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WEALTH MANAGEMENT **ADVISOR**

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Maximize tax breaks with a home-office deduction

Running a business from your home has its perks. You can forgo rush-hour traffic, eat lunch prepared in your own kitchen and take conference calls in your favorite slippers. And if you maintain a separate space to conduct your business, you may be able to deduct some home office expenses.

Make sure you qualify

According to the IRS, your workspace must meet four key tests to qualify for the home-office deduction:

1. **Exclusive use.** You must have a specific area of your home used for only your trade or business. No personal use of the space is allowed.
2. **Regular use.** You must use the area regularly and on a continuous basis.
3. **Trade or business use.** You must use the area in connection with a trade or business.
4. **Place of business.** The area must be your principal place of business or the place where you regularly meet or deal with customers. Using the space for administrative or management functions typically qualifies too, even if a significant portion of your work is done in the field.

Your workspace doesn't have to be an actual office or even a separate room in your home — only a defined space you use for business. In fact, you don't necessarily have to use a portion of your home as an office. It can be any space, such as a storage facility or showroom, that you consistently use.

Areas you use to store inventory are also eligible for a home-office deduction if you use the space regularly.

Know what's deductible

If your home office qualifies for the home-office deduction, it's time to calculate how much you can deduct. Begin by listing your expenses. If you're self-employed, you can deduct 100% of expenses directly related to the home-office space, including your telephone line and utilities if you have separate hookups, painting and repairs, and the cost of an insurance rider on your homeowner's policy.

You're also allowed to deduct a percentage of indirect expenses, such as:

- Mortgage interest,
- Property taxes,
- Association fees or condominium assessments,
- Rent, if you don't own your home,
- Depreciation, if you do own your home for more than 39 years,
- Insurance premiums,
- Security system costs, and
- Bills for repairs, utilities, trash removal and general maintenance.

Use Form 8829, "Expenses for Business Use of Your Home," to list your deductions and then transfer the total to your Schedule C when you file your income tax return.

If you sell your home, you won't have to divide the gain on its sale between the business and residence portions and pay tax on the business portion of the gain. That's provided the residence and office space are within one dwelling or "dwelling unit," as termed by the IRS. You will have to report gain equal to the depreciation deductions you have taken. A detached structure used as an office doesn't qualify for this exclusion.

Follow the rules

You can deduct only the portion of home-related expenses that pertain to your home office, not the full amount that applies to your entire residence. To determine the "home-office" portion of your residence, take the square footage of your office and divide it by the square footage of your entire home. Then you can apply that percentage to each cost to calculate the deduction you can claim.

The tax breaks stop here

If you're not self-employed but work from home for an employer for a significant amount of time, you likely won't benefit as much from the IRS home-office deduction. That's because, in addition to meeting all of the IRS requirements, you must show that your home office is maintained for your employer's benefit and convenience.

Further, your home-office deduction is counted as a miscellaneous itemized deduction on Schedule A, rather than on Schedule C, where self-employed business owners calculate their profit or loss.

You can write off your miscellaneous itemized deductions, but only if they exceed 2% of your adjusted gross income. So if you don't have other miscellaneous itemized deductions, such as investment expenses or union dues, you probably won't have a significant writeoff.

Keep in mind that the home-office deduction, plus all your other deductible business expenses, can't exceed your business income for the year. And to ensure that your claim stands up to IRS scrutiny in case of an audit, keep pictures of your office in your tax file. Also retain records of utilities, mortgage interest, real estate taxes, rent, insurance, bills and receipts for maintenance and service, and other pertinent documents.

> Your workspace doesn't have to be an actual office or even a separate room in your home — only a defined space you use for business.

Get to work

The home-office deduction can reduce your income tax bill, but be sure to assess whether the savings are worth the time and effort required to keep adequate records and claim the deduction. Finally, ensure that your information is accurate to deter IRS audits and potentially costly penalties. ■

Inheriting an IRA? Pay attention to IRS rules

If you inherit an IRA from a family member, be aware of the complex IRS rules that surround this account transfer. The requirements give your inherited IRA the potential to continue growing on a tax-deferred basis. But if you don't follow the rules to the letter, you could make costly mistakes.

