

**RSM! McGladrey**



## **2007 Tax Planning Guide**

# Dear clients and friends,



As predicted last year, we saw additional changes in tax law this past year and more tax-related legislation is sure to go before Congress in the coming months. It can be tough to keep up and be sure you are taking new tax laws into account as you assess your tax picture and try to plan for tax savings.

Since our tax laws are so complex, we're offering this tax planning guide to help you identify the strategies that will best meet your needs, reducing your tax burden and helping your families and businesses benefit in other ways.

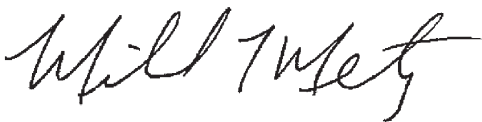
- In the section on tax law changes, you'll see that three major tax bills were passed, including the Small Business and Work Opportunity Tax Act (SBWOTA), the Tax Relief and Health Care Act of 2006 (TRHCA), and Pension Protection Act of 2006 (PPA). These laws variously extend some tax credits and make some previously temporary tax provisions permanent.
- Reducing your taxable income through deductions is always a key strategy. Now you may have expanded opportunities for funding Health Savings Accounts or for rolling amounts from flexible spending accounts or an IRA into an existing Health Savings Account under the TRHCA.
- In the section on tax-smart tactics, we urge you to consider all the consequences of your investment decisions and offer multiple ideas to help you consider the tax consequences of your investment transactions.
- Timing can be everything. Business owners and the self-employed need to be particularly cognizant of opportunities for deferring income or accelerating deductions. And there may be other ways businesses can save by considering things like the Section 199 deduction, a cost segregation study or tax credits you may not be taking advantage of.
- And if you are a business owner, be sure you have a succession plan or exit strategy in place. You can't begin to plan for retirement too soon and having a comprehensive plan that covers estate planning and asset protection in place can bring you lots of peace of mind.

You'll find several helpful charts in this year's guide as well as information on tax breaks for families and students and suggested tax action strategies that help illustrate specific ways to realize tax savings.

If there are ideas that interest you or if you have questions, be sure to contact your tax advisor. This guide is meant to be a helpful resource, not a substitute for consulting a professional tax advisor who can help you formulate and implement a tax plan that works for you.

Please call your RSM McGladrey adviser to learn more on how to reduce taxes and realize your objectives.

Best regards,



Michael L. Metz  
Executive Vice President – Tax Services  
RSM McGladrey

# Table of Contents

<b>2</b>	<b>Tax Law Changes</b> 2006 saw huge changes to the tax landscape
<b>3</b>	<b>Deductions</b> Want to reduce your taxable income?
<b>5</b>	<b>Family and Education</b> Calling all parents and students
<b>7</b>	<b>Investing</b> Tax-smart tactics
<b>9</b>	<b>Business</b> Profits aren't enough
<b>13</b>	<b>Retirement</b> Don't delay
<b>15</b>	<b>Wealth Management</b> Tick tock, tick tock

## Charts

<b>Chart 1:</b> 2007 individual income tax rate schedules	<b>4</b>
<b>Chart 2:</b> 2007 family and education tax break AGI phaseouts	<b>5</b>
<b>Chart 3:</b> 2007 capital gains tax rates	<b>7</b>
<b>Chart 4:</b> 2007 corporate tax rate schedule	<b>10</b>
<b>Chart 5:</b> 2007 retirement plan contribution limits	<b>14</b>
<b>Chart 6:</b> transfer tax exemptions and rates	<b>15</b>

This guide discusses certain general principles of tax law and does not address all the specific requirements or exceptions that may apply in individual situations. RSM McGladrey is not rendering legal, accounting or other professional advice on specific facts or matters. This guide may not be relied upon to provide any relief from any penalties under the Internal Revenue Code or any state, local, or foreign tax law. Consult your tax advisor regarding the application of these general tax principles to your specific situation.

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# Tax Law Changes

## 2006 saw huge changes to the tax landscape

2007 is bringing even more

In 2006, three major tax bills were passed, affecting a wide variety of tax planning areas, such as investing, retirement planning, charitable giving, college funding, business tax relief, health care saving funding, and the alternative minimum tax (AMT). In May of this year, the Small Business and Work Opportunity Tax Act (SBWOTA) was passed, giving breaks to small businesses to help offset the minimum hourly wage increase but also increasing taxes in certain situations. Here's a summary of some important changes signed into law since early 2006.

### Business breaks and "kiddie tax"

SBWOTA includes several tax breaks for businesses and their owners. It extends the initial year expensing election under Section 179 through 2010 and increases the expensing limit to \$125,000. It also extends the Work Opportunity credit to Aug. 31, 2011, and expands it to include more types of disadvantaged workers. In addition, it waives the individual and corporate AMT limits on the use of certain credits, and it extends several tax incentives designated for the Gulf Opportunity Zone (GO Zone).

But the act will increase taxes for some taxpayers by further changing the kiddie tax rules. Before 2006, only

children under age 14 were taxed on unearned income at their parents' tax rate. For 2006 and 2007, the age threshold was increased to include the unearned income of children under the age of 18. Under SBWOTA, however, for 2008, the age limit is increased again to include those under 19, or under 24 if the child is a student and doesn't have earned income that exceeds one half of the amount needed for support.

### Extenders, health care and AMT

The Tax Relief and Health Care Act of 2006 (TRHCA) extends a number of temporary provisions, generally through 2007, such as the state and local sales tax deduction (as an alternative to the state and local income tax deduction), the research and development (R&D) credit, the tuition and fees deduction, and 15-year depreciation for certain leasehold and restaurant improvements. TRHCA also extends several energy-related tax breaks through 2008.

In addition, TRHCA expands opportunities for funding Health Savings Accounts (HSAs). It also provides relief to those who have exercised incentive stock options and paid the AMT in the form of a new refundable credit.

### Retirement plans, charitable giving and 529 plans

The Pension Protection Act of 2006 (PPA) takes measures to ensure full funding of these plans. It also makes permanent the increases in the annual benefit limit that had been set to expire after 2010.

In addition, PPA enhances retirement savings held in IRAs and defined contribution plans, such as 401(k)s, 403(b)s, 457s and SIMPLEs. For example, PPA makes permanent many provisions from the 2001 tax act that were to "sunset" after 2010, such as higher contribution limits, "catch-up" contributions for those 50 and older, and Roth 401(k)s and 403(b)s.

