

T. Dennis Connally Financial Consultants, Inc.



DECEMBER 2002

STRATEGIES FOR INDIVIDUAL TAXPAYERS TO EXPLORE

Aim for Higher Retirement Plan Contributions

One of your long-term financial targets may be a comfortable retirement. Aiming for higher pretax contributions to an employer's retirement savings plan in 2002 can help you hit that target and reduce the amount of taxable wages you have to report on your tax return. You'll save current taxes while you are putting aside money for your retirement. Your contributions to the plan and any earnings on those contributions generally won't be taxed until you begin receiving funds from the plan. In 2002, you may be able to defer up to \$11,000 of pay to a 401(k) or 403(b) plan. (Other limits may apply.) The salary deferral limit for participants in an employer-sponsored SIMPLE plan is \$7,000.

Also, depending on your plan's terms, if you are age 50 or older, you may be able to make an additional catch-up contribution for 2002 (maximum of \$500 to a SIMPLE plan; \$1,000 to the other plans). Check with your employer to find out whether you can increase your contribution amount before year-end and whether you can make catch-up contributions.

Sell Smart

Tax rates on ordinary income and short-term capital gains are currently

as high as 38.6%. Long-term capital gains generally are taxed at 20%. A still lower tax rate (10%) applies to long-term capital gains that would otherwise be taxed at a 15% or 10% ordinary rate, unless the asset was held more than five years before sale. In that case, the 10% rate becomes 8%.

Planning for investment gains can reduce your tax bill significantly.

- ◆ If otherwise feasible, wait to sell appreciated assets until you have met the more-than-one-year holding period for long-term capital gain treatment.
- ◆ Rather than sell appreciated property and pay tax on your gain, you could transfer the property to a college-age child or grandchild. The child would then sell the property to pay the next semester's tuition. Any gain realized would be taxed at the child's rate, which may be lower than yours. In 2002, you can trans-

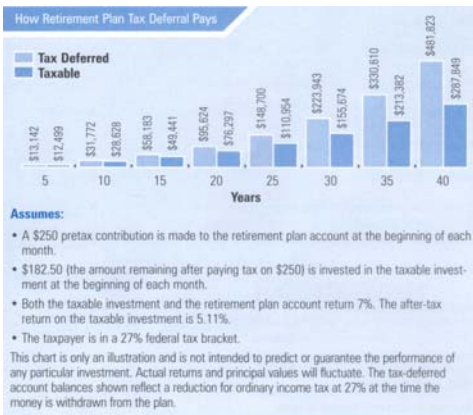
fer as much as \$11,000—\$22,000 if your spouse agrees to "split" your gift— of as many individuals as you want, without federal gift-tax consequences.

Starting in 2006, an 18% rate (instead of 20%) will be available for capital gains on qualifying assets held for more than five years before sale.

Know Your Basis

Figuring a capital gain or loss is relatively straightforward when you sell or redeem your whole investment all at once. You compare your "basis" in the investment (usually, your cost) to the amount you receive. Matters can get more complicated when you have invested in shares of a particular stock or mutual fund at different times and prices and you decide to sell just a portion of your investment. Unless you specifically identify the shares you are selling, the shares you purchased first generally are considered the shares sold. For the tax treatment you want on your sales:

- ◆ Tell your broker at the time of the transaction which shares you want to sell. Selling shares in which you have a high tax basis can reduce your taxable gain or increase your loss to offset other gains.
- ◆ Be cautious with online trades. Your service may or may not allow you to identify the shares you are selling.

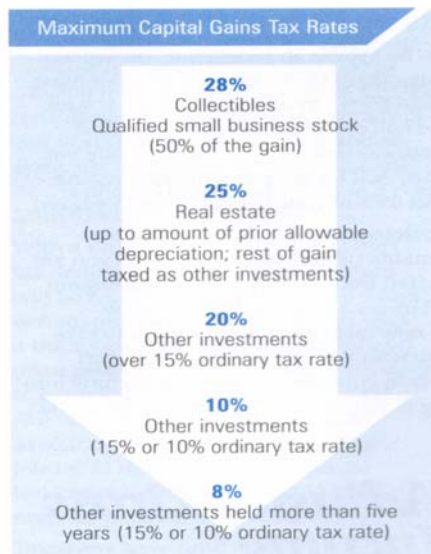


- ◆ Many funds provide average cost information which can be used for figuring your basis. But you're not required to use it, and you may not want to if another method is more favorable.
- ◆ Make sure you count any reinvested dividends as part of your tax basis when you sell the stock you bought through a dividend reinvestment plan. The dividends were taxed to you when they were originally paid. You don't want to pay tax on them twice. The same holds true for mutual fund dividends that have been automatically reinvested.

Use Losses To Offset Gains

Another tax-reducing strategy to consider is timing losses to offset your gains. Capital losses are fully deductible against capital gains, and any capital losses in excess of capital gains may offset up to \$3,000 of ordinary income (\$1,500, if married filing separately). If you have gains in 2002, it might make sense to generate some offsetting losses on investments you no longer want to hold. Conversely, if you expect high losses in 2003, you may want to postpone realizing gains until then. Aside from timing your gains and losses, you can:

- ◆ Tax-swap securities to accelerate losses without significantly changing your investment position. When you tax-swap securities, you sell securities at a loss for tax purposes and replace them with the same or similar securities. Watch out for the tax law's "wash-sale" rules, though. If you sell securities at a loss and purchase substantially identical securities within 30 days before or after the sale, your loss will be disallowed. You can get around this rule by selling securities on which you have a paper loss and replacing them with securities of another company in the same industry having similar prospects. Similarly, you can "double up" on the securities, wait 31 days, and then sell your original securities at a loss.



- ◆ Pay attention to any dividend payments during the 31-day wash-sale period. If these dividends are reinvested in additional shares, you may lose your ability to deduct part of your original loss.
- ◆ Take a capital gains distribution from your mutual fund in a check rather than reinvesting the distribution. Then, sell your shares in the fund. As long as the shares sell for less than the amount you paid for them, you generate a capital loss that can offset some or all of the distributed gain.

Delay Tax on Retirement Plan Distributions

If you leave a job in 2002, you may receive an "eligible rollover distribution" from your employer's retirement plan. If so, consider rolling the distribution over to an IRA (individual retirement account) or another employer-sponsored retirement plan. Starting in 2002, your rollover options are expanded. Instead of being limited to like plans or an IRA, you can rollover eligible distributions from a 401(k) or other tax-qualified plan a 403(b) or a governmental 457 plan, into any of these plans if your new employer accepts rollovers.

As long as you complete the rollover within 60 days, you'll postpone current income tax on the distribution and continue to defer tax on your fu-

ture account earnings. If you have the distribution directly transferred into a plan, the distributing plan won't have to withhold 20% for taxes and you'll have the full amount available for rollover.

Also look into:

- ◆ Using the special 10-year forward averaging tax-computation method to lower your taxes on a qualifying lump-sum distribution. You must have been born before 1936 and meet other requirements.
- ◆ Taking some of your lump-sum distribution in company stock instead of cash, if available. You'll have to pay current income tax, but only on the stock's basis (generally, its value when it was added to your account). Increases in the stock's value from that time forward won't be taxed until you sell the stock. Then, all or part of the increase will be taxed at the capital gains rate—no more than 20%—rather than at your regular tax rate.



Our office will be closed the week of December 23—27. We will reopen on December 30, 2002.

Happy Holidays!



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