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TAX IMPACT

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Moving to another state?

Be sure to check out the tax climate

Most people decide where to live based on career, family and lifestyle choices, not tax considerations. If you're thinking about a cross-country move, it pays to do some research on your new home's tax climate. The weather may be balmy, but you may find the reception from taxing authorities to be icy. Become familiar with your new state's tax structure so you can plan appropriately to minimize your taxes.

Look beyond income taxes

Rating a state's "tax-friendliness" based solely on the presence or absence of a state income tax is a mistake. (To see which are without, see "States with no income tax" below.) There are other taxes to consider — such as property taxes, sales taxes, and inheritance and estate taxes — that may have an even bigger impact. So you need to take your personal circumstances into account, including:

How you earn a living. New Hampshire and Tennessee impose no income tax on wages, but they do tax interest and dividends. So whether you make your money from a job or live off your investment income makes a big difference. Other states have "intangible" taxes that are based on the value of certain investments or other assets. Plus, many states — even some with high income taxes — offer significant tax breaks for pensions, retirement plan distributions and Social Security payments.

States with no income tax

As of this writing, these states impose no income tax:

- Alaska,
- Florida,
- Nevada,
- New Hampshire*,
- South Dakota,
- Tennessee*,
- Texas,
- Washington, and
- Wyoming.

*These states do tax unearned income, such as interest and dividends.

Where you live within the state. Generally taxes, particularly property and sales taxes, are higher in large cities and suburbs than they are in rural areas.

Whether you own your home. A state that's tax-friendly in most areas may impose high property taxes. Of course, property taxes can reduce your federal income tax bill, but they can also cause you to be subject to the federal alternative minimum tax (AMT). Property tax is not deductible for AMT purposes.

Where your property is located. State death taxes are usually imposed by the state of domicile. (See page 3.) But even if you change your domicile to a state without

a death tax, you may be subject to tax by the state where real estate or other property is located. One way to avoid those taxes is to sell property and reinvest the proceeds in the new state. Or, in some cases, it may be possible to avoid the tax by transferring property to a trust or limited liability company.

Understand how domicile and residency differ

When you move from one state to another or buy a second home there, you'll want to avoid a situation in which both states are competing for your tax dollars. But unless you sever all your connections to the old state, you may be subject to tax liability in both. The key to understanding and minimizing taxation by multiple states is domicile.

Your domicile is the place where you have your "true, fixed, permanent home." It's also defined as "the principal establishment to which you intend to return whenever absent." You may be a resident of two or more states at once, but you can have only one domicile. Generally, the state where you're born is presumed to be your domicile unless there's evidence that it has changed.

In most states, you're not subject to tax as a resident unless you spend more than half the year in that state. But if a state is considered your domicile, it may be able to reach all of your income — no matter where you earn it — regardless of how much time you spend in the state. Just because you're subject to taxes in more than one state doesn't mean your tax bill will double. Most states offer a credit for taxes paid to other states.

If needed, change your domicile

To avoid unpleasant tax surprises, establish your domicile and your residence in the new state as soon as possible.

Technically, domicile is a state of mind, so all you have to do to change it is intend the new state to be your true, fixed, permanent home. Unfortunately, the government can't read your mind, so it will look at various factors that reflect your intent, including:

- The number of days you spend in each state,
- Your business activities in each state,
- The locations and relative size and value of your homes,
- Where your children, grandchildren and other family members live,
- Where you keep your prized possessions, such as artwork, furniture, family heirlooms, clothing and books, and
- Other factors, such as where you bank and where you're registered to vote.

There are several steps you can take to establish your domicile in a new state — see "Demonstrating your intent" above.

Keep in mind that, even if you change your domicile, the old state can still tax income from sources located there, such as a business or rental real estate.

Watch out for a tax storm

If you're contemplating moving to another state, talk with your tax advisor about the potential tax implications and steps you can take to reduce your tax bite. The right moves will depend on the tax laws in each state and on your circumstances.

Demonstrating your intent

To change your domicile to a new state, here are just a few of the steps you can take:

- Spend at least 183 days out of the year in the new state and keep a log to show how much time you spend in each state.
- File a "declaration of domicile" in the new state.
- Buy a home in the new state and, if possible, sell your home in the old state.
- Apply for a property tax homestead exemption in the new state.
- Obtain a driver's license and register your car in the new state.
- Use your new residence as your address in important documents, such as insurance policies, passports, wills and trusts.
- If the old state has an income tax, file a final tax return as a "part-year resident" through the date you moved to the new state.
- Use your new address on your federal income tax return and estimated tax payment vouchers. Mail returns and payments to the IRS service center for your new location.

Production numbers

Understanding the manufacturers' deduction

In 2004, the American Jobs Creation Act (AJCA) added the manufacturers' deduction (also known as the Section 199 deduction) to the tax code, creating a new tax break for domestic production activities. But this deduction isn't just for manufacturers. Construction firms, engineers, architects, software developers, agricultural processors and other types of businesses may also benefit.