Finally, PPA brings changes related to charitable contributions, such as requiring substantiation of all cash donations, and makes permanent Section 529 plan provisions that were set to expire after 2010.

### Capital gains and dividends

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), passed in 2006, extends through 2010 the lower (15%) maximum rate on most long-term capital gains and qualified dividends.

# Deductions

## Want to reduce your taxable income?

Find all the deductions available to you

Deductions are key to reducing your taxable income. Fortunately, though Congress has done a lot of tinkering with the tax code in recent years, they've been careful not to take away taxpayers' ability to deduct certain items (or exclude other items from income). So, if you're seeking ways to reduce your taxable income, you'll find them. You just need to know where to look. Here are some important deduction and other income-reduction opportunities to keep in mind.

**Consider a Health Savings Account (HSA).** An HSA (which can be employer-sponsored or set up by an individual) allows contributions of pretax income to an interest-bearing account or an account invested in certificates of deposit, annuities, stocks, bonds or mutual funds. (The 2007 limit is \$5,650 for a family plan or \$2,850 for individual coverage. Account holders age 55 and older may contribute an additional \$800.) You can have more than one HSA as long as total HSA contributions don't exceed the applicable limit. HSAs require that you be covered by high-deductible health insurance. Withdrawals for medical expenses are tax free, and you can carry over a balance from year to year. Plus, under the Tax Relief and Health Care Act of 2006, you may now be eligible to roll over amounts from your FSA (see below) or IRA (see page 13) into your HSA.

**Look into a Flexible Spending Account (FSA).** You can redirect pretax income to an employer-sponsored FSA up to an employer-determined limit. The plan then pays or reimburses you for medical expenses incurred that weren't covered by insurance. What you don't use by the end of the plan year, you lose – though, if your plan allows, you can be reimbursed for expenses incurred up to 2½ months after the plan's year end.

**Make the most of home-related tax breaks.** You can deduct interest on mortgages incurred to purchase, build or improve your principal residence and a second residence as long as your combined home mortgage debt (related to these homes) doesn't exceed \$1 million.

If you have more than two homes, you can choose the home to treat as your second residence. Deduct related points in addition to interest if the loan is for purchasing or improving your principal residence. Refinancing points must be amortized over the loan's term. When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 if you're married filing a joint return) of the gain you realize, as long as you meet certain tests.

**Pay off nondeductible interest with a home equity loan.** You may be able to maximize your interest

## Tax Action Strategy

### Take advantage of rental rules

**If you rent all or a portion of your primary residence or vacation home for less than 15 days, you need not report the income. If you convert your residence from personal to rental use, you may reap other benefits.**

**For example, you may be able to do a like-kind exchange after the conversion. (See page 8.) And, if you used the home as your principal residence for at least two of the five years preceding the exchange, you may be able to exclude up to \$250,000 (\$500,000 if you're married) of the gains before applying the like-kind exchange rules, thus increasing the tax basis of the replacement property by the amount of the excluded gain. Or, if you sell the property at a loss, you may be able to deduct the loss because the property is considered a business asset. However, you can't deduct any decline in value that occurred before the home was converted to rental use.**

deduction by paying off nondeductible interest – such as that on credit cards or auto loans – with money from a deductible class, such as a home equity loan. If you're paying off credit cards, you likely also will benefit by paying interest at a much lower rate. Interest generally is deductible on home equity loan balances up to \$100,000.

### Maximize charitable giving.

Donations are generally fully deductible, as long as you itemize deductions and don't surpass statutory limits – 50%, 30% or 20% of your adjusted gross income (AGI). The applicable limit depends on what you donate and whether the recipient is a public charity or an operating or non-operating foundation. Contributions in excess of the limits may be carried forward – for future use – for up to five years. For larger donations, consider more sophisticated charitable vehicles such as private foundations or donor-advised funds.

Be aware that, under the Pension Protection Act of 2006 (PPA), every cash donation must be supported by a canceled check, credit card receipt or written communication from the charity. Moreover, clothing and household good donations must be in at least “good used condition” to be deductible.

**Give directly from your IRA.** If you're 70½ or older, PPA allows you to give up to \$100,000 in 2007 to charity directly

from an IRA. You won't get a tax deduction if the IRA distribution would otherwise have been taxable, but you save the tax you would have otherwise owed. Plus, you avoid charitable contribution deduction limits, such as the AGI limits.

**Donate appreciated assets.** If you donate property you've held more than one year, you may be able to take a charitable deduction equal to its current fair market value. Plus you'll avoid paying tax on the long-term capital gain you'd incur if you sold the property. For instance, instead of giving cash, donate appreciated publicly traded securities. Beware: The deduction amount is subject to tighter limits (30% or 20% of AGI) than cash contributions.

**Create a charitable remainder trust (CRT).** A great way to benefit a charity while helping ensure your own financial future is to fund this trust, which, for a given term, will pay income to you. At the end of the term, the trust's remaining assets pass to one or more charitable organizations. You receive an income tax

deduction for the present value of the amount that will go to charity. And you can contribute appreciated assets and avoid paying capital gains tax while possibly increasing your annual cash flow.

**Watch out for the alternative minimum tax (AMT).** AMT rates are 26% and 28%, but many deductions allowed in calculating regular tax liability aren't allowed for the AMT, such as state and local income taxes, property taxes, and some miscellaneous itemized deductions. If your AMT liability exceeds your regular tax liability, you must pay the AMT. Unless Congress acts, the AMT exemption amounts for 2007 will fall to \$45,000 for joint filers and surviving spouses, \$33,750 for single filers and those filing as heads of households, and \$22,500 for married persons filing separately, likely making more taxpayers subject to the AMT. Project whether you may be one of them this year or next, and then time income and deductions as much as possible to either avoid the tax or protect your deductions.

