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New Directions in Business and Personal Planning



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Bears, bulls and tax bills

An overview of how investments are taxed

Making prudent investment decisions requires you to consider many things. Your overall financial goals must coexist with your risk tolerance and time horizon. Add in the tax impact of each investment and you've got a lot to think about.

Although tax ramifications are only one aspect of investing, you should strive to take advantage of the tax rules to maximize your return on whatever investments you select.

2 tax principles

Investments are taxed based on two principles — character and timing. Character determines the tax rate or treatment, and timing determines the year it's taxed.

Identifying the character of income is usually thought of as distinguishing between ordinary income and capital gains. But even various types of capital gains are taxed at different rates.

For example, while long-term capital gains (those on assets held more than a year) garner a favorable top rate of 15%, short-term capital gains are taxed the same as ordinary income — with a maximum rate of 35%. Gain on the sale of collectibles can be taxed as high as 28% and real estate gains at 25%.



Changing the timing of income can affect its character — hold an asset beyond the one-year mark and it will be subject to lower rates when sold. Or timing can involve simply postponing tax by deferring income to a later year.

Income investments

Income investments come in a variety of types. Understanding each one's tax cost can help you choose the right instruments and prepare for the taxes involved.

For the next few years, dividends edge out interest in the tax-favored investment income category. Through 2008, qualifying dividends will be taxed at the reduced rate of 15% (5% for those in lower brackets).

This is a significant difference from the maximum ordinary income rate of 35% that previously applied to dividends. But don't forget that the lower dividend rate is a sure thing for only three more years after this one — an important consideration when choosing longer term investments.

On the other hand, interest income is taxed at the higher ordinary income rates, so interest-earning investments may not sound as good as stocks paying dividends. But tax-exempt interest from municipal bonds may escape federal taxation altogether, though you'll generally pay state tax on the interest — except, in many states, on bonds issued by municipalities within the state.

Beware, however, of the alternative minimum tax (AMT). This second tax system was originally designed to catch those who would otherwise escape or substantially reduce their tax liability, but it now increasingly affects other taxpayers as well.

Tax-exempt interest on certain private activity bonds can be subject to the AMT.

Growth investments

Some appreciating investments increase in value while paying no income to you. Consequently, you pay no tax until the investment is sold, at a rate as low as 15% (5% for those in the lower brackets) if you held the asset long term. Unless Congress acts to extend it, however, the 15% capital gains rate will be with us only until the end of 2008.

Capital losses are netted with capital gains. If the net result is a loss, you can deduct up to \$3,000 and carry the remainder to next year.

Unless Congress acts to extend it, the 15% capital gains rate will be with us only until the end of 2008.

As part of your year end planning, always consider your year-to-date capital gains and losses. Look to sell investments with unrealized losses to offset any net capital gain or, alternatively, generate enough gains so you can deduct any loss in the current year. You also may want to time a sale for a year when you are in a lower tax bracket.

Tax-deferred vehicles

Some investment vehicles can produce earnings that aren't taxed until withdrawn. Many retirement plans, including both employer-sponsored plans and IRAs, are designed to provide tax-deferred growth. These vehicles should definitely have a place in your overall investment strategy. You often receive a deduction for plan contributions while enjoying the benefits of tax-deferred compounding.

If the deferral concept appeals to you, be aware that you may be able to defer gain in other ways. For example, with a qualifying exchange of like-kind property — such as real property for real property — you may be able to defer your gain until you sell the replacement property. You report a taxable gain only to the extent you receive cash or nonqualifying property, or are relieved of liabilities. Any gain you defer reduces the basis of the replacement property.

A like-kind exchange can be a wonderful tax planning tool. Just remember that the gain is postponed, not eliminated. And don't exchange property that has declined in value — losses also get deferred under the like-kind exchange rules.

Passive activities

You may receive income from an investment in a business in which you are not an active participant (commonly known as a "passive activity"). One typical example is a limited partnership. Usually, passive losses can offset income from only other passive activities.

Unused, or suspended, passive losses carry forward until you have passive income to offset them, or until you dispose of your interest in that activity. Passive activity investments may be a good fit in your overall investment strategy as long as you're prepared for the tax implications.

A variety of factors

As you can see, the tax treatment of investments depends on a variety of factors. When comparison shopping for different instruments to invest in, consider these elements as well as your tax rate and overall tax situation.

Remember, tax goals are just one part of the equation. Also think about your portfolio balance, risk tolerance and whether an investment makes sense in your circumstances. □



Supercharge your supervisors

Good leaders are the key to a great company

An ongoing Gallup survey of more than 1 million employees has found that, if a company is losing good people, the main reason cited is problems with an immediate supervisor.

The attitudes and behaviors of those managing your workers clearly play a critical role in your company's success. Fortunately, there are a variety of ways you can help your managers boost both productivity and retention. And, of course, you can apply these methods yourself if you're directly supervising employees.