Inheriting from your spouse

IRS rules differ depending on who's inheriting the IRA and how old the IRA account owner is when he or she dies. The most straightforward IRA inheritance involves a surviving spouse, who has three options:

1. Roll over the IRA. If you're the sole beneficiary of your spouse's IRA, you can roll over the assets into an existing or new IRA account under your name. You then can continue to contribute to the account, assuming you have earned income and are younger than age 70½. You are required to take distributions beginning at age 70½ as if the IRA had always been your own.

Even if your spouse was already taking required minimum distributions (RMDs) at the time of his or her death, you're not required to take distributions until you reach age 70½. Therefore, a rollover may be particularly appropriate if you're significantly younger than your spouse. You may be subject to a 10% early withdrawal penalty on any withdrawals taken before you turn 59½.

2. Remain a beneficiary. Another option is to have the IRA transferred into a beneficial IRA. In this case, both the original account owner's name and yours appear on the account. You then can begin taking RMDs in the year following your spouse's death, or, in some cases, postpone distributions until the year your spouse would have turned 70½.

This alternative provides surviving spouses younger than age 59½ with a key advantage: Withdrawals are exempt from the normal 10% early withdrawal penalty.

3. Disclaim the IRA. If your financial situation allows, you can disclaim your interest to allow an inherited IRA to pass to your child or another younger beneficiary who has more time to take advantage of tax-deferred growth potential. He or she will have to take RMDs, but they can be spread over a longer period because of his or her longer life expectancy.

If you choose this option, you must disclaim the assets within nine months of your spouse's death. Also, know that this decision is irrevocable, so you should discuss the option with your tax and legal advisors.

In addition to the previous three options, you can also cash out the account, either immediately or over up to five years. Doing so, however, can result in expensive tax consequences.

Inheriting from a nonspouse

Under a recent change in the tax law, nonspouses can now roll over retirement plan accounts into an IRA in their own name. Nonspouses can also — like spouses — transfer IRA accounts into a beneficial IRA. One difference, however, is that you must begin taking RMDs by Dec. 31 of the year following the account owner's death. Those distributions will be based on your life expectancy.

If you miss the Dec. 31 deadline, you'll generally be required to withdraw the entire account value by the end of the fifth year after the original account owner's death. You typically won't face a 10% early withdrawal penalty, though you will owe ordinary income taxes on any distributions.

Nonspouses can also choose to disclaim the IRA and allow it to pass to a younger beneficiary. The requirements are the same as for spouses — you must disclaim the assets within nine months of the account owner's death, and your decision, once made, is irrevocable.

Seek advice

If you're likely to inherit an IRA, become familiar with these complicated IRA inheritance rules. Your tax advisor can help make sure you get the most favorable tax treatment possible. ■

When calculating returns, don't forget about risk

Let's say you own two mutual funds: Fund ABC returned 21% last year and Fund XYZ, 19%. Which is the better investment to hold for the future? If you consider only last year's performance, it's ABC. But what if you learn that ABC's manager regularly takes on twice as much risk as the manager of XYZ? Would ABC still be your better choice overall?

As an investor, your goal is to generate the best possible return while taking on the least amount of risk. Sophisticated investors rely on a variety of statistical measures to determine the risk level of their portfolios (or of the holdings in their portfolios). Three of the most widely used are beta, standard deviation and the Sharpe ratio.

Beta

Beta allows you to compare an investment's volatility to that of a broad market index. By definition, that index will have a beta of one. If your investment also has a beta of one, you'll know that it has tended to be as volatile as the index. Investments with a beta of greater than one have been more volatile, while those with a beta of less than one have been less volatile.

When checking the beta of your investment, make sure it's based on a relevant benchmark. For example, if you own a large-cap stock fund, the S&P 500 — a common index used for beta calculations — is probably a good choice. But if you own an emerging markets stock or investment-grade bond fund — to name just two examples — the S&P 500 isn't the most relevant choice for your volatility comparison.

Standard deviation

Standard deviation measures the range of returns you can expect during a given time period. It can help you put annual returns in context by showing the expected variability of a fund's performance.

The higher the standard deviation, the greater the expected performance range — and the more volatility you can anticipate from your investment. In other words, securities with a high standard deviation can provide you with the potential for big gains when market conditions are favorable, as well as the potential for big losses when conditions are unfavorable.

