes if they apply. The higher your marginal tax rate, the greater the benefit tax-free income provides.

Employers may contribute to your FSA as well but are not required to do so. Some provide \$500 for each employee, whether or not the employee contributes, while others match contributions dollar for dollar. Those contributions are not part of your gross income and so are also tax free.

If your spouse works for an employer who offers an FSA, he or she may contribute up to the cap as well.



USING AN FSA

In your employer's annual open enrollment period in the fall of each year you decide if you're going to participate in the FSA or other of the options in the plan and how much you'll contribute through payroll deductions. Once you make those choices, they're fixed for the following year.

You pay for the qualifying expenses either out-of-pocket or by using a dedicated debit card or stored-value card available with the plan. If you've laid out the cash, you submit your receipts to the plan administrator for reimbursement. You should note, though, that not all retailers are equipped to accept FSA debit cards, so you should either check ahead of time or be prepared to pay another way.

The debit card is loaded at activation with the full amount you have selected to contribute, so it is possible to pay for a large cost early in the year provided it doesn't exceed that amount.

Whichever way you pay, it's essential that you keep detailed records of your expenditures. You may be required to provide that backup information if asked.

WHAT'S COVERED?

The expenses you can pay for with FSA funds include, but certainly aren't limited to, costs you associate directly with medical care, such as deductibles, coinsurance, or copayments or other costs associated with hospital stays or doctor visits that your insurance doesn't cover in full. Dental care, for which many people don't have insurance, is covered as is vision care, glasses and contacts, and hearing aids.

Other eligible items include prescription and over-the-counter medications, insulin, toiletries including menstrual care products, bandages, home test kits for Covid, bandages, medical equipment including crutches and walkers, and diagnostic devices. For a full list, check IRS Publication 969 "Health Savings Accounts and Other Tax-Favored Health Plans."

OTHER WAYS TO SAVE

A dependent care FSA (DC-FSA) helps to pay for day care, preschool, summer camps, and before or after school programs for children under 13 and those incapable of caring for themselves. The annual contribution limit is \$5,000 for married couples filing jointly, single parents or guardians or \$2,500 if you're

ONE LIMITATION

If you're a sole practitioner, a partner, a member of an LLC, or the owner of an S corporation, you're not eligible to participate in an FSA if you have a 2% or more ownership stake.

RULES AND REGULATIONS

While you have a lot of leeway in spending your FSA account, certain rules apply. Among other things, you can't use FSA money to pay health insurance premiums.

Generally, you must use the full balance of the account within the calendar year. That means you must estimate carefully how much your qualifying expenses are likely to be. That may be especially important if both you and your spouse contribute separately. Of course, there's nothing wrong with a flurry of buying at the end of the year if you still have money left. But random buying, even if the expenses qualify, works against the fact that you contribute to the account to save money by reducing taxes.

Employers can offer one of two options for dealing with outstanding balances:

- A grace period of up to 2 ½ months to spend down account balance
- The right to carry over a specific inflation-adjusted amount (\$570 in 2022) to use in the following year

FSAs are not portable, so you can't take them with you if you leave your employer for any reason. But an employee who does leave can receive reimbursements through the end of calendar year, up to the amount that he or she has actually contributed to the account.



married but filing separately. However, you can't claim the child and dependent care credit for amounts paid through a DC-FSA. The money may also be used for elder care if the adult lives with the FSA holder at least eight hours a day and is claimed as a dependent.

Other pretax options cover adoption assistance and commuter benefits.

Health Savings Accounts

You can pay current and future healthcare costs tax free.

If you participate in a high-deductible health plan (HDHP) and don't have other health insurance, you're eligible to open a **health savings account (HSA)**. That entitles you to contribute up to the annual limit—\$3,650 for an individual or \$7,300 for a family in 2022—to cover a wide range of healthcare costs. When you reach 55, you can add an additional \$1,000 a year as a catch-up contribution.

You owe no income tax on your contributions or any contributions your employer may make. Earnings in the account accumulate tax deferred. And withdrawals are tax free if they're used to pay qualified medical expenses including deductibles, prescription and over-the-counter drugs, and a long list of other products and services.

What's more, an HSA is portable. The account assets are always yours whether you change employers, switch to conventional health insurance, or enroll in Medicare when you turn 65.

