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# **The Ernst & Young Tax Saver's Guide 2003**

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By Margaret Milner Richardson and  
the Tax Partners and Professionals of  
Ernst & Young LLP

Peter W. Bernstein, Editor



**John Wiley & Sons, Inc.**



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In the preparation of this book, every effort has been made to offer current, correct, and clearly expressed information. The information included in this book is based on the Internal Revenue Code amended as of August 2002.

The information in the text is intended to afford general guidelines on matters of interest to taxpayers. The application and impact of tax laws can vary widely from case to case, however, based upon the specific or unique facts involved. Accordingly, this book is not intended to serve as legal, accounting, or tax advice. Moreover, tax rules and regulations often change. Readers are encouraged to consult with professional advisors for advice concerning specific matters before making any decision. The author and publisher disclaim any responsibility for positions taken by taxpayers in their individual cases.

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# **The Ernst & Young Tax Saver's Guide 2003**

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With over 6,500 tax practitioners in the United States and more than 20,000 worldwide, Ernst & Young has one of the largest tax practices in the world. This book draws upon the experience of many of those professionals for its content.

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Ernst & Young, a global leader in professional services, helps clients to quickly and confidently make financial decisions designed to enhance value. Its 110,000 people in more than 130 countries have the industry and financial experience to provide fresh perspectives on operating in the new economy. Ernst & Young offers traditional audit and tax services, as well as customized services in corporate finance, online security, risk management, the valuation of intangibles, and e-business acceleration. In addition, legal services are available in various parts of the world where permitted. A collection of Ernst & Young's latest ideas on the new economy can be found at [www.ey.com/thoughtcenter](http://www.ey.com/thoughtcenter).

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Peter W. Bernstein is the editor of *The Ernst & Young Tax Guide* and *The Ernst & Young Tax Saver's Guide*.

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# How to Use This Book

*The Ernst & Young Tax Saver's Guide 2003* is a year-round tax planner with easy-to-follow, money-saving tax strategies. This book, with its concise explanations of key provisions of federal tax law, can also be used for quick reference to provide guidance on important personal and business transactions. It is not intended to give you line-by-line instructions on how to prepare your federal tax returns. A separate Ernst & Young publication—*The Ernst & Young Tax Guide*—is available for that purpose.

This book is organized into three sections:

Part I, Tax Strategies for Individuals, contains chapters that tell you what to include as income, what you can deduct, and how you calculate your tax. It also has chapters that relate specifically to your business travel and entertainment expenses; your home; retirement plans, such as IRAs and 401(k)s; charitable contributions; capital gains and losses; and mutual funds. In addition, sprinkled throughout all the chapters are money-saving tips about options and strategies you might consider to cut your tax bill. Part I concludes with a chapter on year-end planning for individuals.

Part II, How to Improve Your Financial Future, should help you with some of the tax considerations guiding your current investments. In addition, options you might consider to ensure yourself a comfortable and secure retirement are presented here. The chapter on estate planning offers tax-saving ideas on gift, estate, and generation-skipping taxes.

Part III, Tax Strategies for Businesses, discusses many of the fundamental tax questions that confront the owner of any business. There is a special chapter on S corporations. The last chapter contains year-end planning suggestions that can save businesses money.

Among its many benefits, this book offers the following special features:

## E&Y FOCUS

This feature considers topics of current interest, such as leasing a car or deferred compensation plans, and suggests smart money moves that you may want to consider.

### TAXSAVER

Highlighted throughout every chapter in the book are numerous *TAXSAVERS*—specific strategies and recommendations that can help you cut your tax bill.

### TAXORGANIZER

Do you need to save that receipt for tax purposes? *TAXORGANIZERS* point out things you need to do *now* to make it easier to file your taxes later.

## **TAXALERT**

This feature highlights recent changes in the tax law that you should know about. Tax law changes that have been enacted recently are included. If you are aware of a new development in the law before the end of the year, you can often take timely and appropriate action and save yourself some money.