Sharpe ratio

How do you know whether a fund performed well because the manager made smart investment choices, or risky bets that happened to work out well this time? One tool that can help answer this question is the Sharpe ratio, which allows you to evaluate an investment's performance relative to its risk.

You can calculate a Sharpe ratio by subtracting your portfolio's performance from its risk-free rate of return (for example, the expected return from U.S. Treasury bonds), and then dividing the difference by the portfolio's standard deviation. The higher the number, the better the portfolio's risk-adjusted performance.

The Sharpe ratio alone doesn't tell you much, but it can be useful in comparing multiple portfolios. For example, the S&P 500 index had a Sharpe ratio of 0.36 for the five years ending Sept. 30, 2007, according to Standard & Poor's. Let's say your mutual fund matched the S&P 500's annual returns but offered a much higher Sharpe ratio. You'd know it achieved the same results at significantly less risk.

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Putting it all together

As you research specific investments, these three risk measures can be found from a variety of Web sites and can be useful as you evaluate your portfolio's risk. But the numbers tell only part of the story. If you're unsure of how to apply the data you find online, or if you want to know more about the level of risk in your portfolio, your financial professional can help you make better sense of it all. ■

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Perfect timing

When to make charitable gifts

The satisfaction of supporting worthwhile causes and organizations may make philanthropy an easy choice for you. In fact, charitable giving can be an important component of your estate plan. Deciding when to make donations, however, may not be so easy.

Should you make gifts during life or after death?

A major factor to consider is whether to give gifts during your lifetime or through your will or living trust after your death. Be sure to assess the pros and cons of each scenario.

When you donate property to charity through your will or living trust, your estate typically can claim a charitable deduction. If you donate assets during your lifetime, the property's value is no longer a part of your estate, so the gift yields the same estate tax benefit as a bequest. But in addition, gifts made during your lifetime entitle you to a charitable deduction for income tax purposes.

Be aware that these income tax deductions are limited, based on a percentage of your adjusted gross income (AGI), the type of asset you donate and the nature of the organization receiving the gift. Charitable gifts that exceed these AGI limits generally can be carried forward for up to five years.

If you're concerned about your future financial needs, it might not be wise to make large gifts during your lifetime. Making charitable gifts through your will or living trust allows you to retain access to the assets during your lifetime, and the estate tax charitable deduction generally is unlimited.

Alternatively, consider giving during your lifetime using a charitable remainder trust (CRT). A CRT allows you to make a gift today and receive a partial income deduction, while retaining the right to a stream of payments from the trust that may alleviate any financial concerns about making the gift.

What gifts will most benefit the charity — and you

When donating to charity, it's important to select the right asset. Typically, it's best to give appreciated securities — such as publicly traded stock, mutual fund shares and closely held stock — because these donations may be more tax-efficient.

When you donate property to charity through your will or living trust, your estate typically can claim a charitable deduction.

For example, if you sell stocks that have increased in value since you purchased them, you'll have to pay income tax on the capital gain — even if you then donate the proceeds to charity. But if you donate the actual shares to charity, the charitable organization can sell them, and neither you nor the charity will owe capital gains tax.

You can deduct the shares' full fair market value on the day you make the transfer, provided you've held them for more than one year. If the value of the contributed securities exceeds 30% of your AGI, you can't deduct the excess but can carry it forward for use during the next five years.

You may take advantage of this strategy even if you don't want to immediately dispose of your stock. You donate your appreciated stock to charity for the tax benefit and then buy back the same stock with other funds. When you later sell those shares, your tax basis will be higher than it would have been.

Other gifts may include real estate; life insurance; retirement benefits; and personal property such as automobiles, artwork and antiques. Be mindful, however, that if you're donating personal property you can deduct only your cost basis and not the fair market value of the property unless the charity will actually use the property in connection with its stated mission. Consult with the charity to ensure that your gift is in keeping with its gift-giving policy.

Give wisely

Philanthropy is a good thing. Not only do your charitable gifts support important causes, but they also can provide you with tax savings. Just make sure you're making the right kind of gift, at the right time, so that everyone benefits. ■