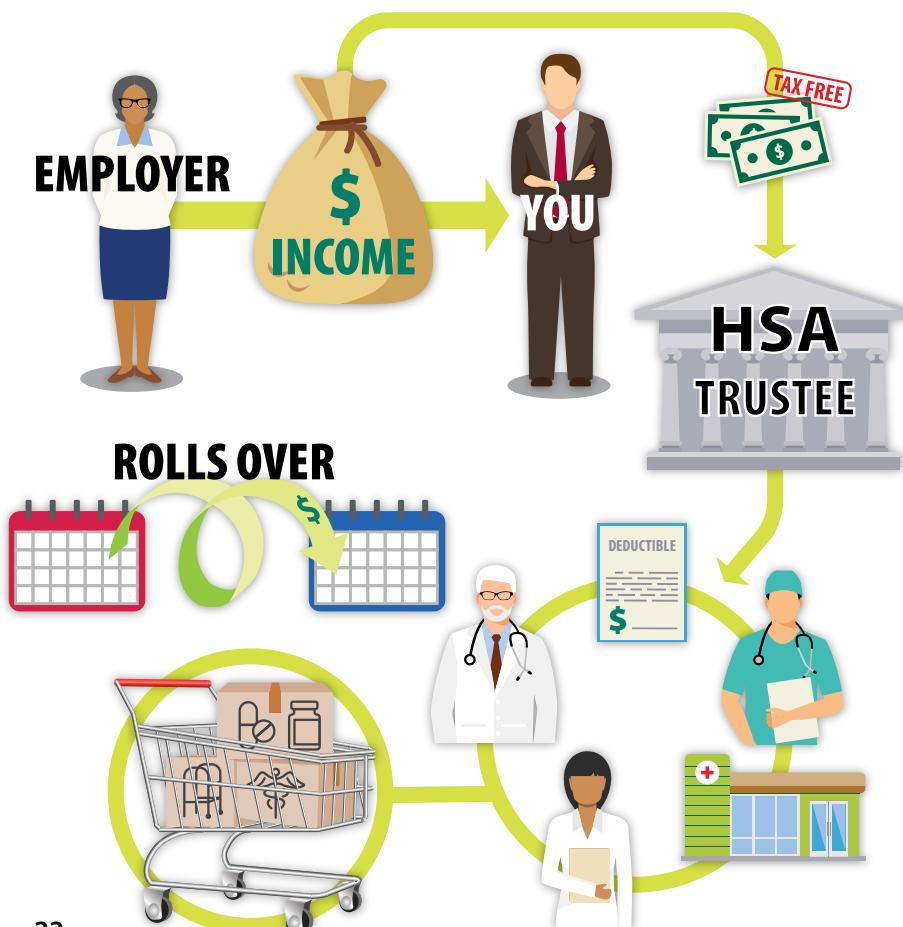
WHAT'S A HDHP?

An HDHP has a higher deductible than most health insurance plans and usually a lower premium. After you meet the deductible—at least \$1,400 for an individual and \$2,800 for a family but often much higher—the insurer pays its share of your qualifying medical costs. There's a cap on how much you must pay out-of-pocket: \$7,050 for an individual or \$14,010 for a family in 2022. Out-of-network costs don't count against either the deductible or the cap.

And unlike tax-deferred retirement savings accounts, there are no required minimum distributions (RMDs).

HOW AN HSA WORKS

If you have an HDHP as an employee benefit, your employer may have chosen a bank or other financial institution



to act as trustee for employee HSA accounts. Or you can choose your own trustee if your employer hasn't identified one, if you prefer a different provider, or if you purchased the HDHP yourself. You'll find that HSAs are available from most organizations that offer IRAs.

One convenience of using the provider your employer has identified is that you can have pretax income deposited directly to your account. That may also be possible if you choose a different trustee and provide the routing number and account number. You should be sure to ask.

If you must contribute after-tax income, you can deduct your contribution when you file your tax return for the year using Schedule 1 with IRS Form 1040 and attaching Form 8889.

USING YOUR HSA

A primary purpose of an HSA is making it easier to pay your current healthcare expenses, including the deductible you must meet to trigger coverage from your insurer. Because the money in your HSA is totally tax free, these costs take a smaller bite of your income.

However, HSAs have an important feature that works to your benefit if you have money left in your account at the end of the year. You can roll over these amounts indefinitely for as long as the account is open—potentially for your lifetime.

If you can afford to pay your current medical expenses without tapping your HSA and contribute the maximum every year, the account can function as a tax-advantaged savings account. If you have selected a provider that offers a menu of low-cost investments with the potential for providing strong returns, the accumulated value could be substantial.

When you reach 65, you can no longer contribute to your HSA. But you can still benefit from tax-deferred

earnings and make tax-free withdrawals to pay your medical expenses, which tend to increase, sometimes significantly, as you grow older. And you can use withdrawals to cover other expenses, though those amounts are taxable.

CHOOSING AN ACCOUNT

Among the factors that impact account quality are the fees that may apply, the investment options that are available, how easy it will be to access your account, and the institution's reputation for customer service. That information, except the last, should be available on the provider's website.

Fees are particularly important because however you use your HSA they eat away at your balance. You'll want to pay particular attention to the cost of possible monthly fees, withdrawal fees, and investment fees if you are using the account primarily to accumulate savings.

Account access may or may not depend on location. If the account provides a debit or stored value card or account-linked checks, physical proximity may not matter. But the extent of back-up documentation you need to withdraw money for qualified expenses may also be an access issue. You'll find that some providers are more demanding than others.

Remember, too, that you're not tied to any HSA account. If you're not happy, you can open a new account and authorize a trustee-to-trustee transfer. The change has no impact on the tax-free status of your account. And you can have multiple HSAs if you wish, provided the total amount you contribute in any year you have an HDHP doesn't exceed the annual limit.



EXCEPTIONS TO THE RULE

Generally speaking, you can't have an HSA and a flexible spending account (FSA) at the same time. But there are two exceptions.