Computing this deduction is complicated and, until recently, there were many questions left unanswered. Fortunately, the IRS has provided interim guidance on applying the deduction and issued final regulations on the subject.

What is it?

The manufacturers' deduction permits eligible taxpayers to deduct a specified percentage of their income from "qualified production activities" or their taxable income for the year, whichever is lower. The deduction is also limited to 50% of certain W-2 wages a taxpayer pays during the year.

The applicable percentage is 3% this year, increasing to 6% for 2007 and 9% for 2010. Once the deduction is fully phased in, its impact will be to lower the top effective marginal tax rate on qualifying income from 35% to 32%.

How does it work?

Qualified income is calculated by taking gross receipts from qualified domestic production activities (domestic production gross receipts, or DPGR) and subtracting the costs of goods sold and certain other direct and indirect costs allocable to those activities. Gross receipts qualify for the deduction if they're derived from any lease, rental, license, sale, exchange or other disposition of:

- Qualifying production property (including tangible personal property, computer software and certain sound recordings) manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States,
- Qualified films produced by the taxpayer,
- Construction, engineering or architectural services performed in the United States for domestic construction projects, or
- Electricity, natural gas or potable water produced by the taxpayer in the United States.

Two exceptions are receipts from the sale of food and beverages prepared by the taxpayer at a retail establishment and the transmission or distribution of electricity, natural gas or potable water.

Which gross receipts qualify?

To determine whether gross receipts qualify, you must analyze them item by item. If a unit of property fails to qualify — because, for

example, it's not produced in significant part within this country — it may be possible to define an item as a component of the property that meets the requirements.

Let's suppose that you manufacture leather and rubber shoe soles in the United States, import shoe uppers and manufacture shoes for sale by attaching the soles to the imported uppers. If the shoes fail to meet the manufacturers' deduction requirements but the soles do, you must treat the soles as the item for purposes of the deduction.

Also, under a de minimis exception, if nonqualified property accounts for 5% or less of your gross receipts, you may treat all of your receipts as DPGR.

What does "in significant part" mean?

To qualify for the deduction, property must be manufactured, produced, grown or extracted "in significant part" within the United States. Generally, this test is met if, based on all the facts and circumstances, the activities the taxpayer performs in this country are "substantial in nature."

The regulations also provide a safe harbor: A taxpayer meets the in-significant-part test if its U.S. labor and overhead costs related to the property constitute at least 20% of the property's cost of goods sold. The final regulations also provide guidance for leases, license agreements and other transactions in which "cost of goods sold" doesn't apply.

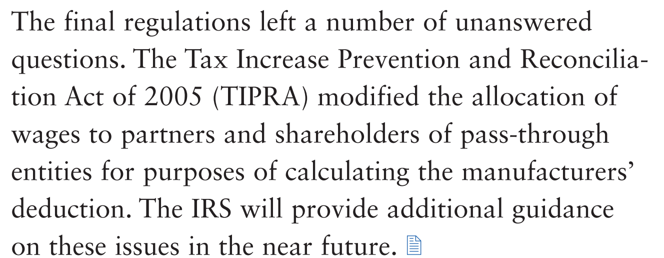
How are costs allocated?

The tax code and regulations provide detailed rules for allocating costs of goods sold and certain deductions, expenses and losses between DPGR and non-DPGR. The final manufacturers' deduction regulations allow you to use a simplified deduction method if you have average annual gross receipts of $100 million or less or total assets of $10 million or less.

Under the simplified method, you can allocate costs and other items based on the percentage of your total receipts that qualify as DPGR.

Is more guidance expected?

These are just a few examples of the issues addressed by the recent final regulations. Guidance is also provided on the treatment of software, calculation of the W-2 wage and taxable income limitations, computation of the deduction by pass-through entities, and more.



The final regulations left a number of unanswered questions. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) modified the allocation of wages to partners and shareholders of pass-through entities for purposes of calculating the manufacturers' deduction. The IRS will provide additional guidance on these issues in the near future.

Ensure your construction activities are in line

For construction activities to qualify for the deduction, you must actually perform the activities. In other words, you can't just hire someone else to do them and claim the deduction. But you don't have to be a general contractor, either. The final regulations clarify that construction activities are those typically performed by a general contractor, including management and oversight of the construction process.

The final regulations also make clear that materials and supplies consumed in the construction process are included in domestic production gross receipts. Receipts attributable to land sales are not included, however, and the regulations provide guidance on allocating receipts between land and construction activities.

Avoiding withdrawal pains

6 ways to tap IRA funds penalty-free

Withdrawing savings from your IRA before you retire should be a last resort. You lose the benefit of continued tax-deferred growth, and withdrawing funds before age 59½ will result in income taxes and a 10% penalty.