## Chart 1

# 2007 individual income tax rate schedules

Married filing jointly or surviving spouse	Marginal tax rate		Single	Marginal tax rate	
Taxable income	Base Tax	(tax on next dollar)	Taxable income	Base tax	(Tax on next dollar)
\$ 0	\$ 0	10%	\$ 0	\$ 0	10%
\$ 15,650	\$ 1,565	15%	\$ 7,825	\$ 783	15%
\$ 63,700	\$ 8,773	25%	\$ 31,850	\$ 4,386	25%
\$ 128,500	\$ 24,973	28%	\$ 77,100	\$ 15,699	28%
\$ 195,850	\$ 43,831	33%	\$ 160,850	\$ 39,149	33%
\$ 349,700 and above	\$ 94,601	35%	\$ 349,700 and above	\$ 101,469	35%
<b>Married filing separately</b>			<b>Head of Household</b>		
\$ 0	\$ 0	10%	\$ 0	\$ 0	10%
\$ 7,825	\$ 783	15%	\$ 11,200	\$ 1,120	15%
\$ 31,850	\$ 4,386	25%	\$ 42,650	\$ 5,838	25%
\$ 64,250	\$ 12,486	28%	\$ 110,100	\$ 22,700	28%
\$ 97,925	\$ 21,915	33%	\$ 178,350	\$ 41,810	33%
\$ 174,850 and above	\$ 47,301	35%	\$ 349,700 and above	\$ 98,356	35%

Source: U.S. Internal Revenue Code

# Family and Education

## Calling all parents and students

Some great tax breaks are available to you

As any parent knows, rearing children and ensuring they receive a quality education can be expensive. Fortunately, many tax breaks are available for parents and others who are supporting loved ones – as well as for students themselves. So, be sure you take advantage of every tax break available to you.

### Take advantage of tax credits.

You may be able to claim a \$1,000 credit for each child under age 17 at the end of the calendar year. And you may be eligible for a credit for child or dependent care expenses paid on behalf of children under age 13 that's worth at least 20% of

qualifying expenses, subject to a cap. If you adopt, you may be able to take a credit of \$11,390 in 2007 or the employer adoption assistance program income exclusion, also \$11,390 per eligible child. But note that these credits include restrictions, and some phase out if your income is above certain levels. (See Chart 2 below) Also, starting in 2007, the child and adoption credits are the only family- or education-related credits that will provide any benefit against the alternative minimum tax (AMT).

**Hire your kids for additional tax benefits.** If you own a business, you can

### Chart 2

## 2007 family and education tax break AGI phaseouts

### Adjusted Gross Income Phaseout Ranges

Tax Break	Single Filers	Joint Filers
Child tax credit <sup>1</sup>	\$ 75,000 - \$ 95,000	\$ 110,000 - \$ 130,000
Adoption credit	\$ 170,820 - \$ 210,820	\$ 170,820 - \$ 210,820
ESA contribution	\$ 95,000 - \$ 110,000	\$ 190,000 - \$ 220,000
Hope credit	\$ 47,000 - \$ 57,000	\$ 94,000 - \$ 114,000
Lifetime Learning credit	\$ 47,000 - \$ 57,000	\$ 94,000 - \$ 114,000
Tuition and fees deduction	\$ 65,000 - \$ 80,000	\$ 130,000 - \$ 160,000
Student loan interest deduction	\$ 55,000 - \$ 70,000	\$ 110,000 - \$ 140,000

<sup>1</sup>Assumes one child  
Source: U.S. Internal Revenue Code

## Tax Action Strategy

### Shift income to children

For children ages 18 and older, all 2007 income (earned and unearned) will be taxed at their own, generally lower, marginal rates – as low as 5% on long-term capital gains and qualified dividends. So giving them income-producing assets can save your family tax dollars this year. In 2007, you and your spouse together can give up to \$24,000 of assets free of federal gift tax to each of your children (or grandchildren) without using any of your \$1 million lifetime gift tax exemption. (For more on gift tax planning, see page 15.)

Until last year, the “kiddie tax” applied to children under age 14. But for 2006 and 2007, the rule has been expanded to apply to children under age 18. As a result, their unearned income that is beyond \$1,700 will be taxed at their parents’ marginal rate – so, the income tax benefit of shifting income to them will be limited. And in 2008, the kiddie tax will be further expanded to children who qualify as dependents because they are either under age 19, or under age 24 and a full-time student, if their earned income doesn’t exceed one-half of the amount needed for their support. Consider whether these changes alter your income tax and estate tax planning.

hire your children and fully deduct their pay. And if your business is unincorporated and has no owners other than you and certain family members, and your children are under age 18, you won't owe any payroll or unemployment taxes on their wages. Your kids benefit too: They can earn as much as \$5,350 (the 2007 standard deduction amount for singles) and pay zero federal income tax. They can earn an additional \$4,000 tax-deferred if they contribute it to a traditional IRA, though that will make them ineligible to make Roth IRA contributions. Keep in mind that the children must perform actual work for wages in line with what you would pay nonfamily employees.

**Start your teen's retirement saving now with a Roth IRA.** Roth IRAs can be perfect for teenagers because they're typically in low tax brackets and have many years to let their accounts grow tax free. The contribution limit for minors is the same as for adults under 50: the lesser of \$4,000 (in 2007) or 100% of earned income from a legitimate job reported on their tax returns. (For more on Roth IRAs, see page 13.)

**Consider a 529 plan.** Section 529 plans enable parents (or grandparents) to either secure current tuition rates with a prepaid tuition program or create tax-free savings plans to fund college expenses. And the plans are now even more attractive because Sec. 529 provisions that had been set to expire after 2010 have been made permanent. Most 529 plans are state-sponsored, though private institutions can offer prepaid tuition plans. 529 savings plans typically

offer much higher contribution limits than Coverdell Education Savings Accounts (ESAs – see next paragraph), but fewer investment options. Distributions used to pay qualified higher education expenses are income-tax free. 529 plans provide estate planning benefits as well: Your contribution can qualify for the \$12,000 annual gift tax exclusion (\$24,000 for gifts by married couples). By filing a gift tax return, you even can elect to use annual exclusions for five years all at once (for example, a \$60,000 contribution or a \$120,000 joint contribution).

**Cover more education costs with Coverdell ESAs.** ESAs allow you more investment options than 529 plans, and the expenses can be for elementary (including kindergarten) and secondary school in addition to college. Subject to income limitations (see Chart 2), you can contribute \$2,000 to an ESA to benefit a child under age 18 (unless the child has special needs, in which case special rules apply). The contribution isn't deductible, but distributions of earnings will be tax free if used to pay for the beneficiary's qualified education expenses. The deadline for contributions is the due date of the income tax return for the year of contributions – April 15 of the following year.