If you have an HSA, you can also contribute to a limited purpose FSA (LPFSA), whose funds can be used exclusively to pay dental and vision expenses. But you

can't draw on both accounts to cover the same expense, or what's known as double dipping.

With an HSA, you can also participate in a dependent care FSA, withdrawing to cover what you spend to care for children younger than 13 and dependents of any age who cannot care for themselves.

Using Trusts

You can reduce what your estate owes in taxes by using certain trusts.

A trust is a legal document that transfers property but also allows you to manage that property, avoid probate, and perhaps most attractive, save on taxes. Since no single trust can accomplish everything you may want to achieve, the solution is to establish multiple trusts, some while you're alive and others in your will. The former are living, or *inter vivos*, trusts and the latter are testamentary tests created after your death. Some living trusts are revocable, which means they can be changed. Others are irrevocable.

As the person creating a trust, you're known as the **settlor, donor, or grantor**. The trust document specifies what property is included and establishes the ground rules for how the assets will pass to the beneficiaries you have designated. To ensure that your wishes are followed, you name a **trustee**. He or she has a fiduciary responsibility to act in the beneficiaries' best interest.

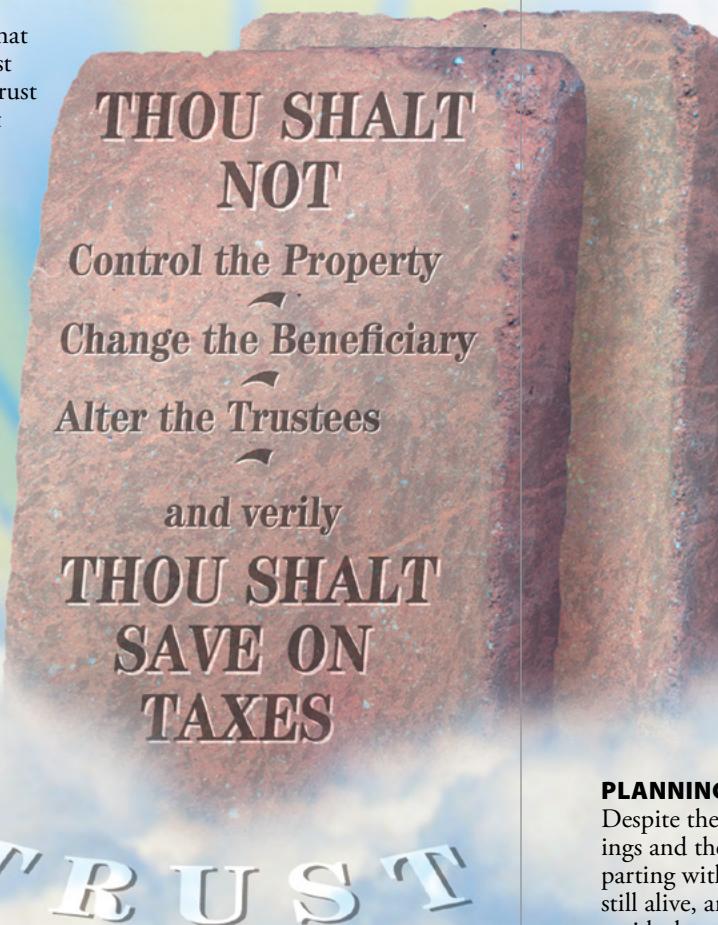
IRREVOCABLE LIVING TRUSTS

Once property is put into an irrevocable trust, it's there for good. The same is true of beneficiaries. You can't add one, or take one away. And the only way to change a trustee is for that person to agree to resign or to die. So why would anyone agree to such an inflexible arrangement? The answer, in short, is tax savings.

Irrevocable trusts can provide significant tax savings because the property you transfer to the trust is no longer yours. The trust itself—not you—pays income taxes on what the assets earn. When you die, the trust property is not part of your estate and is not subject to estate taxes. What's more, through the terms of the trust, you can exert continuing control over the way that your property is distributed to your beneficiaries.

GIVING UP CONTROL

To reduce your estate for tax purposes, though, the assets you give away or put in trust must belong permanently and unconditionally to the recipient. From the government's point of view, you no longer control the property if someone else has the legal right to decide what to do with it, or if it's part of a trust that you can't change your mind about.



TAXING ISSUES

One of the disadvantages of transferring property to an irrevocable trust is that most of a trust's earnings are taxed at the highest individual income tax rate. For many people, this could mean that trust income is being taxed at a higher rate than they're paying as an individual—an unkind irony.

One way a trust can reduce a trust's income tax is by distributing the earnings to the beneficiaries, so the money is spread around to be taxed at lower rates. But that solution may be at odds with your other goals for the trust, such as asset growth to provide greater income in the future, or limiting the current disposable income of your beneficiaries.

The solution is to have the beneficiaries pay tax on the distributions and

agree to allow the assets to remain in the trust, where they can continue to compound.

TRUSTS AND TAXES

When you set up a trust and transfer assets to it, you have to consider the tax consequences. You can give the trust up to \$12.06 million in 2022 without owing federal gift taxes. But if you transfer more than that, the tax will be due, at the same rates as your estate would owe if you died with a taxable estate, at the maximum rate of 40%.

