

Investments

What Should 'Survivor' Richard do with His Million Bucks?

The first thing he should do is count how much he's left with after taxes. With the hefty chunk of change that remains, Rich could take a successful step toward funding his retirement, if he invests wisely. Like any individual with money to invest, Rich would do well to sit down with a qualified financial planner to determine his current financial condition, where he'd like to be, and how to get there.

How Much Does He Really Get?

Let's set the record straight. Rich may have won the million dollars but that's not enough to make him a millionaire. By the time Rich got back to the United States with his trunk full of money, Uncle Sam will have taken approximately \$370,000 in federal taxes and Rhode Island will have snagged about \$100,000 in state taxes. Still \$530,000 is not bad for 39 days of work.

How Should Rich Invest His Winnings?

At 39, Rich can start planning for an early retirement. How early can he retire? Well, if Rich invests \$500,000 of his winnings without spending a penny until he is 55, he will build a \$1.8 million nest egg for his retirement (assuming an 8% after-tax return on his investment.) That's about \$15,000 a month until he turns 75. (Second place Kelly should really be kicking herself. Because she is so young, just 23, if she had won the loot and invested her money until age 55, Kelly would have a nice sum of \$6.4 million.) Of course, Rich made his plans clear, he wants to spend some of his money. Here are some things he should keep in mind:

- Rich would benefit from a financial plan that would meet his financial goals. A mix of annuities, mutual funds and stocks would help Rich build his wealth but also leave some room to enjoy the money.
- His son won't qualify for financial aid, so Rich should set some money aside in a trust or qualified state tuition plan to make sure college costs are taken care of. By the time his son starts college in 2009, Rich will have to pay nearly \$120,000 in tuition and living expenses, depending on inflation and school choice. That's 23% of his winnings.
- Even though he is only 39, Rich should consider some estate planning. Congress is still debating repeal of the estate tax. So if anything were to happen to Rich in the near future, his estate could get hit with a tax bill. The good news for Rich is that the exemption amount on estates is increasing each year until it reaches \$1 million in 2006, so more of his wealth will be protected from taxes.

You're Never too Young for Retirement Planning

You can open a Roth IRA for your children at any age, as long as they have earned income from part-time employment. The same restrictions that apply to adults' Roths apply to children, including the IRS limit on contributions to \$2,000 or earned income, whichever is less. Beginning in 2002, the maximum contribution is increased to \$3,000.

Stock Sales Require Proper Reporting

If a friend or family member gives you a gift, the IRS doesn't need to know about it. But if you sell someone stock, securities or other assets, you've created a taxable transaction. You must report the sale on Schedule D.

Traditional IRA Deductions Depend on Income

"Contributing to any kind of IRA is a good idea, even if you can't deduct your contributions. That's because the earnings in the account grow tax-free until you withdraw them. With a traditional IRA, you may be able to deduct your contributions, too:

- If you are single and participate in an employer-maintained retirement plan, you can deduct the full amount of your traditional IRA contributions if your adjusted gross income (AGI) is less than \$33,000. You can deduct a portion of your contributions if your AGI is between \$33,000 and \$43,000. If your AGI is \$43,000 or more, you can't deduct any contributions. If you do not participate in an employer-maintained plan, you can deduct all of your contributions, no matter how high your AGI is.
- If you are married, filing a joint return, the rules are a bit more complicated. If neither you nor your spouse participates in an employer-maintained retirement plan, your traditional IRA contributions are fully deductible. If you participate in such a plan, your contributions are fully deductible if your AGI is less than \$53,000, partly deductible if your AGI is between \$53,000 and \$63,000, and nondeductible if your AGI is \$63,000 or more. If your spouse participates in an employer-maintained plan but you don't, your traditional IRA contributions are fully deductible if your AGI is less than \$150,000, partly deductible if your AGI is between \$150,000 and \$160,000, and nondeductible if your AGI is \$160,000 or more.

Another IRA option is the Roth IRA. Contributions to this type of IRA are never deductible, but qualified withdrawals from a Roth IRA are nontaxable.

The rules governing traditional and Roth IRAs are complex, but your H&R Block tax professional can help you choose the right IRA option for your situation.

Note: The above amounts apply only to tax year 2001 returns.

The Truth About Tax-Free Mutual Funds

If you decide to sell those tax-free mutual funds you bought, be prepared to settle with Uncle Sam. Even if your dividends from the mutual fund were not taxable, you must report either a gain or a loss when you sell your shares. The gain is taxable and loss can be used to offset other ordinary income with some limitations.

Take Stock of Your Gains

Cashed in the mother lode? Don't want to pay the mother of all tax bills? You can defer paying capital gains taxes on stock sales by purchasing specialized small business

investment company stock within 60 days of the date you sold your initial stock. If not, you may need to cash in some losers to offset your winnings.