**Teach yourself – and your kids – about education credits.** When your kids hit college, you may be able to claim a Hope credit for the first two years of postsecondary education. For qualified tuition and related expenses required for enrollment on at least a half-time basis, the

maximum credit, adjusted annually for inflation, is \$1,650 per student for 2007. Similarly, you may be eligible for the Lifetime Learning credit of up to \$2,000 per taxpayer for an unlimited number of years of postsecondary, graduate and certain other education expenses. If your income is too high to qualify for either credit (see Chart 2), your child may be able to claim it. You or your child may claim either the Hope or Lifetime Learning credit and take tax-free 529 plan or ESA distributions as long as the 529 plan or ESA funds aren't used to pay the same expenses for which the credit is claimed.

**Set a course for education-expense deductions.** If your income exceeds the limits for the education credits, you may be able to deduct "above the line" a portion of qualified higher education tuition and fees. This deduction is also subject to adjusted gross income (AGI) limits, but they're higher. (See Chart 2.) The maximum deduction for 2007 is \$4,000.

**Deduct student loan interest.** Taxpayers paying interest on student loans may be able to deduct up to \$2,500 of interest above the line. Income phaseout ranges are now adjusted annually for inflation. (See Chart 2.)

# Investing

## Tax-smart tactics

Consider all the consequences of your investment decisions

Savvy investors think about more than just picking the “right” investments; they focus on asset allocation and diversification, considering the tax consequences of each transaction made along the way. There are many tax-smart tactics that can help you reach your goals.

### Time capital gains and losses.

The 15% long-term capital gains rate – 20 percentage points lower than the highest regular income tax rate of 35% (see Chart 3) has been extended through 2010. It applies only to investments held for more than 12 months. Remember this if you’re considering purging your portfolio of an underperforming stock. Holding on to it may help you cut your tax on the profit in half. Timing is also important if you’ve cashed in some big gains during the year. Before year end, look for unrealized losses in your portfolio and sell them off, thus offsetting the gains. If you end up with a net loss, you can claim up to \$3,000 of the net capital loss against ordinary income this year and carry forward any excess to future years.

### Identify which shares you’ve

**sold.** Investors usually want to sell high-tax-basis shares when possible to reduce gain or increase the loss and offset other gains.

But if you bought the same security at different times and prices, you must identify which shares you’ve sold when you file your tax return or you’ll be deemed to have sold the shares on a first-in, first-out (FIFO) basis. If you hold stock certificates, you must surrender the appropriate ones.

### Reduce turnover to save more

**tax dollars.** Selling stocks frequently or holding mutual funds with high turnover rates tends to repeatedly create capital gains. Holding stocks long-term or choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates. But be sure to consider overall performance, not just taxes, when selecting stocks or mutual funds.

**Avoid wash sales.** The wash sale rule prevents you from taking a loss on a security if you buy a substantially identical security (or option to buy a security) within 30 days before or after you sell it – you can recognize a loss only when you sell the replacement security. Fortunately, there are ways around the wash sale rule. For example, you may buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold. Alternatively, consider doubling up on your investment for a 31-day period before selling the original shares or selling and then waiting 31 days to repurchase.

### Exercise stock options with

**care.** Before exercising (or postponing exercise of) options or selling stock purchased via an exercise, consider the complicated tax rules that may substantially add to your tax liability if you act hastily – or minimize it if you plan properly. At the same time, financial risks can be great if you focus solely on getting the best tax treatment.

Chart 3

## 2007 Capital Gains Tax Rates

Holding Period	Maximum Tax Rate
12 months or less (short term)	35%
More than 12 months (long term)	15%
<b>Key long-term 15% rate exceptions:</b>	
Collectibles, such as artwork	28%
Gain attributable to depreciation on real property	25%
Gain that would be taxed at 10% or 15% based on the taxpayer’s regular income tax rate	5%

Source: U.S. Internal Revenue Code

## Tax Action Strategy

# Consider dividend-paying stocks

With the extension of the lower 15% maximum federal tax rate on qualified dividends through 2010, dividend-paying stocks continue to be desirable to many investors. But beware of potential price increases as a result, perhaps offsetting the tax advantage with an inflated price. Nevertheless, the lower rate serves as a reminder that dividend-paying stocks may have a place in your portfolio.

### **Consider an installment sale or like-kind exchange.**

An installment sale allows you to defer capital gains on most assets other than publicly traded securities. You can defer your overall tax burden by spreading the gain over several years as you receive the proceeds. Warning: Depreciation recapture income is recognized in the year of sale, even if no cash is received. If you're selling investment or rental real estate, consider a like-kind exchange. You may be able to defer paying tax on the gain over the time you hold the replacement property, though you'll reduce your depreciation deductions on that property.

### **Weigh the tax impact of bonds.**

Although interest on U.S. government obligations is taxable on your federal return, it's generally exempt on your state and local returns. In contrast, interest on state and local government bonds is excludable on your federal return. If the state or local bonds were issued in your home state, interest also may be excludable on your state return. But corporate bond interest is fully taxable for federal and state purposes.

**Swap your bonds.** With a bond swap, you sell a bond, take a capital loss and then immediately buy another bond of similar quality from a different issuer. The wash sale rule (see "Avoid wash sales" on page 7) doesn't apply because the bonds aren't considered substantially identical. Thus, you achieve a tax loss with virtually no change in economic position.

**Beware of OID income.** Bonds (except U.S. savings bonds) with

original issue discount (OID) build up "interest" as they rise toward their maturity price. The IRS says you earn a portion of that interest annually – even though the bonds don't pay you this interest annually – and expects you to pay tax on it. So, these investments may be best suited for tax-deferred vehicles, such as IRAs, or for investors with sufficient cash flow to absorb this tax.

### **Take the investment interest expense deduction.**

You can deduct investment interest – up to your net investment income for the year – on any money you borrow to buy or carry taxable investments. But you can't include long-term capital gains or qualified dividends in your net investment income for investment interest deduction purposes without waiving the favorable 15% rate and subjecting your gains or dividends to your higher ordinary income tax rate.

# Business

## Profits aren't enough

Keep your bottom line healthy with regular tax planning

If you own or operate a business, you know how tough it can be to stay ahead of the competition while strengthening the balance sheet. But making a nice profit doesn't necessarily guarantee a healthy bottom line. You also need to be aware of how your company – and those profits – will be taxed. Of course, you also should consider the business risks before executing any tax-saving strategies. Your tax advisor can help you home in on the best ways to keep your tax bill under control and your bottom line healthy.