Some states have gift taxes, too, and impose them on smaller gifts than the federal government does. So you might owe state taxes, but not federal taxes. Often the biggest benefit from setting up an irrevocable trust is that any appreciation of the trust's assets after the date of the gift doesn't increase the value of your estate.

PLANNING AHEAD

Despite the shrinking income tax savings and the potential drawback of parting with your property while you're still alive, an irrevocable living trust is an ideal way to pass property to your beneficiaries. That's because the one change you can make to an irrevocable trust is to add assets to it. If you make annual tax-exempt gifts, you're reducing your estate while protecting the property until you think your beneficiary is wise enough to use the assets in ways you would approve. But you must be certain the trust is set up with **Crummey** power, to meet tax-exempt requirements.

One smart idea may be to put assets that you expect to increase in value, or cash to buy those assets, into a trust. For example, you can put stock valued at \$10,000 into a trust called a **qualified minor's trust** you set up for your child. You're within the annual tax-free gift limit. And when the trust terminates and the property becomes hers outright, it will be worth whatever the current value of the stock is—presumably but not necessarily more than its original

A CRUMMNEY CHOICE

You can add up to the annual gift exclusion in cash or other assets to an irrevocable trust every year without owing gift tax, thanks to D. Clifford Crummey, who won a court case against the IRS in 1968. The only conditions are that the beneficiary must have the right to withdraw the gift within a fixed time period and has to be notified of that right. You choose the time at which the trust will end, and the assets become the beneficiary's property. Until that date, you can act as trustee or appoint someone else to the job.

price. By using the trust, you've not only saved gift taxes on the current gift, but also on the **appreciated value** of the stock. You've also reduced income and estate taxes because the property no longer belongs to you.

SKIP LIGHTLY

If you create a trust to benefit your grandchildren, or anyone two or more generations younger than you are, it's known as a **generation-skipping trust**.

As long as the assets in the trust are \$12.06 million or less in 2022 (or double if a married couple each create a trust) the transfer is exempt from the **generation-skipping tax (GST)**. If the assets are more, they're taxed using a complex formula based on the maximum federal estate tax rate, on top of whatever estate or gift taxes are due. When Congress revised the laws governing estate taxes in 2012 the amount vulnerable to the generation-skipping tax and the tax rate were made consistent with the limits and rates on estates.

If you establish a trust to pay for your grandchild's—or any child's—college expenses, the annual amount counts as income to the child's parents in some states. The logic is that it's the parents' responsibility to provide for their children's education.

SPENDTHRIFT CLAUSES

If you're creating a trust because you're nervous about a beneficiary's ability to handle money, most states let you put on the brakes with a safety device known as a **spendthrift clause**. That way, borrowing against principal and any future income is limited, and the funds are protected from creditors—at least until the money is actually paid. So even if you can't control the spending speed, you can limit the refueling rate.

Testamentary Taxsavers

Creating a trust in your will lets you do good to others and well by your estate.

Like any other trust, a testamentary trust protects your assets while providing for your beneficiaries. Unlike a living trust, where you transfer your property while you're still alive, a testamentary trust is created by your will after you die. You set the terms that the trustee follows in distributing the assets. You also determine how long the trust will last and who gets what's left.

THE ESTATE ADVANTAGE

If your estate is valued at less than the amount you can leave tax free, or if you give away most of your property before you die, you may decide that there's no need to establish a testamentary trust.

There are several advantages to using a trust, however. One is that you can establish how the assets are to be paid out to your beneficiaries. And if you select a trustee who is good with money, the assets should continue to grow and produce even more income.

Finally, you can structure a **bypass trust** so that someone—usually your spouse—benefits from the trust during his or her lifetime while the principal is set aside for your other beneficiaries. Your spouse or other designee gets the income from the trust, and can be given the power to withdraw up to 5% of the assets, or \$5,000 a year, whichever is greater.

If this first beneficiary doesn't need the money, it can be left to grow undisturbed. And if the trust's value has doubled or tripled by the time your spouse dies, there's still no estate tax due because the value of the trust, for tax purposes, was set at the time you died.

BETTER LATE...

Your heirs can sometimes do estate planning after your death by disclaiming, or renouncing, your bequest. Your spouse, for example, could disclaim the right to inherit a share of your estate to take advantage of your estate tax exemption, allowing your children to inherit directly.

SAVING TAXES

A testamentary trust can limit the taxes on the estate of a married couple by allowing each partner to take advantage of the federal estate tax exemption. Trusts that are set up to take advantage of this tax-saving feature are variously known as **family, bypass, credit shelter, or exemption equivalent trusts**.