- *Special chapters on year-end tax planning for individuals and businesses.* The prudent taxpayer must make decisions before December 31 about a number of important tax questions—for example, whether to report income now or defer it to next year and whether to pay a deductible expense this year or in the future.
- *Important information on the tax aspects of “life-cycle events.”* These are the occasions, transactions, and eventualities that most of us will almost certainly have to deal with at some time during our adult lives. A special index to the life-cycle events discussed in this book follows this introduction.
- *Concisely presented rules of the tax law pertaining to individuals, estates, gifts, and business entities.* Included in each section are examples that show you how the rules work and “*TAXSAVERS*”—strategies to help you plan better.  
*The Ernst & Young Tax Saver’s Guide* contains two more features that will be of year-round use to individuals and businesses alike:
- *Up-to-date tax tables*—the ones that you will use most often can be found at the end of this book; and
- *Tax calendar*—month-by-month reminders of important tax action dates for individuals and businesses.

# Index to Life-Cycle Events

This special index can be used to locate the sections of the text that contain important information on the tax aspects of life-cycle events—those milestones that most adults will be facing at one time or another during the course of their lives. By reading this information, you'll get off to a good start in understanding and planning for the tax consequences associated with various life-cycle events.

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# Changes in the Tax Law You Should Know About

The tax legislation enacted in 2002 was, for the most part, a direct reaction to the tragic events of September 11, 2001. In particular, the Victims of Terrorism Tax Relief Act of 2001 provided certain income, estate, and other tax relief to victims and survivors of the September 2001 attacks and the April 1995 Oklahoma City bombing. Similarly, in March 2002, the Job Creation and Worker Assistance Act addressed the economic after-effects of September 11. That law extended unemployment compensation benefits, provided an expanded carryback period for certain net operating losses, and allowed a 30% “bonus” depreciation deduction. In addition, the new law also included the extension of the expired tax provisions and a package of tax incentives to encourage rebuilding and reinvestment in New York.

Although there is little in these laws that will have a direct effect on the tax planning of most individuals or small business taxpayers, certain notable changes in the law will take effect for the 2002 tax year as a result of The Economic Growth and Tax Relief Reconciliation Act of 2001.

## Tax Rates Reduced

For tax years beginning in 2002, the income tax rates have been reduced. The following TaxAlert highlights these changes.

### TAXALERT

**10% Tax Rate.** *The 10% tax rate is reflected in the tax tables and tax schedules. You do not have to make a separate computation or figure a credit to get the benefits of this rate.*

**Other Tax Rates.** *The other tax rates, 27.5%, 30.5%, 35.5%, and 39.1%, are reduced to 27%, 30%, 35%, and 38.6%, respectively.*

*These reduced rates should be reflected in amounts withheld (such as backup withholding) on certain payments made after 2001.*

## Estimated Tax Safe Harbor for Higher-Income Individuals

For estimated tax payments for tax years beginning in 2002, the estimated tax safe harbor for higher-income individuals (other than farmers and fishermen) has been modified. If your 2001 adjusted gross income is more than \$150,000 (\$75,000 if you are married and filing a separate return for

2002), you will have to pay the smaller of 90% of your expected tax for 2002 or 112% of the tax shown on your 2001 return to avoid an estimated tax penalty. See “Estimated Tax Payments and Withholding,” on page 168.

## **Higher Education Expenses**

You may be able to deduct as an adjustment to income up to \$3,000 of qualified tuition and related expenses you paid. The expenses can be for you, your spouse, or your dependent.

## **Interest on Student Loans**

Two changes apply to the deduction for student loan interest.

- The provision that limited your deduction to interest paid during the first 60 months is repealed.
  - The income levels at which the deduction is phased out are increased.
- For more information on the deduction for student loan interest, see Publication 970.

## **Coverdell Education Savings Accounts**

The following changes apply to Coverdell education savings accounts.

- Contribution limit increases to \$2,000 per beneficiary.
- The income phaseout increases for joint filers.
- Qualified education expenses include elementary and secondary school expenses.
- Age limits do not apply to special-needs beneficiaries.
- Contributions may be made until April 15 of the following year.
- Tax-free distributions can be used for special-needs services.

## **Employer-Provided Educational Assistance**

The following changes apply to employer-provided educational assistance.

- Income exclusion is made permanent.
- Income exclusion applies to graduate-level courses.

## **Qualified Tuition Programs**

The qualified tuition program (formerly qualified state tuition program) includes programs established and maintained by one or more eligible educational institutions.

Two other changes affect this program.

- Distributions from a state program that are used to pay qualified higher education expenses are tax free. Other distributions are subject to 10% additional tax.
- Tax-free distributions can be used for special-needs services.