**Defer income.** In potentially high-income years, consider deferring some income to later years. For example, if your business uses the cash method of accounting, you may be able to defer billing for your products or services as you approach year end. Or, if you use the accrual method, you can delay shipping products or delivering services until the new tax year. If you expect to be in a higher income tax bracket next year, you may be better off accelerating income into the current year.

**Accelerate deductions.** This can also save taxes in a high-income year. If you're a cash-basis taxpayer, a simple example is your state tax deduction. If you make an estimated state tax payment before Dec. 31, you can deduct it this year rather than next year. Be sure to consider the alternative minimum tax (AMT) effects of your planning. If you want

to accelerate deductions and don't have ready cash, consider charging expenses on your bank credit card. In low-income years, deferring deductions may make sense. For accrual taxpayers, accelerating and deferring deductions is possible, but much more complicated.

### **Take advantage of the manufacturers' deduction.**

The manufacturers' deduction, or the Section 199 deduction, presents many businesses with a wide range of planning and computational challenges and opportunities. In 2010, when it's fully phased in, the deduction will be equal to 9% of the lesser of qualified production activities income or taxable income (adjusted gross income for individuals). The deduction is 6% for 2007 through 2009 (up from 3% in 2006).

The deduction is further limited to 50% of W-2 wages paid by the taxpayer during the calendar year (or, for fiscal year taxpayers, during the calendar year that ends in the fiscal tax year). Effective for taxable years beginning after May 17, 2006, only W-2 wages attributable to domestic production may be included.

Because the deduction is limited by wages, businesses that use few employees or rely heavily on independent contractors probably won't benefit much from it.

A qualified production activity is much broader than the traditional meaning of manufacturing. For example, the deduction is available to businesses engaged in activities such as construction, engineering, computer software production and agricultural processing. It applies to several categories of qualifying activities, including any lease, rental, license or sale of qualifying production property that's manufactured, produced, grown or extracted in whole or in significant part in the United States.

The deduction isn't allowed in determining net earnings from self-employment and, generally, can't create or increase a net operating loss (NOL). But it can be used against the AMT. (See the Tax Action Strategy on page 11 for more on NOLs.)

Determine whether your business qualifies, if there are ways to increase your deduction, and how to capture the necessary information in your accounting system.

### **Consider business structure.**

Structures range from sole proprietorship to C corporation. (Note that, beginning in 2007, an unincorporated business owned by a married couple can be treated as a sole proprietorship instead of a partnership.) Income taxation and owner liability are the main factors that differentiate one from another. Many businesses choose entities that combine flow-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations. Some tax differences may provide planning opportunities. For example, to reduce the 2.9% Medicare tax, S corporation shareholder-employees may want

to keep their salaries reasonably low and increase their distributions of company income (which generally isn't taxed at the corporate level). But C corporation owners may prefer to take more income (which is taxed at the corporate level) as salary, to the extent reasonable, because the Medicare tax is lower than the (generally 15%) tax they'd pay on dividends.

**Maximize depreciation with a cost segregation study.** If you've recently purchased or built a building or are remodeling existing space, make sure you maximize your depreciation deductions. Although real property generally must be depreciated over 27½ or 39 years using the straight-line method, certain parts of the "building" can qualify for a shorter depreciable life.

A cost segregation study identifies property components, and their related costs, that can be depreciated over five or seven years using 200% of the straight-line rate, or over 15 years using 150% of the straight-line rate. This allows you to depreciate the property much faster and may dramatically increase your current deductions. Typical assets that qualify for this faster depreciation include decorative

fixtures, cabinets, security equipment, parking lots, landscaping and architectural fees allocated to qualifying property.

The benefit of a cost segregation study may be limited in certain circumstances – for example, if the business is subject to the AMT or is located in a state that doesn't follow federal depreciation rules.

**Act now to take advantage of accelerated depreciation.** Through 2007 a shortened recovery period of 15 years (rather than 39 years) is allowed for qualified leasehold and qualified restaurant improvements. Those made to the interior of a qualifying nonresidential building more than three years after the building was placed in service generally qualify. And the improvements can be made by either the lessor or the lessee.

**Take into account other depreciation rules.** Careful planning during the year can help you maximize depreciation deductions in the year of purchase. You generally will want to use the Modified Accelerated Cost Recovery System (MACRS), instead of the straight-line method, to get a larger deduction in

the early years of an asset's life. The IRS generally treats all newly acquired tangible assets other than real estate as being placed in service at the midpoint of the year. This gives you six months of depreciation in the first year. But if you made more than 40% of the year's asset purchases during the last three months of the year, you must use the generally less favorable midquarter convention.

**Manage your inventory.** You must calculate the dollar amount of inventory you have on hand at year end. If your ending inventory value is low and the cost of merchandise sold is higher, your taxable income will be lower – so the inventory method you choose can significantly affect your taxable income.

**Maximize tax credits.** Tax credits reduce your business's tax liability dollar-for-dollar. Several tax credits that had expired at the end of 2005 have been extended through 2007, including the Empowerment Zone and the research and development credits. The Work Opportunity and Welfare-to-Work credits also were revived for 2006, combined into a single credit for 2007, extended through Sept. 30, 2011, and expanded to include

## Chart 4

# 2007 Corporate Tax Rate Schedule

Taxable Income	Base Tax	Marginal Tax Rate (Tax on Next Dollar) <sup>1</sup>
\$ 0	\$ 0	15%
\$ 50,000	\$ 7,500	25%
\$ 75,000	\$ 13,750	34%
\$ 100,000	\$ 22,250	39%
\$ 335,000	\$ 113,900	34%
\$ 10,000,000	\$ 3,400,000	35%
\$ 15,000,000	\$ 5,150,000	38%
\$ 18,333,333	\$ 6,416,667	35%

<sup>1</sup> Personal service corporations taxed at flat 35% rate.

Source: U.S. Internal Revenue Code

additional qualified groups, such as disabled veterans.

**Write off bad debts.** Business bad debts are treated as ordinary losses and can be deducted when they become either partially or wholly worthless. For individuals and certain other entities, the IRS may consider loans made to closely held corporations as not business related and, if not repaid, reclassify them as non-business bad debts, which must be wholly worthless to be deductible and are treated as short-term capital losses.