Remember, though, the only property that can be put into a testamentary trust is property you own outright. Some

With a Will Only

SPOUSE 1

LEAVE
ESTATE
TO SPOUSE



SPOUSE 2

LEAVE
COMBINED ESTATE
TO HEIRS



ESTATE
OWNS TAX
ON AMOUNT
OVER EXEMPT
AMOUNT

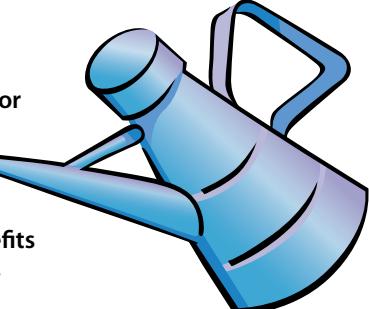
You can leave an estate worth up to the exempt amount free of federal tax to anyone you choose. If you're married, and leave your entire estate to your spouse tax free, it becomes part of his or her estate.

If your estate is worth less than the exempt amount, an option called portability allows your surviving spouse to add the difference to the amount he or she can leave tax free.

Your spouse can leave an estate equal to the exempt amount tax free.

A SPRINKLING TRUST

If you establish a trust with a number of beneficiaries—your children or grandchildren for instance—you can give your trustee sprinkling powers. That way, if one beneficiary needs more income than the others, or if an uneven distribution would save on taxes, the trustee can sprinkle the benefits around rather than following a stricter formula.



or bonds—rather than give up joint ownership of your home.

MARITAL TRUST

If you leave your entire estate to your spouse, you might want to establish a **marital trust** to oversee the estate's management or the way it's distributed after your spouse's death.

As long as your spouse has the right to the income from your estate for life, the marital deduction will still apply, and no estate tax will be due.

Since the remaining value of the marital trust is added to your spouse's estate when he or she dies, that estate may have to pay taxes if it's larger than the exempt amount. However, since the exempt amount is so large, fewer than 0.01% of estates currently actually owe estate tax in any given year.

One kind of marital trust gives your spouse the right to distribute the property you leave in trust as he or she chooses. In legal language, that's known as a **general power of appointment**. The chief benefit of such a trust, from your perspective, is the financial management your trustee will provide.

With a **qualified terminable interest property trust, or QTIP**, you choose the ultimate beneficiaries who will receive the income or principal of the trust after your spouse's death. If you want to ensure that your assets will go to your children from a previous marriage, for example, this type of trust lets you do it.

With a Testamentary Trust

SPOUSE

LEAVE
ASSETS IN
TESTAMENTARY
TRUST



SPOUSE

LEAVE
ASSETS IN
TESTAMENTARY
TRUST



HEIRS
GET ASSETS IN
BOTH TRUSTS
FREE OF
ESTATE TAX

Then, when your spouse dies, the value of his or her trust goes to the beneficiaries tax free. Since there's no way to be sure which spouse will die first, the wills of both spouses should provide for a testamentary trust.

Gifts

From a tax perspective, there's more to giving gifts than meets the eye.

If the key to minimizing estate taxes is to reduce your estate, then giving gifts will get the job done. Before you start spreading money around, though, it pays to consider the benefits and the limitations of generosity.

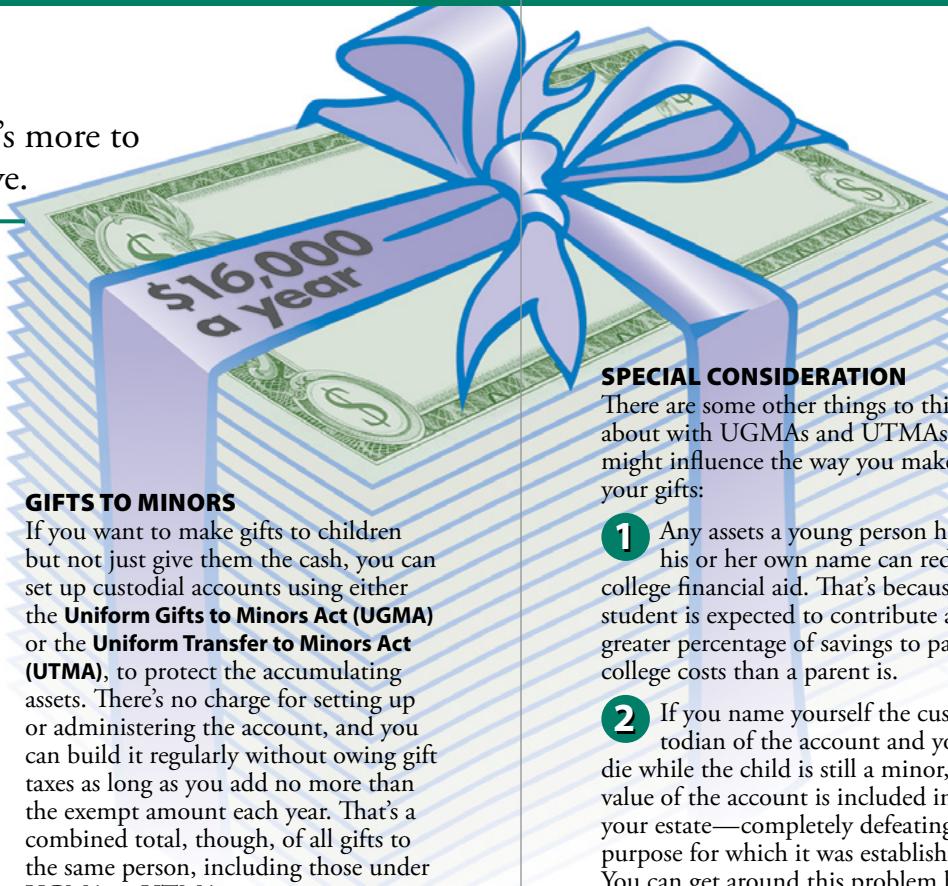
You can give anyone you choose a tax-free gift of cash or other property valued at up to the annual tax-exempt limit each year, for as many years as you like. That's \$16,000 for 2022, and will be increased in \$1,000 increments in future years, indexed to increases in inflation.