**TAXALERT**

**Qualified Tuition (Section 529) Programs.** Section 529 plans allow a taxpayer to either buy tuition credits or to contribute to a special higher education savings account for a designated beneficiary. These programs, which were beneficial under prior law, have become even more valuable as a result of changes made by the new law.

The most significant change made by the 2001 Act is that qualifying distributions from these programs will no longer be subject to tax. Under prior law, account earnings used for qualifying expenses were taxable to the student at the time withdrawn. Under the new law, post-2001 distributions from qualified tuition plans will be fully excluded from gross income.

**Tax Benefits for Adoption**

Changes apply to the adoption credit and to the exclusion for benefits under an employer-provided adoption assistance program. These changes include the following.

- The credit for children without special needs is made permanent.
- The exclusion under an adoption assistance program is made permanent.
- The credit and exclusion amounts increased to a maximum of \$10,000.
- The income levels for phaseout are increased.

**Benefits for Public Safety Officers' Survivors**

For tax years beginning after 2001, a survivor annuity received by the spouse, former spouse, or child of a public safety officer killed in the line of duty will generally be excluded from the recipient's income regardless of the date of the officer's death. Survivor benefits received before 2002 are excluded only if the officer died after 1996.

**Foreign Earned Income Exclusion**

The amount of foreign earned income that you can exclude will increase to \$80,000. See Publication 54.

**Self-Employed Health Insurance Deduction**

The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increases to 70%.

**Increased IRA Contribution and Deduction Limit**

Your maximum contribution (and any allowable deduction) limit is increased. Previously, the limit was \$2,000. The new limit depends on your age at the end of the year.

- If you are under age 50, the most you can contribute is the smaller of \$3,000 or your taxable compensation.
- If you are age 50 or older, the most you can contribute is the smaller of \$3,500 or your taxable compensation.

## **Rollovers of IRAs into Qualified Plans**

For distributions after December 31, 2001, you may be able to roll over, tax free, a distribution from your IRA into a qualified plan.

## **Rollovers of Distributions from Employer Plans**

For distributions after December 31, 2001, you can roll over both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA.

### **TAXPLANNER**

**Expanded Rollover Options.** *Beginning in 2002:*

- *All IRA distributions (except for after-tax amounts) can be rolled into employer plans.*
- *Certain after-tax contributions to a qualified plan can be rolled over to an IRA or defined contribution plan.*
- *Surviving spouses will be able to roll over any distribution attributable to a decedent-employee into any eligible retirement plan in the same manner as if the spouse were the employee.*

## **Hardship Exception to the 60-Day Rule**

For distributions after December 31, 2001, the IRS may waive the 60-day requirement to roll over distributions from your IRA or your employer's pension plan where the failure to do so would be against equity or good conscience, including casualty, disaster, or other events beyond your reasonable control.

## **Limit on Elective Deferrals**

The maximum amount of elective deferrals under a salary reduction agreement that can be contributed to a qualified plan is increased to \$11,000 (\$12,000 if you are age 50 or over). However, for SIMPLE plans, the amount is increased to \$7,000 (\$7,500 if you are age 50 or over).

### **TAXPLANNER**

**Defined Benefit Plans.** *For 2002, the maximum annual benefit payable at retirement in a defined benefit plan generally is the lesser of (a) 100% of*

average compensation or (b) \$160,000. In addition, the dollar limit will no longer be adjusted based on the Social Security retirement age.

Instead, the dollar limit will be reduced for benefits beginning before age 62 or increased for benefits beginning after age 65.

### **TAXPLANNER**

**Deduction Limit for Contributions to Profit-Sharing Plans.** Under prior law, the deduction for contributions to a profit-sharing plan was limited to 15% of compensation. Beginning in 2002, the limit will increase to 25% of compensation.

## **New Credit for Elective Deferrals and IRA Contributions**

You may be able to take a credit of up to \$1,000 for qualified retirement savings contributions.

**Tax Credit for Certain Retirement Deferrals.** Beginning in 2002, joint filers with adjusted gross income (AGI) below \$50,000 and single filers or those who are married filing separately with AGI below \$25,000 can qualify for a tax credit of up to \$1,000 for contributions or deferrals to retirement savings plans. The maximum credit is 50% of the contribution or deferral (up to \$2,000). The amount of the credit is determined on a sliding scale.

### **TAXPLANNER**

**Employer-Provided Retirement Advice.** Beginning in 2002, qualified retirement planning services provided by an employer will constitute a fringe benefit excludable from an employee's income.