**Look into qualified deferred compensation plans.** To attract and retain the best employees and manage your tax liability, qualified deferred compensation plans can be useful. They include pension, profit-sharing and 401(k) plans, as well as SIMPLEs and SEPs. You can enjoy a tax deduction for your contributions to employees' accounts, and the plans offer tax-deferred savings benefits for employees. (For more on the benefits to employees, see page 13.) The Pension Protection Act of 2006 (PPA) includes many provisions affecting traditional pension plans, so it's critical to ensure you're in compliance with the new rules if you provide such a plan.

**Provide fringe benefits.** Fringe benefits are a crucial part of any compensation package. Some fringes, referred to as "statutorily excluded" benefits, aren't included in employee income. With these fringes, both the employer and the employee come out ahead: The employer receives a deduction, but the value of the benefit is tax free to the employee. Plus, the business usually avoids payroll taxes on these amounts.

This favored tax treatment gives both parties incentive to "shift" some compensation from salary to fringe

benefits. Examples of benefits treated in this manner include group-term life insurance (up to \$50,000), health insurance, parking and employee discounts.

**Follow the rules for nonqualified deferred compensation.**

Nonqualified deferred compensation arrangements are a promise to pay executives and key employees sometime in the future for services to be currently performed. The plans are often geared to the individual and based on his or her performance or on the company's performance. Under PPA, employers with defined benefit retirement plans that are underfunded at a certain level or are terminated single-employer pension plans can't fund nonqualified deferred compensation plans.

Some 2004 tax law changes – many of which are still in the process of being implemented – are tightening the rules for nonqualified deferred compensation. The changes generally affect the timing of initial deferral elections, changes to elections, timing of distributions and how benefits are funded. Distributions are allowed only for specific events – such as separation from service or disability – and payment of benefits generally can't be accelerated. If a plan fails to meet the requirements, it will result in loss of tax deferral. In addition, all amounts previously deferred will be taxed, plus charged interest and a penalty of 20%.

These rules apply to a wide range of plans and arrangements, but they specifically exclude 401(k)s and other qualified employer plans, qualified governmental plans, and any bona fide plan covering vacation leave, sick leave, compensatory time, disability pay or death benefits. Nonqualified deferred compensation can still be an effective way to compensate employees. If you haven't already done

**Tax Action Strategy**

# Claim all business losses

Generally a net operating loss (NOL) may be carried back two years to generate a current tax refund, which can provide a cash infusion in times of loss. Any loss not absorbed in the prior two-year period is then carried forward for up to 20 years. If you prefer, you may choose to waive the carryback and carry the entire loss forward, which may be beneficial if your marginal tax rate in the carryback years is unusually low, or if the alternative minimum tax (AMT) in prior years makes the carryback less beneficial. The portion of an NOL that qualifies as a Gulf Opportunity (GO) Zone loss can be carried back five years. Keep in mind as you do your business tax planning that the GO Zone NOL expires after Dec. 31, 2007. Other losses that may generate a deduction include casualty and theft losses (to the extent they aren't covered by insurance) and losses from the sale or abandonment of business assets.

## Tax Action Strategy

# Expense when you can

Generally, equipment with a useful life well beyond the taxable year must be capitalized. An exception is the Section 179 expensing election. It allows a current deduction for assets that otherwise would be subject to normal depreciation rules. The maximum Sec. 179 deduction for 2007 is \$125,000, and it will be indexed for inflation through 2010. But for tax years beginning after 2010 this amount is scheduled to drop back to \$25,000 per year.

Given that, it may be appropriate to schedule major capital asset purchases in the next few years when the greatest tax benefits may be available. And if you have more than the maximum \$125,000 limit in 2007, choose those assets for expensing that would have had the longest life under the regular depreciation rules. If total asset acquisitions in 2007 exceed \$500,000, the expensing election begins to phase out.

An expanded Sec. 179 expensing election and a special depreciation allowance are available for qualified Gulf Opportunity (GO) Zone property. Some of those provisions are scheduled to expire for property placed in service after Dec. 31, 2007. But the Small Business and Work Opportunity Tax Act of 2007 extended the Sec. 179 GO Zone provisions through 2008, and the deadline for the special depreciation allowance for certain residential and nonresidential property is Dec. 31, 2010, if the building is located in specified portions of the GO Zone. Certain property used in such buildings also may qualify for the extended special depreciation allowance.

so, you need to amend your plan documents by Dec. 31, 2007.

**Develop a comprehensive succession plan.** All business owners should create an exit strategy to sell their companies or pass them on to their children, other family members or key employees. Your plan should include choosing the best and appropriate amount of insurance; utilizing valuation discounts; developing a buy-sell agreement; and determining whether an employee stock ownership plan (ESOP) could work for you. You will want to have a comfortable retirement while the business continues under the leadership and direction of your children or key employees – or in the hands of a new owner. A business succession plan will require consulting with family members, developing an effective management structure, and working with legal and financial advisors to set up and implement the plan.

**Make the most of selling your business.** The first tax consideration may be whether to sell assets or your equity interest, such as stock. With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. Buyers, on the other hand, generally want an asset sale to maximize future depreciation write-offs.

The transaction of transferring a business can be either taxable or tax-deferred, depending on whether the seller is receiving immediate cash or stock. Although it's generally best to avoid – or postpone – tax, there are some advantages to a taxable sale. For example, the seller doesn't have to worry about the quality of buyer stock or other business risks that might come with a tax-deferred acquisition. Also, the buyer receives a stepped-up basis in the assets and doesn't have to deal with the seller

as a continuing equity owner, as would happen in a merger transaction. The parties also don't have to meet the technical requirements of a tax-deferred transaction.

If a taxable sale is chosen, the transaction may be structured as an installment sale, due to the buyer's lack of sufficient cash or the seller's desire to spread the gain over a number of years. Installment sales are also useful when the buyer pays a contingent amount based on the business's performance. Watch out, though: An installment sale can backfire because depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives. Also, if tax rates increase in the future, the overall tax could wind up being more on an installment sale than on a cash sale. As a result, the extension of the 15% rate on long-term capital gains through 2010 is good news for anyone considering an installment sale. Be sure to calculate the potential tax effect before you finish negotiations.