Teaching without micromanaging

Today's managers must be more than team leaders — they must also be teachers. Attentive supervisors exploit situations that will help subordinates learn how to work smarter and more efficiently.

Typically, learning occurs most readily when rewards (or consequences) are applied as close to the intended behavior's occurrence as possible. Thus, train managers to look for moments when employees are being

successful and immediately recognize those efforts. Supervisors should praise them in the presence of others and regularly. Low-cost rewards such as the occasional free lunch or movie pass can also be highly motivational.

Attentive supervisors exploit situations that will help subordinates learn how to work smarter and more efficiently.

Be sure managers also address problems right away. The way they deal with them depends on the nature of the trouble. For minor difficulties, just leaving a friendly voice mail or carefully worded e-mail can do the trick. But for major (or potentially major) dilemmas, a face-to-face meeting, documented in writing, is typically best.

But while supervisors are keeping an eye out for good (and bad) behavior, they shouldn't micromanage.

Managers who perch atop employees' shoulders, checking every detail of their work, are as bad for a company as rude customer service or defective products.

Why? Because the more supervisors micromanage, the more they communicate the wrong message — that they don't believe employees can get the job done. Thus, micromanaging not only lowers morale, but also hinders efficiency, as the supervisor is basically spending valuable time doing the worker's job rather than his or her own.



Being open and supportive

While avoiding micromanaging is important, supervisors shouldn't cloister themselves either. They should establish open lines of communication, scheduling one-on-one and team meetings regularly so staffers can take part in business decisions affecting themselves, their departments and the company as a whole.

Along the same lines, encourage managers to show trust in their subordinates by authorizing them to make decisions. Supervisors should remain available when needed, but they need to also allow their staffs the flexibility to accomplish business objectives in a comfortable, self-driven manner.

What's more, train managers to support their staffs when roadblocks occur. If someone makes a mistake, supervisors shouldn't rush to judgment or overreact. Instead, they must play the role of the educator and help the person learn from the situation and ensure it doesn't happen again.

Optimizing annual reviews

In the 1950s, 75% of American jobs were in manufacturing, so output was easily measured. Today, this figure stands at less than 10%, according to Gallup. Maybe that's why there are so many ways to conduct formal annual reviews.

However your organization approaches these sometimes stressful rituals, keep in mind that a well-designed performance appraisal is valuable because it can:

- ❏ Provide feedback and counseling to the employee about how the company perceives his or her performance,
- ❏ Set milestones for the upcoming year and assist in determining any developmental needs, and
- ❏ Create a written record of performance and assist in allocating rewards and opportunities as well as justifying disciplinary actions or termination.

Thinking points: 3 productivity questions to ponder

Few companies would settle for, say, only a 60% yield from an asset such as a fax machine. So why should you demand less from your workers? Here are some productivity questions to ponder with your managers:

1. Is turnover among your best employees more than 10%?

If so, it may be time to loosen the reins. People who can't be as creative or productive as they'd like tend to go elsewhere.

2. Are more than 80% of your workers performing so well that they would be extremely difficult to replace?

Great performance is a key indicator of well-tapped potential. If you could easily replace a significant number of employees, you may want to rethink why you hired them in the first place.

3. Do employees value their paychecks more than your business?

When workers are in it only for the money, they tend to hold back some (or even much) of what they could contribute.

Brainstorm some ways you and your managers could get employees more invested in your company's success.

Conversely, allowing managers to give annual reviews short shrift by only orally praising or reprimanding an employee leaves a big gap in that worker's written history. Effective supervisors document inappropriate activities — and superior achievements — when they occur.

To ensure your company's annual reviews are as productive as possible, make sure managers aren't:

Winging it. Establish clear standards and procedures for annual reviews. For example, supervisors should prepare for the meeting by filling out documentation used throughout the company.



Failing to consult others. If a team member works regularly with other departments, his or her supervisor

should tap employees in those other areas for feedback before the meeting. The manager may learn some surprising things.

Keeping employees in the dark. Nothing in a performance review should come as a major surprise to employees. Be sure managers are communicating with workers about their performance throughout the year and let them know well ahead of time what will be discussed, how much time to set aside for the meeting, and how to prepare for it.

Failing to follow through. Make sure supervisors and their staffs agree on key objectives for the coming year and establish checkpoints in the months ahead to assess their progress.

Staying on message

Employees want to feel important and be part of something great. Yet it's all too easy for a workplace to succumb to monotony without someone there to stay on message and regularly stoke morale. That's where managers come in.