While such gifts aren't tax deductible, you pay no tax when the gift is made and neither does the recipient. If your spouse joins in the gift, together you can give each person up to twice the limit each year, with each of you considered to have given half.

You can also make gifts larger than the \$16,000 annual exemption without owing gift tax until your cumulative taxable lifetime gifts exceed the current exempt amount. When you hit that mark, you owe tax at the same rate as the top estate tax rate.

Even if tax is not due, you have to report gifts valued at \$25,000 or more to the IRS on Form 709 when you file your income tax return.

The amount you can give in gifts and the size of the estate you can leave tax free are linked. In effect, that means that in 2022, for example, you can split the \$12.06 million total exempt amount you're allowed between lifetime gifts and a tax-free estate in any proportion you like. Or you could have the entire exemption applied either to gifts or to your estate.



GIFTS TO MINORS

If you want to make gifts to children but not just give them the cash, you can set up custodial accounts using either the **Uniform Gifts to Minors Act (UGMA)** or the **Uniform Transfer to Minors Act (UTMA)**, to protect the accumulating assets. There's no charge for setting up or administering the account, and you can build it regularly without owing gift taxes as long as you add no more than the exempt amount each year. That's a combined total, though, of all gifts to the same person, including those under UGMA or UTMA.

One advantage of UTMAs is that you can include assets that don't produce regular earnings, like real estate and paintings, in addition to cash and securities, such as stocks and bonds.

THEY CAN TAKE IT WITH THEM

If you can live with the idea that the child will take control of the assets in a UGMA or UTMA account at age 18, 19, 21, or 25, depending on state law, it's a simple way to pass along your assets. While you're not required to liquidate the account and hand over cash to the child on the date of majority, bear in mind that on that date the child has the right to the money and can demand it.

SPECIAL CONSIDERATION

There are some other things to think about with UGMAs and UTMAs that might influence the way you make your gifts:

- 1** Any assets a young person has in his or her own name can reduce college financial aid. That's because a student is expected to contribute a greater percentage of savings to pay college costs than a parent is.
- 2** If you name yourself the custodian of the account and you die while the child is still a minor, the value of the account is included in your estate—completely defeating the purpose for which it was established. You can get around this problem by naming another adult as custodian.

- 3** Since students under 24 and others under 19 pay tax on earnings at their parents' rate, you might give growth rather than income investments to minimize the tax bite.

GIFTS TO OTHERS

The annual tax-exempt limit applies to gifts you make to people of all ages, not just minors. For gift tax purposes, the value of the gift is its value at the time it is given—not what it was when you acquired it. If the item is worth more when you give it than it's been worth in the past, you don't have to pay capital gains on the increased value. However, if the person receiving the gift sells it, he or she will owe capital gains based on its **cost basis**, or your original cost, which might result in a sizable tax bill.

SPECIAL GIFTS

If you want to pay for someone's educational expenses, you can make a direct payment to the college or university equal to the cost of tuition.

The understanding is that the student's bill

will be considered paid.

You can't

pay for

room and

board this

way, but

tuition is

usually

the bulk

of the cost

in any case.

The same option

exists for paying

hospital bills. The

process is known as

a **qualified transfer**,

and there don't seem

to be any restrictions on qualifying.

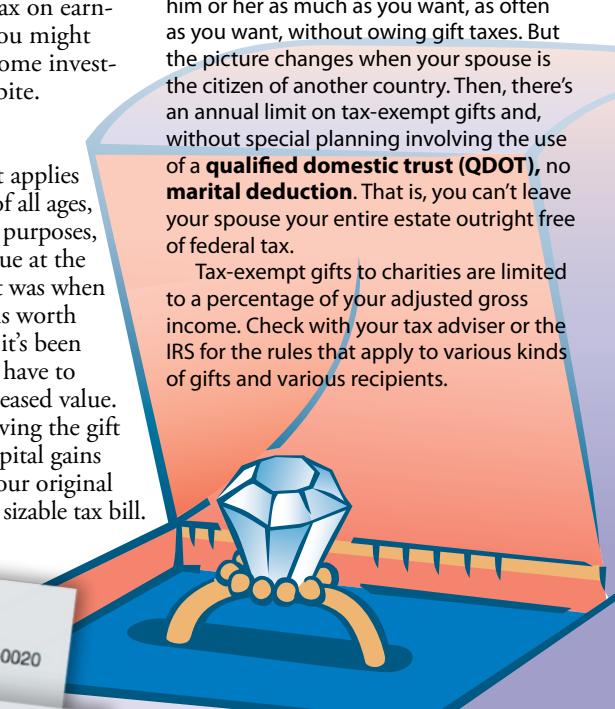
Plus, these payments do not limit your right to give up to the exempt amount per year to the beneficiary of the transfer as a tax-exempt gift.