### **TAXPLANNER**

**Estate, Gift, and Generation-Skipping Transfer Taxes.** The estate and generation-skipping transfer (GST) tax rates are gradually reduced over the next 9 years, after which these taxes are repealed for 2010 only. The top gift tax rate is also gradually reduced over the next 9 years but is not repealed.

For decedents dying in 2001, the exemptions amount is \$675,000 for estate tax and \$1,060,000 for GST tax; the tax rate is 55%, plus a 5% surtax on certain estates over \$10 million. For decedents dying in 2002, the exemption amount will be \$1 million for estate tax, and the \$1,060,000 for the GST tax will be indexed for inflation. The tax rate will be 50% for the estate tax. The surtax will be repealed. After increasing to \$1 million in 2002, the gift tax exemption will remain constant and will not be indexed for inflation.

## **Five-Year Carryback of Net Operating Losses**

The 2002 Tax Act temporarily extends the general net operating loss (NOL) carryback period to 5 years (from 2 years) for NOLs arising in

taxable years ending in 2001 and 2002. In addition, the 5-year carryback period applies to NOLs from these years that qualify under present law for a 3-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain presidentially declared disaster areas). The law also allows an NOL deduction attributable to NOL carrybacks arising in tax years ending in 2001 and 2002, as well as NOL carryforwards to these tax years, to offset 100% of a taxpayer's alternative minimum tax income (AMTI).

## **Discharge of Indebtedness of an S Corporation**

Under the new law, income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation.

## **Qualified Foster Care Payments**

The 2001 law makes two modifications to the exclusion for qualified foster care payments for taxable years beginning in 2002. First, it expands the definition of qualified foster care payments to include payments by any placement agency that is licensed or certified by a state or local government or an entity designated by a state or local government to make payments to providers of foster care. Second, it expands the definition of a qualified foster care individual by including foster care individuals placed by a qualified foster care placement agency (regardless of the individual's age at the time of placement).

## **Deduction for Classroom Materials**

For tax years 2002 and 2003, a kindergarten through grade 12 teacher, instructor, counselor, or principal is eligible for an above-the-line deduction of up to \$250 annually in out-of-pocket expenses for books, supplies, computer equipment, and other qualified materials used in the classroom.

## **Alternative Minimum Tax Relief for Individuals**

For tax years 2002 and 2003, an individual is permitted to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits (i.e., the dependent care credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. home-buyer's credit).

# 10 Smart Tax Planning Tips

- 1.** Start your planning early. This allows you time to take advantage of strategies that may take several months to implement.
- 2.** Make your contributions to an IRA or Keogh plan early in the year. The combination of making contributions early in the year and compounding will make your money grow faster than if you wait until the last minute. See page 92.
- 3.** Contribute the maximum to your 401(k) plan and start early in the year. If you wait too long, you may not be able to contribute the full amount because of limitations. See pages 97–98.
- 4.** Do not take a lump sum distribution from your pension plan unless you roll it over to an IRA account in a timely manner. **Caution: There is a 20% withholding tax on lump sum distributions.** See page 102.
- 5.** If you plan to work after your normal retirement date, consider how it will affect your Social Security benefits. Also, consider whether you would be better off applying for your benefits by age 62 or waiting until normal retirement age. See page 210.
- 6.** If you have property that would generate a long-term capital gain if sold, consider using it to make your charitable contributions. (Your contribution deduction will be based on the fair market value of the stock and you won't have to pay tax on the gain.) See page 112.
- 7.** Charitable contributions are subject to certain tax limitations. Some of your contributions to charities may not be deductible until a later year if you exceed the prescribed limits. Furthermore, if you do not meet the substantiation requirements the contribution won't be deductible at all. Also consider making your charitable contributions toward the end of your tax year. See page 114.
- 8.** Replace personal debt with mortgage debt to the extent possible. Interest expense on mortgage loans is—subject to some limitations—deductible; personal or consumer interest is not. See page 45.
- 9.** Consider the after-tax yield of an investment when comparing returns on different investments. See pages 26–27.
- 10.** Consider giving gifts to your children. You may want to shift income to them since children are usually in lower tax brackets and so pay less in taxes. However, if your children are under age 14, their income above certain levels will be subject to the special “kiddie tax” rates. See page 155.