Determining the Value of Inherited Assets

The fair market value of assets on a person's death determines the basis for the beneficiary. If the fair market value is less than the descendant's basis, the property will "step down" to the fair market value. If the fair market value is more than the descendant's basis, the property will "step up" to fair market value.

Four-Year Spread on Roth Conversions: RIP

It's too late for you to spread the income from your traditional IRA/Roth IRA conversion over four years. Any conversion made after 1998 must be reported in full in the year of the conversion.

Leveraging your Life Expectancy During Retirement

If your current income isn't quite funding your early retirement, IRA regulations allow you to take penalty-free distributions based on your life expectancy. If you do this, you must continue until at least age 60, and you may not change the payment schedule once it has been determined. Several ways exist to figure the amount of the payment, so contact a qualified advisor. Once you reach age 60, you can stop taking payments if you choose or you may increase the amount you withdraw.

Roth Conversions and the \$100,000 Plateau

Income from converting your regular IRA to a Roth do not count toward the \$100,000 adjusted gross income (AGI) conversion limit that determines if you can make the conversion.

Turning Profit-Sharing Income into a Roth IRA

If you want to transfer profit-sharing retirement plan proceeds from a previous employer to a Roth IRA, you must first roll the proceeds into a traditional IRA. You can then convert the traditional IRA to a Roth. You must pay tax on the amount you convert to a Roth IRA in the year you make the conversion.

Using Trusts for Tax Benefits

In a trust setup in which you are both the creator and the beneficiary, you are considered the owner of the trust, and the income is taxable to you. If you are seeking to minimize your taxes, consult a financial advisor who can help you with your tax planning.

IRA Contributions not Always a Tax Shelter

Contributing to an IRA could reduce your taxes, depending on your eligibility for a deductible IRA. IRA contributions can result in a reduction of your adjusted gross income but don't reduce your tax liability dollar-for-dollar.

A Matter of Trust

Using a trust for the benefit of your children or grandchildren for educational purposes can involve somewhat complex planning. You should consult a financial planner for the

best avenues because there are a variety of trusts. A trust can be a useful planning tool, but it really depends on your circumstances.

Pension Participation Prevents IRA Deduction

If you worked for an employer for any period of time during a year in which you also participated in a pension plan, you are considered to have been in the pension plan for the entire year. As a result, you are considered an active participant even if you are vested. Therefore, your traditional IRA deductions may be limited.

A Gift to Your Children

You can give your children as much as you'd like per year in stocks or cash. However, depending on the value of the stock or cash, you may have to file a gift tax return, Form 706.

Don't Try This at Home: Valuation of Private Stock

The valuation of closely held stock is a complicated calculation, and the IRS has revenue procedures on how it is done. You should consult a qualified appraiser if you need a valuation of closely held stock that is not publicly traded.

Walking the Day Trading High Wire

Few individuals qualify to report stock sales and investment expenses using the rules for day traders. In fact, most people that try don't make it. Day traders buy and sell a large volume of stock on a regular basis and seldom hold any share of stock for longer than a few days. And even then, status as a day trader is not a sure thing. If you have significant expenses from investment, we suggest you deduct them on Schedule A because, most likely, you will not meet the requirements for treatment as a day trader. If you have questions about day trader qualifications, please ask your tax preparer or go to www.hrblock.com, click on the Investment Center, and navigate to "Investor Education."

Bonds...I Bonds

I Bonds, or Inflation adjusted bonds, are a type of savings bond. An I Bond is different from an EE Bond in that an I bond is issued at face value, rather than at the 50 percent face value for EE Bonds. Interest paid on an I Bond is adjusted semi-annually based depending on the rate of inflation. Also, EE Bonds are guaranteed to reach face value in 17 years; I Bonds have no such guarantee. I Bonds may not be exchanged for any other series of savings bonds. If you want to know more about I Bonds, go to www.hrblock.com and click on the Investment Center link.

Take Stock of Your Inheritance at Fair Market Value

Your basis for inherited stock is the fair market value at the date of death. If it's a stock that is traded on an open market, you can see what the value is on that date. The per-share basis is generally the average of the highest and lowest quoted price on that date. If the stock isn't traded on a market, you will have to use the IRS revenue procedure for closely traded or non-traded stock, not openly traded in the market. It is a complicated valuation, so you should seek professional advice.