TAX-FREE GIFTS

If your spouse is a US citizen, you may give him or her as much as you want, as often as you want, without owing gift taxes. But the picture changes when your spouse is the citizen of another country. Then, there's an annual limit on tax-exempt gifts and, without special planning involving the use of a **qualified domestic trust (QDOT)**, no **marital deduction**. That is, you can't leave your spouse your entire estate outright free of federal tax.

Tax-exempt gifts to charities are limited to a percentage of your adjusted gross income. Check with your tax adviser or the IRS for the rules that apply to various kinds of gifts and various recipients.



Form 709

United States Gift Tax Return
(Section 6019 of the Internal Revenue Code) (For gifts made after December 31)
Calendar year 20.....

Department of the Treasury
Int'l

OMB No. 1545-0020
Expires 5-31

Page 2

Form 709 (Rev. 2018)

SCHEDULE A

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions—see instructions

A Item number	B Donee's name and address Relationship to donor (if any) Description of gift If the gift was made by means of a trust, enter trust's identifying number and attach a copy of the trust instrument If the gift was of securities, give CUSIP number	C Donor's adjusted basis of gift	D Date of gift	E Value at date of gift
1				

And More Gifts

It's cool-headed, not hard-hearted, to think about what your gifts will cost you and your estate.

When you're considering making a gift, you probably ought to consider the tax consequences of the way you give it. For example, if the choice is between giving property you own, or selling the property and making a cash gift, the size of the gift makes a big difference.

And if the choice is between making a gift or leaving the same property as a legacy in your will, you need to think about **cost basis**, the value assigned to the property that the recipient gets. It could have a major tax impact if he or she sells the property.

MAKING THE MOST OF A DEAL

When you make a charitable gift, you can take a tax deduction for the value of the property. In most cases, it makes the most sense to contribute appreciated assets—those that have increased in value since you bought them—because you can deduct the current value and avoid capital gains on the increase in value.

for example

Purchase shares of stocks costing	\$ 10,000
Value of shares at time of gift	\$ 40,000



**GIVE
THE
STOCK**

Vs.



**SELL THE
STOCK AND
GIVE THE CASH**

YOU	THE CHARITY
<ul style="list-style-type: none"> Take deduction based on current value (\$40,000) Owe no capital gains tax 	<ul style="list-style-type: none"> Gets benefit of full value of your donation (\$40,000)

YOU	THE CHARITY
<ul style="list-style-type: none"> Pay capital gains tax on profit: $\begin{array}{r} \$ 30,000 \\ \times .15^* \\ = \$ 4,500 \end{array}$ <ul style="list-style-type: none"> Tax 	<ul style="list-style-type: none"> Receives only \$35,500 instead of \$40,000

* Tax at 15% long-term capital gains rate.

GIFTS TO TRUSTS

Money you put into a trust is considered a gift in some circumstances, but not others. In general, the difference hinges on whether or not the trust is revocable or irrevocable, and who the beneficiary is.

Revocable trusts don't result in gift taxes because the transfer of property is considered incomplete. That's because you can change your mind about what's in the trust and who benefits.

But if the trust is irrevocable, gift taxes apply if the beneficiary is anyone but yourself or your spouse. In fact, if you're the beneficiary of an irrevocable trust during your lifetime, the property you put into the trust is considered a gift to your surviving beneficiaries. You figure the value based on US Treasury department tables that are included with the rules on gift taxes.

Give It or Leave It

If you're undecided whether to make gifts now or leave property as a legacy in your will, you can balance a variety of pluses and minuses for each option.

GIFTS

Advantages	Disadvantages
<ul style="list-style-type: none"> If you spread gifts over the years you can provide generously for your beneficiaries and reduce your estate at the same time. Your gift may be worth more to the beneficiary since it's not subject to estate and inheritance taxes. You can help meet financial needs when they occur. 	<ul style="list-style-type: none"> Once a gift is given, you don't have access to it even if you need it. You can't control how gifts are used. For giftees may end up owing capital gains tax if he or she sells the gift, but the silver lining is that capital gains taxes are generally lower than estate taxes.

LEGACIES BY WILL

Advantages	Disadvantages
<ul style="list-style-type: none"> You keep your assets as long as you need them. You can change your mind about items left in your will until the last minute. The cost basis of the asset—the starting point for figuring capital gains—is currently the value at the date of your death. That could save taxes if the assets were sold. 	<ul style="list-style-type: none"> Wills can be contested. Federal estate taxes may reduce the size of your legacy. State inheritance taxes may be due. The step-up in cost basis may be eliminated when tax laws are revised, and higher capital gains taxes could be due on sale of inherited assets.

A NEW PERSPECTIVE

Since the likelihood of your owing federal estate taxes is relatively small, you may want to give increased estate planning attention to managing potential taxes on your investment earnings and capital gains and to reducing possible state estate taxes.