# I

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## Tax Strategies for Individuals

There are many tax-saving strategies you can use to lower your tax bill. This book has been organized to assist you in developing and implementing the tax-saving strategies most effective for you. The first step, as anyone who has collected information for an annual tax return knows, is to determine what portion of your income is subject to tax and what may not be. Income, of course, is not just the money you get in your paycheck. It includes interest and dividends, rent and royalties, pensions and annuities, alimony and separate maintenance payments, among many other things—all of which are explained in Chapter 1. We've also pointed out permissible ways you can reduce the amount of income you have to report.

The second step (described in Chapter 2) is to figure out which of the expenses you incurred during the year can be deducted to lower your taxable income. We've included suggestions about how you can maximize your deductions and therefore lower the amount of tax you owe. The chapters on Travel and Entertainment Expenses, Tax Planning and Your Home, IRAs and 401(k) Plans, Charitable Contributions, Capital Gains and Losses, and Mutual Funds explain in greater detail strategies that can help you deal with these important topics.

The third step, the calculation of your tax, is explained in Chapter 9. It involves several calculations—you need to figure out, for example, whether to claim the standard deduction or to itemize, and for some taxpayers, whether you are subject to the alternative minimum tax. We've tried to describe the process in as simple and straightforward a way as possible. The results can be richly rewarding.

The last step represents both an end and a new beginning. The sophisticated taxpayer can take steps at the end of the year that can defer taxes until next year. This is the primary focus of Chapter 10. If you can shift

the tax from this taxable year to the next taxable year, you have saved the use of those deferred funds for a year. More important, Chapter 10 illustrates how a taxpayer can start planning so that less tax will have to be paid in future years.



# 1

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## What You Have to Include as Income

### INTRODUCTION

The first step in determining how much in taxes you'll have to pay is to figure out your *taxable income*. That is the amount, figured by subtracting from your gross income certain adjustments and allowable deductions, upon which your tax is based. Your gross income includes income from all sources, such as:

- Alimony and separate maintenance payments
- Compensation for services, including salary, wages, tips, fees, commissions, and certain employee benefits
- Gains from dealings in property
- Gross income from a business
- Income from an interest in an estate or trust
- Income from paying off a debt for less than you owe
- Certain income from life insurance and endowment contracts
- Interest and dividends
- Pensions and annuities
- Rents and royalties
- Court awards in noninjury or nonsickness cases (e.g., job discrimination)
- Your share of income from a partnership or S corporation, whether it is distributed or not.

This chapter discusses what you have to include in calculating your taxable income. Along the way, you'll find many tax-saving suggestions that should help you lower your taxable income—and your tax bill.

### WAGES, SALARIES, AND OTHER EARNED INCOME

As a general rule, you must include in your gross income everything you receive as payment for personal services including wages, salaries, com-

missions, and tips. If you receive property or services as compensation, you generally should include the fair market value of the property or services as wages in the year you receive it.

Unless you anticipate a tax rate increase next year, you will generally find it to your advantage to defer recognizing income, where permissible, to a later year. Usually the date of receipt determines the year income is taxable. So, failure to cash a check or refusal to accept a payment will not defer income.

### **TAXALERT**

*The tax act signed into law in spring 2001 by President Bush includes rate reductions in 2002, 2004, and 2006.*

### **E&Y FOCUS: Deferred Compensation Plans**

Deferred compensation plans are designed by employers for executives who can afford to defer a portion of their earnings. Under such plans, you make an election to defer some portion of your income until a stated time; you are taxed on the deferred income only when it is received.

Deferrals can be made from your regular salary or from bonuses. You generally should make an election to defer income before that income is earned. Furthermore, you and your employer must enter into a written deferral agreement.

Deferred compensation plans serve one of two functions, depending on whether they are short-term or long-term plans:

- Short-term arrangements are generally most effective when used to take advantage of tax-rate changes. For example, suppose that in the current year the top rate on your taxable income is roughly 39% (38.6%). The next year you expect your top rate to drop to 30%. You might use a deferred compensation plan to shift income from one year to the next so that it will be taxed at a lower rate.
- Long-term arrangements are aimed primarily at providing key employees with bonuses and retirement income in excess of the amounts allowed by law to be provided under the employer's qualified pension and profit-sharing plans. Some experts are dubious about the benefits of long-term deferrals, mainly because they believe tax rates will be higher in the future than they are currently. If they're right, the deferred income would be taxed at a higher rate—defeating one of the primary purposes of deferring the income. It's worth noting that most deferred compensation plans include a provision for increasing the amounts deferred to reflect what you would have earned by receiving the payments up front and then investing them. Also, given the restrictions on qualified plans (plans entitled to tax-favored status), non-qualified plans continue to be popular with executives.