**Benefit from tax breaks for the self-employed.** If you're self-employed, you can deduct 100% of health insurance costs for yourself, your spouse and your dependents. This above-the-line deduction is limited to the net income you've earned from your trade or business. You can also deduct above the line half of the self-employment tax you pay on your self-employment income. And you may be able to deduct home office expenses against your self-employment income.

# Retirement

## Don't delay

Planning now may help you achieve a prosperous retirement

Let's face it, who doesn't want a retirement that's not just secure but prosperous? The key is to work at building your retirement nest egg now. The Pension Protection Act of 2006 (PPA) may help you reach your goals even faster: It makes permanent many provisions from the 2001 tax act that were set to expire after 2010, such as the higher annual contribution limits for IRAs, 401(k)s, 403(b)s, 457s and SIMPLEs, and the catch-up provisions for those 50 and over. Here are some strategies to consider.

### **Anticipate inflation's effect.**

If your retirement is many years in the future, considering how inflation will affect your retirement living expenses is especially important. For best results, take into account two periods of inflation: the time you'll be accumulating retirement funds and the estimated length of your retirement. Knowing exactly how much the cost of living will increase is impossible, but past inflation rates can help you generate a likely estimate. Equally important, life expectancies are increasing, and a longer retirement period means you'll need more assets built up so your money can survive as long as you do.

**Contribute to a traditional IRA.** You may be able to take an above-the-line deduction for traditional IRA contributions up to \$4,000 or 100% of earned

income, whichever is less. Taxpayers age 50 and older can also make "catch-up" contributions of up to \$1,000. The contribution limits will increase in future years. But if you or your spouse participates in an employer-sponsored plan, your deduction may be limited based on your adjusted gross income (AGI).

**Consider a Roth IRA.** Like a traditional IRA, a Roth IRA may allow you to make annual contributions of the lesser of your compensation for the year or \$4,000 (reduced by annual contributions to all your other IRAs), plus a catch-up contribution of \$1,000 if you're age 50 or over. The contribution limits also will increase in future years. You can't deduct contributions, but you can take qualified distributions tax free. Your contribution may also be limited based on your AGI. If eligible, consider converting your traditional IRA (or another retirement plan, once it's been rolled over to an IRA) to a Roth IRA. This option will be available to more taxpayers starting in 2010, when the AGI limit (currently \$100,000) for eligibility will be waived.

**Maximize contributions to employer-sponsored plans.** Because contributions are pretax, they reduce your taxable income. The 2007 limit for employee contributions to 401(k), 403(b), 457 and SARSEP plans is the lesser

of 100% of compensation or \$15,500 (\$500 more than in 2006). Plus, your employer may match some or all of your contributions – also on a pretax basis. And plan assets grow tax-deferred. Similarly, under a SIMPLE, you may elect to contribute up to \$10,500 of your salary pretax, and your employer is required to make contributions as well. Again, assets grow tax-deferred. Contribution limits are scheduled to rise, and taxpayers age 50 and older can make additional "catch-up" contributions to these plans. (See Chart 5.)

## Tax Action Strategy

## Be aware of your retirement portfolio

**Consider which investments you should hold inside and outside your retirement accounts. For instance, if you hold taxable bonds to generate income and diversify your overall portfolio, consider holding them in an IRA or qualified retirement plan where there won't be a current tax cost. But try to own dividend-paying stocks that qualify for the 15% tax rate outside of retirement plans so you'll benefit from the lower rate. Keep in mind that, unless Congress extends it, the 15% dividend rate is available only through 2010. Also, periodically reallocate your retirement plan assets. For example, the allocation you set up for your 401(k) plan 10 years ago may be too aggressive now that you're closer to retirement.**

**Take advantage of the Roth 401(k).** PPA makes permanent the Roth contribution provision, which means more employers are likely to amend their plans to allow them. If you participate in a 401(k) or 403(b) plan and the plan allows it, you may designate some or all of your elective contributions as a Roth contribution. Unlike regular 401(k) contributions, Roth 401(k) contributions are taxed, but plan assets grow tax free. And, in contrast to a Roth IRA, there's no phaseout of eligibility based on AGI.

**Save more with a Keogh, single-employee SEP or solo 401(k).** If you're a business owner or self-employed, you may be able to deduct contributions to a Keogh, single-employee SEP or solo 401(k). This year, the annual contribution limit for defined contribution Keogh plans goes up \$1,000 to \$45,000, as does the limit on single-employee SEP contributions. Also, if you're age 50 or over you can augment your

solo 401(k) savings with the catch-up contribution, which for 2007 is \$5,000. Limits for all three plans are indexed for inflation each year, and their earnings accumulate tax-deferred.

**Avoid early withdrawal penalties with a lump-sum rollover.** With a few exceptions, retirement plan distributions made before age 59½ are subject to a 10% penalty. But when you change jobs, you may receive a lump-sum distribution from your employer's retirement plan. To avoid being penalized, consider rolling it over to the plan sponsored by your new employer within 60 days. Or, roll it over into a traditional IRA, which may give you more investment choices. Either way, a rollover will avoid current income tax and early withdrawal penalties while allowing the assets to continue to grow tax-deferred. If possible, transfer by direct rollover to avoid any income tax withholding issues.

**Plan for required minimum distributions.** For employer-sponsored plans and traditional IRAs, once you reach age 70½ you're subject to the required minimum distribution rules. There's a narrow exception to this rule for an employee: If your plan allows, you don't own more than 5% of the company and you continue to work after age 70½, you won't be subject to the rules on an employer-sponsored plan until you retire.

Whether you should take distributions before age 70½ or more than the minimum after that age depends on how much you'll receive from other income sources, your life expectancy and other factors. Generally, maximizing tax-deferred growth provides more savings if you can afford to leave the funds in the plan – even if it means depleting other investment accounts.

## Chart 5

# 2007 Retirement Plan Contribution Limits

Plan type	Contribution limit	Contribution limit for taxpayers 50 and over
Traditional and Roth IRAs	\$ 4,000	\$ 5,000
401(k)s, 403(b)s, 457s and SARSEPs <sup>1</sup>	\$ 15,500	\$ 20,500
SIMPLEs	\$ 10,500	\$ 13,000
SEPs and defined contribution Keoghs	\$ 45,000	\$ 45,000 <sup>2</sup>

<sup>1</sup>Includes Roth versions where applicable.

<sup>2</sup>Not subject to "catch-up" provisions.