FAMILY LIMITED PARTNERSHIPS

Another approach to using gifts to pass valuable property to your children and grandchildren has been to create a **family limited partnership**. The parents, or senior family members, serve as general partners and maintain control over the assets in the partnership, usually real estate or a family business. The junior members of the family are limited partners, with no current authority but a growing share of the partnership assets.

Each year, each general partner can give each limited partner a share in

the assets as a tax-free gift. And they're allowed to transfer the assets at a discount to face value. For example, the value of gift could be closer to \$17,500 than the \$16,000 limit. The discount is legitimate if there's a valid business purpose for the partnership.

It is always possible that these partnerships may not continue to be an estate planning option. However, they have survived a number of earlier attempts to eliminate them.

STEPPING IT UP

The value of assets your heir inherits is established by what's known as a step-up in basis, or what each asset was worth at your death. If he or she sells immediately, there would be little if any capital gain to be taxed.

GLOSSARY

Adjusted gross income (AGI) is what remains of your gross income after specific deductions known as adjustments to income are subtracted. They include student loan interest and contributions to certain tax-advantaged plans among others. Next, you subtract your standard or itemized deduction, plus the qualified business deduction if you qualify, from your AGI to find your taxable income.

Beneficiary is a person or institution named by the owner, creator, or donor to receive the assets in a specific account, insurance policy, estate, or trust.

Capital gain is the profit you realize on the sale of an asset.

Capital loss is the negative amount you realize if you sell an asset for less than you paid to buy it.

Capital gains tax is the amount you pay on any profit you realize from selling. The tax rate than applies is 0%, 15%, or 20%, based on your income.

Cost basis is the original price of a capital asset, usually the purchase price plus sales taxes. You use cost basis to calculate capital gain or loss when the asset is sold. If you receive the asset as a gift, your cost basis is the same as the giver's. If you inherit an asset, its cost basis is adjusted to reflect what it's worth when the deceased's estate is valued. This is known as a step-up in basis.

Deduction is an amount you can subtract on your income tax return to reduce your taxable income. You may choose the standard deduction that applies to your filing status or you may choose to itemize your deductions if their total is higher than the standard amount.

Effective tax rate is the percentage of your total taxable income that you pay as income tax. It's always lower than your marginal tax rate.

Individual retirement account (IRA) is a tax-advantaged account you establish with a financial institution to invest retirement savings. Earnings in all IRAs are tax deferred. Based on your income, you may qualify to deduct your contribution on your income tax return or choose a tax-exempt Roth IRA.

Marginal tax rate is the highest rate you pay on any portion of your taxable income.

Modified adjusted gross income (MAGI) is your AGI with certain adjustments to income you've taken in calculating the AGI added back in. Your MAGI is used to determine your eligibility for certain tax credits. A MAGI isn't fixed, however, because different credits require different adjustments to be added back.

Required minimum distribution (RMD) is the portion of your tax-deferred retirement accounts that you must withdraw each year beginning at age 72. You calculate the amount you must take by dividing the balance of the account at the end of its fiscal year, usually December 31, by a number linked to your current age. The number, called the distribution period, is available in the IRS Uniform Lifetime Table (Table III).

Revocable trust is a trust that you can end or amend at any time. The assets in the trust are included in your estate and distributed to your beneficiaries in accordance with the trust's terms, outside of the probate process. These trusts aren't used to reduce your taxes.

Step-up in basis occurs when your beneficiary inherits an asset through your will or trust or is your joint owner with right of survivorship. With a step-up, the cost basis of the asset is adjusted to its current worth at the time your estate is valued.

Tax credits allow you to subtract a fixed amount directly from the tax you would otherwise owe. Each credit is linked to a specific expenditure such as dependent care or tuition costs. In most but not all cases you qualify for a credit based on your MAGI.

Tax deferred means any tax that might otherwise be due on contributions to certain accounts or investment earnings in those accounts is postponed, typically until money is withdrawn from the accounts. However, some accounts, such as Roth IRAs and health savings accounts (HSAs), benefit from tax-deferred earnings but are not taxed at withdrawal.

Tax efficient describes an investment that generates a smaller amount of taxable income than less efficient investments with similar portfolios.

Tax exempt describes an investment whose earnings are not subject to income taxes. Examples of tax-exempt investments include certain municipal bonds, Roth IRAs and Roth versions of employer-sponsored retirement savings plans, 529 college savings plans, education savings accounts (ESAs), and health savings accounts (HSAs). Assets in your estate and gifts you make during your lifetime, over and above annual tax-exempt gifts, are tax-exempt up to the combined total lifetime exemption. In 2022, it is \$12.06 million.

Testamentary trust is a trust established in your will that goes into effect at your death. You can use testamentary trusts to reduce potential estate taxes and to maintain control over the way your assets are managed and distributed.

Trustee is a person or institution who controls the property in a trust and has a fiduciary duty to manage it for the benefit of the trust's beneficiaries.

The American College of Physicians (ACP) is the professional home for 161,000 internal medicine specialists and subspecialists worldwide. Internal medicine physicians are the cornerstone of comprehensive healthcare.

Thank you for your membership and for the work you do every day on behalf of your patients and the profession.

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