**Make Sure You Collect Your Deferred Compensation.** Many traditional "nonqualified" (i.e., unfunded) deferred compensation plans

are based on an unsecured promise from your employer to pay compensation in the future. But how can you be sure your company will pay up?

Various arrangements have been developed to provide the employee with an additional sense of security that the promise will be honored without causing the income to be immediately taxable. One such device is known as a “rabbi trust,” so named because the first arrangement approved by the IRS was developed by a synagogue for its rabbi.

Under a rabbi trust arrangement, amounts sufficient to pay the deferred compensation are placed into an irrevocable trust by your employer. Once in the trust, these amounts can be accessed by the employer’s creditors only upon the employer’s bankruptcy or insolvency; the amounts are not otherwise available for use by the original employer or a successor employer. This means that, unless the employer becomes bankrupt or insolvent, amounts in the rabbi trust will be available to pay the deferred compensation in future years.

**“Noncash” Compensation.** The following are some of the more common forms of noncash compensation that are subject to tax:

1. *Employer-provided automobile for personal use.* If your employer provided you with a car, your personal use of the car is considered taxable noncash compensation.
2. *Educational assistance.* You generally must include in income any educational expenses your employer paid for you, unless the courses are required by your employer, are job-related, or the expenses are paid for under a special plan meeting IRS requirements.
3. *Bargain purchase of employer’s assets.* If you are allowed to purchase property from your employer at a price *below* its fair market value as compensation for your services, you must report as income the difference between the property’s fair market value and the amount you paid for it (see the exception following under “Qualified employee discount”).
4. *Stock options.* The difference between the stock’s fair market value and the option price should generally be reported as additional income when you exercise an option to buy stock from your employer. A special rule, however, applies to incentive stock options. This rule usually delays the tax until you sell or exchange your stock. (See pages 27–30 in this chapter.)
5. *Group term life insurance premiums for over \$50,000 of coverage.* An employer’s payments for group term life insurance premiums for coverage over \$50,000 are considered to be additional income to you unless the beneficiary of the “over \$50,000 life insurance” is an organization to which a contribution would be a charitable contribution.
6. *Club memberships.* If your employer provides you with a membership in a country club or similar social organization, you are subject to tax on the value of the membership.

**Tax-Free Fringe Benefits.** Certain fringe benefits you receive from your employer are specifically excluded from taxation. These include:

1. *No-additional-cost service.* If you receive services from your employer that are regularly offered for sale to customers and your employer incurs no substantial additional cost in providing them to you, you do not have to include the value of these services as income. *Example:* Stand-by space on flights for airline employees.
2. *Qualified employee discount.* You do not have to report additional income if the discount your employer extended to you is less than the discount your employer would regularly offer to customers. For the purchase of services, the discount must be less than 20% of the price regularly charged to customers. *Example:* Appliance retailers' discounted sales of their merchandise to their employees at the lowest discounted price offered to customers.
3. *Working condition fringe benefits.* You do not have to include in income the value of property or services provided to you by your employer if you would be entitled to a business deduction for such items on your personal return had you paid for these items. *Example:* Business periodical subscriptions.
4. *De minimis fringe benefits.* Fringe benefits items so small in value that it would be unreasonable or administratively impractical for your employer to account for them. *Examples:* Personal use of copying machine, occasional parties for employees.
5. *Tax-free employee parking and transit benefits.* An exclusion from gross income is allowed for an employee whose employer offers the choice between cash and parking or a transit benefit, and the employee chooses parking or a transit benefit. If the employee chooses cash, the amount offered is includible in income.

We've mentioned just a few examples. You should consult with your employer and your tax advisor to find out how to treat a particular item.

**401(k) Plans.** If your employer has a 401(k) plan or another plan that allows you to postpone income, you can elect to defer a certain amount of your salary on a pre-tax basis. Such amounts are withheld from your salary and are not reported as income until withdrawn from the plan. For further information about 401(k)s and other retirement plans, see Chapter 5.