Source: U.S. Internal Revenue Code

# Wealth Management

## Tick tock, tick tock

Time can be your friend or your foe when it comes to financial independence

Time never stops. And neither should your efforts to build and protect your – and your family’s – financial independence. Engaging in smart tax planning strategies now will go a long way toward ensuring a financially secure future for you and your loved ones. But, as each year passes without you having a comprehensive plan that covers estate planning and asset protection, you’ll have less time to grow and safeguard your wealth. There are many ways you can get started – and keep going.

**Consider transfer tax exemptions and rates.** During your lifetime or at death, you can transfer up to the exemption amount (\$1 million during life and whatever is left of that \$1 million plus an additional \$1 million at death) free of federal gift and estate taxes. If your taxable estate is equal to or less than the remaining exemption, no

federal estate tax will be due when you die. But if your federal estate exceeds this amount, it will be subject to estate tax. With the gradual phaseout of the estate tax and then its scheduled return in 2011 (see Chart 6), gift and estate planning is especially important.

**Make lifetime gifts.** Gifts you make during your lifetime are subject to federal gift tax. Fortunately, you can exclude most gifts of up to \$12,000 per recipient each year (\$24,000 per recipient if your spouse elects to split the gift with you) without using up any of your lifetime exemption. To use the annual exclusion, you must give recipients a “present interest” in the property. In other words, the recipient generally must have current access to the funds. If you want to retain more control, consider a Crummey trust, where, because of a temporary withdrawal right, the gift will qualify

### Chart 6

## Transfer Tax Exemptions and Rates

Year	Estate and GST Tax Exemptions <sup>1</sup>	Gift Tax Exemption	Highest Estate, GST and Gift Tax Rate
2007	\$ 2 million	\$ 1 million	45%
2008	\$ 2 million	\$ 1 million	45%
2009	\$ 3.5 million	\$ 1 million	45%
2010	(repealed)	\$ 1 million	35% <sup>3</sup>
2011	\$ 1 million <sup>2</sup>	\$ 1 million	55% <sup>4</sup>

<sup>1</sup>Less any gift tax and GST tax exemptions, respectively, used during life.

<sup>2</sup>The GST tax exemption is adjusted for inflation.

<sup>3</sup>Gift tax only. Equal to highest marginal income tax rate, which is currently 35%.

<sup>4</sup>Reverts to 2001 rules. The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates and gifts over \$10 million.

Source: U.S. Internal Revenue Code

## Evaluate insurance needs

Along with protecting your family’s financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren’t involved in a family business, or pass leveraged funds to succeeding generations free of estate tax. Long-term disability insurance is also important. For many, future earning power is their biggest asset, and employer-provided coverage is often insufficient. Long-term care insurance also is worth considering, because savings can disappear fast if you or a loved one requires years of such care.

for the annual exclusion – even though the recipient doesn't have access to the gifted assets after the withdrawal right expires.

You may also pay eligible educational and medical expenses for a loved one without the payment being treated as a taxable gift, so long as the payment is made directly to the organization.

**Determine which property to gift.** Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make. To minimize estate taxes, gift property with the greatest future appreciation potential. To minimize income taxes, gift property that hasn't already appreciated significantly since you've owned it. That's because your basis in the property generally carries over to the recipient, who will owe taxes on any gain when he or she sells it. While the estate tax is in effect, it may make sense to wait to transfer highly appreciated assets until your death, because the basis will be stepped up to the value at the date of death and the capital gains tax can be avoided. For property that has declined in value, your best bet is to sell the property to take advantage of the tax loss. You may then gift the sale proceeds.

**Take advantage of the unlimited marital deduction.** Your estate generally can deduct the value of all assets that pass in a qualified manner – either outright or in trust – from you to your spouse at your death, provided your spouse is a U.S. citizen. (If your spouse isn't a U.S. citizen, you can still take advantage of the unlimited marital deduction, but you must use a qualified domestic trust, or QDOT.) But if your combined estates are greater than the exemption amount, simply using the full marital deduction to avoid taxes

on the first spouse's death could result in needless tax liability on the surviving spouse's death. A credit shelter trust can help minimize the estate tax by taking advantage of both spouses' exemptions.

**Keep an eye on the GST tax.** The generation-skipping transfer (GST) tax was designed to limit an individual's ability to transfer wealth to successive generations without incurring a gift or estate tax at each generation. It is now, and scheduled to remain, equal to the top estate tax rate, and the GST tax exemption is also equal to the estate tax exemption. (See Chart 6 on page 15.) You can make the most of this exemption by setting up a GST or dynasty trust. You can preserve your GST tax exemption for future transfers by making annual exclusion gifts to grandchildren or more distant generations. Such gifts generally are exempt from the GST tax.

**Set up trusts to preserve assets and control.** Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. They serve a variety of purposes. For example, a qualified terminable interest property (QTIP) trust is good for benefiting first a surviving spouse and then children from a prior marriage. An irrevocable life insurance trust (ILIT) can keep insurance proceeds out of your and your spouse's taxable estates. A qualified personal residence trust (QPRT) allows you to give your home to your children today – removing it from your taxable estate at a reduced gift tax value (provided you survive the trust's term) – while you retain the right to live in it for the trust's term. A grantor-retained annuity trust (GRAT) works similarly for other investments,

except instead of retaining the right to live in your home over the trust's term, you receive payments from the trust for a specified period.

**Plan for family business interests.** If you're a family business owner, transferring business ownership can preserve your business and accumulated wealth – if planned properly. For instance, consider tax breaks such as the family business estate tax deferral and valuation discounts. And protect yourself with a well-structured buy-sell agreement. Gifting family business stock also can be an effective estate-tax-saving strategy. Keep in mind the gift's value determines the gift and estate tax ramifications. The IRS may challenge the value you place on a gift. A valuation by a professional appraiser can help the value stand up to such scrutiny.

**Split up assets carefully in a divorce.** Divorce is never easy, and it becomes even more difficult when marital property is significant. Talk with your advisors about how to handle the taxes, "innocent spouse" tax law provisions, and qualified domestic relations orders (QDROs) for retirement funds and property transfers. Discussing these items thoroughly will help you make the best of a difficult situation.

**Protect assets.** In our litigious society, asset protection planning is more important than ever. Ask your financial professional about strategies such as transferring assets to your spouse; family limited partnerships; liability insurance; Delaware, Alaska or offshore trusts; and even your retirement plan.



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