But if you need funds to handle unforeseen circumstances and you've run out of options, you can take advantage of several exemptions that allow you to make an early withdrawal from your IRA penalty-free — though funds will still be subject to ordinary income taxes. Six common exemptions are:

1. Disability. If you become disabled, you can withdraw IRA funds penalty-free. Keep in mind that you must meet the IRS's definition of disability and be prepared to furnish proof. The IRS considers you to be disabled if you're unable to engage in any "substantial gainful activity" as a result of a physical or mental impairment that's expected to result in death or to be of long-continued or indefinite duration.

2. Deductible medical expenses. There's no penalty on IRA withdrawals up to the amount of your deductible medical expenses for the year. Deductible medical expenses are those that exceed 7.5% of your adjusted gross income (AGI), regardless of whether you itemize. For example, if your medical expenses for the year are $10,000 and your AGI is $100,000, you can withdraw up to $2,500 from your IRA to help cover those costs.

3. Health insurance premiums. If you're unemployed, you can withdraw IRA funds penalty-free to pay health insurance premiums for you and your family. To qualify for this exemption, you must receive federal or state unemployment compensation for at least 12 consecutive weeks, and the IRA distribution must be made in the year you receive the unemployment compensation or in the following year. The exemption doesn't apply to IRA distributions made after you've been re-employed for 60 days.

4. Higher education expenses. There's no penalty on IRA withdrawals used to pay qualified higher education expenses — including tuition, fees, books, supplies and equipment — for you or your family. But the amount you can withdraw penalty-free is reduced by the amount of any expenses paid with a Pell Grant or certain other tax-free educational assistance.

5. First-time home purchase. You can withdraw IRA funds penalty-free — up to a lifetime limit of $10,000 — if they're used within 120 days to pay qualified acquisition costs for a first-time purchase of a principal residence by you or certain family members. Note that the term "first-time" doesn't rule out previous home ownership. It simply means that the homebuyer and, if applicable, his or her spouse have not owned a principal residence during the previous two years.

6. Periodic payments. The 10% penalty doesn't apply to distributions that are part of a series of substantially equal periodic payments, paid at least annually, over your life expectancy or over the joint life expectancies of you and a designated beneficiary. Once you start the payments, however, you can't modify them for five years or until you reach age 59½, whichever is later. Otherwise, you may trigger retroactive penalties and interest on all of your payments, including the ones you've already received.

These and other exemptions may also apply to Roth IRAs and qualified retirement plans, such as 401(k) and 403(b) plans. But there are different rules and restrictions depending on the plan type involved, so consult your tax advisor to review your options.

Tax Tips

Using powers of appointment to avoid GST taxes

The generation-skipping transfer (GST) tax is a flat tax at the highest marginal estate tax rate (currently 46%) on gifts or bequests to grandchildren or others who are two or more generations below you. The GST tax exemption currently shields up to $2 million from GST taxes; it increases to $3.5 million in 2009.

But if you expect to exceed the exemption, you may be able to avoid GST taxes by giving your children general powers of appointment that allow them to direct your property to their children. Although this strategy causes the property to be included in your children's estates, the GST tax savings almost always will outweigh any estate tax liability that may result.

Alert: E-mail tax scam

The IRS is warning taxpayers about the latest in a series of e-mail "phishing" scams designed to look like a page from the IRS Web site. In this scheme, the "IRS Antifraud Comission" (sic) claims that someone has enrolled your credit card in the Electronic Federal Tax Payment System and attempted to pay taxes with it. You're asked to click on a link that will help you recover your funds and personal information is requested that can be used to steal your identity.

IRS officials stress that they never send unsolicited e-mails asking for personal information, nor do they ask taxpayers for PIN numbers or passwords that allow access to credit card and bank accounts.

Why you might want to convert your IRA

High-income taxpayers who were prevented from converting to a Roth IRA because of income limits received a gift from Congress earlier this year. The Tax Increase Prevention and Reconciliation Act (TIPRA) eliminated the $100,000 adjusted gross income ceiling for Roth IRA conversions. There's one catch: You can't take advantage of this opportunity until 2010.

There are a number of advantages to conversion: Roth IRA earnings are tax free, even though contributions aren't deductible. Plus, unlike traditional IRAs, a Roth IRA isn't required to make minimum distributions starting at age 70½. Conversion of a traditional IRA into a Roth IRA is considered a taxable distribution, but it's not subject to the 10% penalty on early withdrawals. If you convert your IRA in 2010, you can elect to spread the income over a two-year period.

Save the environment and taxes, too

The conservation easement is an often-overlooked estate planning tool that allows you to save taxes now while preserving the beauty and utility of land and structures for future generations. By giving up certain rights to develop property, you reduce its market value.

The tax benefits are now greater than before. Under the Pension Protection Act of 2006, the deduction for the value of the easement, subject to certain limits, has increased from 30% to 50% through 2007. You may also be entitled to state income tax deductions or credits.

Because a conservation easement reduces the property's market value, it also lowers estate taxes. In addition, the donor may exclude up to 40% of the land's value from his or her estate with a maximum exclusion of $500,000.

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