Encourage yours to speak regularly about why each worker's contribution matters and what makes your company the great place it is. By creating an enthusiastic and supportive atmosphere, you'll spur productivity, strengthen loyalty and boost the prestige of your business inside and out. □



Moneylines: News briefs for businesses and individuals

New bankruptcy law gets tough on debtors. President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 this past spring. It makes bankruptcy more of a last resort than ever, requiring those with incomes exceeding specified levels to pay some or all of their obligations (including credit card charges and medical bills) under a court-ordered agreement. The legislation stands to disqualify

4% to 20% of those who would have previously been able to resolve their debts via bankruptcy, says the American Bankruptcy Institute.

Many companies never recover from data losses. With businesses storing more and more information digitally, the risks of losing this data have skyrocketed. In fact, 50% of small to mid-size companies that suffer a significant data failure lasting more than 24 hours end up shutting their doors, according to a 2005 study by technology researchers Gartner. If you haven't upgraded your company's backup systems lately, don't let the next big storm or another catastrophe leave you wishing you had.

More families are recognizing the need for life insurance. Roughly 50% of U.S. households now think they need more life insurance and 25% intend to buy it, states a 2005 study by marketing researchers LIMRA International. That 50% figure is up from 39% in 1998, the last time the study was conducted. Observers cite growing concerns about financial security and less employer-sponsored life insurance coverage as possible reasons for the surge.

Sarbanes-Oxley's "ripple effect" is shaking up many private companies. A 2005 study by law firm Foley & Lardner LLP found that 87% of the privately owned companies that participated felt the act was affecting their operations. Many had implemented self-governance reforms such as developing codes of ethics and electing independent directors. Viewing Sarbanes-Oxley as an impetus to tighten up your financial reporting isn't a bad idea — you need not spend the big bucks public companies do, and you could wind up saving money by discovering and eliminating inefficient processes.



IRS ruling breathes new life into IDGTs

Dean, the owner of a rapidly growing grocery store chain, believed he was too busy to think much about estate planning. This all changed after a recent fire at one of his locations. It left Dean and his employees dashing to safety just in time and thinking about the future's uncertainty. As he rebuilt the store, Dean also decided to visit his financial advisor and get to work constructing a viable estate plan.

One of Dean's biggest concerns was passing along interests in his business to his loved ones while minimizing estate taxes. His advisor immediately thought of an intentionally defective grantor trust (IDGT).

Under this strategy, Dean would set up a trust to which he'd transfer family business interests (though the trust could hold almost any type of assets) and name his loved ones as beneficiaries. The transfer would create a taxable gift, but the business interests and any future appreciation in their value would be removed from his estate.



Such a trust is called "intentionally defective" because, as grantor, Dean would reserve powers over, or interests in, the trust that would cause him to be treated as the owner of the trust assets for income tax purposes without causing those assets to be included in his taxable estate. He would pay income tax on any trust income, even though he wouldn't have rights to that income.

Because the trust itself wouldn't pay taxes, the assets effectively would grow tax free, maximizing the wealth that would pass to Dean's beneficiaries. Plus, his income tax payments would further reduce his taxable estate without tapping his lifetime gift tax exemption or annual gift tax exclusions.

Ambiguities alleviated

In the past, IDGTs were plagued by uncertainties regarding the precise tax treatment of grantors' tax payments and any reimbursements the trust may make for those payments. The IRS alleviated many of these ambiguities last year in Revenue Ruling 2004-64.

Assuming a grantor creates the IDGT with an independent trustee, the ruling illustrates the tax treatment of the grantor's income tax payments and various reimbursement provisions in three common situations:

1. When no reimbursements occur. In some cases, the grantor pays income taxes on the trust's income from his or her funds, and neither state law nor the trust instrument requires or permits the trust to reimburse the grantor. Here the grantor is legally obligated to pay the taxes, so the payments aren't considered taxable gifts. And because the grantor can't use the trust assets to satisfy the tax liability, none of the assets are included in his or her estate under Internal Revenue Code Section 2036.

2. When reimbursements are mandatory. Some IDGTs (or applicable state laws) require the trustee to distribute income or principal to cover the grantor's tax liability. Although such distributions aren't considered taxable gifts from the beneficiaries to the grantor, this right to reimbursement will cause trust assets to be included in the grantor's estate under Sec. 2036.

3. When reimbursements are discretionary. If the trust (or applicable state law) gives the trustee the discretion to reimburse the grantor, the trustee's exercise of that discretion won't, by itself, cause the trust assets to be included in the grantor's estate under Sec. 2036. But additional circumstances, such as an express or implied understanding between the grantor and trustee regarding the trustee's exercise of discretion, may trigger inclusion in the taxable estate.

Dangers revealed

While bolstering the viability of IDGTs, Revenue Ruling 2004-64 also reveals that giving reimbursement powers to an IDGT trustee, discretionary or not, is dangerous. Dean's financial advisor suggests he bear this in mind as he creates his estate plan — and so should you. ▣



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