Bonding with Your Interest

Accumulated interest on a taxable discount bond is reported as taxable interest even if you didn't receive a check on the interest. Accumulated interest on a non-taxable discount bond is reported as non-taxable interest on Line 8b of Form 1040A or Form 1040. The accrued discount on the bond is reported in the same manner; if you purchased the bond after the original issue date (OID), the OID may have to be re-calculated. Given the complexity of the process, we advise you to consult an H&R Block tax professional.

Max out Your SEP

A self-employed person can contribute 13.0435 percent, up to \$25,500, of his or her net income. Employees can contribute up to 15 percent of their wages.

The Complications of Calculating Gains

Generally, if you take distributions from a mutual fund, you must compute the gain. Your basis in the mutual fund is your cost-basis in those shares which includes your original purchase, reinvested dividend and capital gains and any additional purchases made. Special rules are allowed for computing basis in mutual funds, contact your tax professional for more information.

Selling Your Stock the Right Way

Selling your stock shares with the lowest basis requires advanced planning. Before you sell, you must specifically identify the shares at the time you are selling them and your broker must confirm in writing that those were the shares sold. If you don't do that, you are deemed to have sold the stock in the order you purchased it. The next time you consider selling, be sure to ask your broker about the requirements of specific identification.

The Advantages of Having a DRIP

A DRIP is a Dividend Reinvestment Plan. It allows you, as an investor, to buy additional shares or partial shares with your dividends rather than receiving a check. Many DRIPs allow you to invest a certain dollar amount every week, month or quarter, so the amount of shares you purchase depends on the market value of the shares at the time of the purchase. It is a common practice of most mutual funds and investment programs to enable you to make an automatic re-investment of your dividends.

Buy Low, Sell High, and Tell Your Tax Guy

Daytrading transactions create capital gains and losses, which are reported on Schedule D. Any net losses exceeding \$3,000 need to be carried over to subsequent years. Be aware of wash sales. If you sell a stock at a loss and buy it again within 30 days before or after the sale, you cannot deduct the loss, but the loss does reduce the basis of the replacement stock. You can deduct your investment expenses, not your losses, on Schedule A as an itemized deduction.

Reduce Taxes with Income Timing

If you have a year-end bonus coming that you plan to save rather than spend and you know your income will be lower next year, see if you can arrange to have the bonus paid

to you after the new year. If you're considering selling stock that will bring you a large gain, ask your tax preparer about the tax effect of postponing the sale until next year or offsetting the gain with a loss from the sale of other stock.

Taming the Alternative Minimum Tax

If you're claiming large deductions for taxes or employment expenses, or if you exercised incentive stock options, you may be subject to the alternative minimum tax. To plan for the alternative minimum tax, you'll need to take at least two tax years into account. For example, if you'll be subject to this tax for 2002, but not for 2003, you may want to postpone paying expenses such as real estate tax and a fourth-quarter state estimated tax payment until 2003. See your tax return preparer for help in determining both whether you are subject to the alternative minimum tax and what you can do to minimize its effects.

Know the Ins and Outs of Investment Interest

Despite a widespread belief that only mortgage interest is deductible, the law still allows investors to deduct interest on loans used to make investments. Such interest is deductible to the extent of your investment income. When totaling up your investment income for purposes of this limit, you generally can't count capital gains that get special treatment under the law. Congress doesn't want to let you deduct investment interest in a higher bracket if your gains are being taxed at only 10 or 20 percent. You have the option of including your capital gains in investment income but then can not take advantage of the lower capital gains rates. Contact your tax professional for help in determining which option may be best for you.

Get Familiar with Foreign Tax Credits

You don't have to work at Rick's Place in Casablanca to earn the foreign tax credit. You may deserve it, for example, if you own shares in a mutual fund that invests in foreign securities. If information from the fund shows that foreign taxes were paid on your behalf, you can treat that amount as an itemized deduction or claim a credit for taxes paid. The credit is almost always worth more because a credit offsets your tax liability dollar for dollar while the itemized deduction simply reduces the amount of income on which you pay tax.

Smart Gifts Make Great Write-Offs

There's a special break if you donate property such as stock or mutual fund shares to charity. If you owned the asset for more than a year, you get to write off its value on the day that you made the gift, not what you originally paid for it. You don't have to pay tax on the appreciation while you owned the stock, either. In the past, that untaxed appreciation could fall victim to the alternative minimum tax, but no more. Take advantage of this break now if you donated appreciated property last year and keep it in mind in the future. Whenever you make substantial contributions, consider using appreciated property instead of cash. What if you really want to keep the stock in your portfolio? Donate the shares you own and use the cash you would have given to buy shares on the open market. The advantage is that you'll owe tax only on profit that accrues after you repurchase the shares. If the stock or mutual fund shares you plan to

donate have decreased in value, sell the shares and donate the cash. That way, you can deduct your loss and claim a charitable deduction as well.