### TAXALERT

*A key element of tax planning is reducing your income. One way to do that is to take advantage of your employer's 401(k) plan, particularly if the deductible amount you are permitted to contribute to an IRA is limited (see pages 89–93). With a 401(k), you can elect to defer up to a maximum of \$11,000 in 2002 (\$12,000 if you're age 50 or above). Recently enacted changes to the law increase the contribution limits in the years ahead as follows:*

	<b>Individuals Under Age 50</b>	<b>Individuals Age 50 and Above</b>
2003	\$12,000	\$14,000
2004	\$13,000	\$16,000
2005	\$14,000	\$18,000
2006	\$15,000	\$20,000

### **TAXSAVER**

*Although the funds in your 401(k) plan are meant to be set aside for your retirement, you may still have access to them if you need money. Your plan may permit you to borrow from the plan, subject to strict rules. Despite the restrictions, you may be better off borrowing from your retirement fund than getting a loan from your bank. If the loan from the bank is for personal purposes, it could result in nondeductible interest. While a loan from your 401(k) plan does not generate deductible interest, the interest you pay is allocated to your account (although, of course, your rate of return may be lower than what your assets were earning prior to the loan). Your best bet might be to borrow from the equity in your home. The interest on such a loan would generally be tax deductible.*

## **INTEREST AND DIVIDENDS**

Interest that you receive on bank accounts, on loans that you have made to others, or from other sources is taxable. However, interest received on obligations of a state or one of its political subdivisions, the District of Columbia, or a possession of the United States or one of its political divisions is usually tax exempt for federal purposes. Interest paid by the IRS on a tax refund arising from any type of original tax return, if the refund is not issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return was filed, is taxable. (The interest rates on such payments are set periodically by the IRS.)

## **Qualified Tuition Programs**

Qualified tuition programs (QTPs) are tax exempt. Gifts made to a QTP are eligible for the gift tax exclusion and the students/participants in state sponsored programs are not taxed on distributions used for qualified higher education expenses. Distributions from school sponsored programs will be tax free starting in 2004.

“Qualified higher education expenses” are tuition, fees, books, supplies, equipment required for the enrollment or attendance at a college or university (or certain vocational schools), and room and board.

**TAXALERT**

*Under the new tax law previous restrictions on expenses for room and board have been eased.*

## U.S. Saving Bonds

U.S. saving bonds are direct obligations of the United States government. Three types of bonds are available; Series EE bonds, Series HH bonds, and Series I bonds. All three are subject to federal income tax, though in some circumstances (explained below) interest on Series EE and Series I bonds may be deferred for many years, and if used for certain educational purposes may even be exempt from tax. All of these bonds, however, are exempt from state and local income taxes.

**Series EE Bonds.** These are bonds that are issued at a discount—that is, they're purchased at a fixed amount, and are redeemed at a higher amount depending upon how long the bonds are held. Cash method taxpayers have the option of reporting income on the bonds when the bonds are redeemed or reporting it annually as it accrues. Accrual method taxpayers must report the income as it accrues.

**TAXSAVER**

*Series EE bonds can be an interesting tax-sheltered investment in two ways. First, because most individuals are cash method taxpayers paying taxes on income as it is received, interest income from Series EE bonds is not recognized until the bonds are redeemed. But, there is a second way you can shelter your interest income from Series EE bonds for an even longer time. If, instead of redeeming the bonds when they come due, you exchange them for Series HH bonds (that pay interest semiannually), you can avoid recognition of the accumulated Series EE bond interest until the Series HH bonds are redeemed.*

**Example:** *Clay purchases \$7,500 worth of Series EE bonds, which pay interest of 4% per year. In slightly more than seven years, the bonds will have grown in value to \$10,000. Instead of redeeming them at that point, he exchanges them for \$10,000 worth of Series HH bonds, which pay interest at the rate of 4% per year. The \$2,500 of interest income earned over the years on the Series EE bonds would not be taxable at the date of exchange but would be deferred. Clay will receive \$400 of taxable interest income per year on the Series HH bonds. The \$2,500 of deferred interest income on the Series EE bonds would not be taxable until the Series HH bonds reach final maturity or are redeemed.*

*There is, however, a limitation on the purchase of EE bonds. An individual may purchase only up to \$15,000 (\$30,000 face value) per year.*

The interest received on EE bonds depends on when the bonds are purchased. Different rules apply to bonds purchased before May 1995,