

WEALTH MANAGEMENT ADVISOR

MANAGING YOUR AMT EXPOSURE

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DECISIONS, DECISIONS

How to make the right one when the time comes to choose your successor



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Managing your AMT exposure

Strategies to help minimize the impact of this parallel tax system

If you haven't yet seen your tax bill increase because of the alternative minimum tax (AMT), consider yourself lucky. But also consider yourself warned: The AMT's reach is expanding. According to the Treasury Department, 25 million Americans may face the tax next year if Congress doesn't reform it first.

Unfortunately, there's not much you can do to escape the AMT entirely. But you may be able to take steps to limit the amount of AMT you owe.

A deduction-free zone

The AMT, enacted in 1969, was intended to prevent the highest income earners from avoiding federal income taxes through tax shelters and deductions. But because the AMT isn't indexed for inflation, more and more taxpayers today are becoming vulnerable to it, particularly as regular tax rates have decreased.

The biggest difference between the two tax systems is that the AMT doesn't allow many common income tax deductions, such as for state and local income taxes, real estate taxes, unreimbursed employee business expenses, or personal exemptions.

The AMT essentially is a parallel tax system. At tax time, you calculate both your regular income tax and your AMT liability. If your income tax is higher, you owe no AMT. But if your AMT is higher, you must pay the excess, in addition to your regular income tax liability.

Tax management strategies

From its start, the AMT was designed to be difficult to avoid. However, taking these steps may help you reduce your overall exposure:

Prepay expenses. If you can project that you won't be subject to AMT this year and you



might be next year, consider prepaying certain income tax deductible expenses. For example, by paying state and local income taxes or interest on a second mortgage in advance, you may be able to claim additional deductions this year, as opposed to waiting until next year when the AMT could prevent you from realizing their full benefits. Conversely, delay paying deductible items if possible when this year presents an AMT exposure.

Shift income between years. The AMT works in mysterious ways. Additional ordinary income can reduce its impact, but not always because of the phaseout of the AMT exemption. Only a reasonably accurate tax projection can predict whether it's wise to shift income between years. Of course, changes in your marginal regular tax rates as well as AMT enter into the calculation.

Watch your options. Incentive stock options (ISOs) are one of the biggest potential AMT triggers. When you exercise these options and hold onto the stock, the difference between your exercise price and the paper value of the company's shares is immediately taxable under the AMT. In contrast, under the regular income tax, exercising ISOs isn't a taxable event; you're taxed only when you sell your shares.

If the exercise is likely to expose you to AMT, you may benefit from selling your shares in the same year that you exercise the options, especially if your gain is large. You'll have to pay tax at your ordinary income tax rate rather than the lower long-term capital gains rate, but you'll avoid AMT on the exercise. This approach also ensures you'll have the cash on hand (from the sale proceeds) to pay what could be a large tax bill, depending on the number of shares you own, and that you won't be at risk of a decline in value while you still hold the stock.

If you plan to keep your shares for a considerable amount of time because you're confident they'll increase in value, consider exercising your ISOs as soon as they vest. If you're right about the direction of the stock, you'll minimize the spread between the options' exercise price and their share price at the time of your sale — thus lowering your long-term AMT liability. Bear in mind that a recent change in the law makes it easier to recoup the AMT tax you pay on ISOs in future years through a now refundable tax credit beginning in 2007.

ISOs are inherently complicated, so seek professional advice regarding your situation.

Avoid private-activity bonds. Earning income from certain types of municipal bonds also can put you in AMT territory. Even though municipal bond income normally is fully exempt from income taxes, income from private-activity bonds (bonds issued for a combination of public and private purposes) is subject to the AMT.

If you're likely to be a victim of the AMT, make sure your portfolio provides minimal or no exposure to private-activity bonds. Many mutual fund companies have limited their allocation to these types of securities, but check your fund's prospectus or ask your advisor to be sure.

Reform on the way?

Congress is under increasing pressure to reform the AMT, but large budget deficits have left the federal government increasingly dependent on its revenue. Thus, the AMT's future — both short- and long-term — is uncertain. For now, it's a growing problem for more and more taxpayers. If you're facing the AMT, ask your tax advisor about ways to manage your exposure. ■

Not born in the U.S.A.

Ensure that your noncitizen spouse enjoys the benefits of your estate

When it comes to estate planning, married couples typically use the marital deduction as an important planning tool. It allows you to pass an unlimited amount of assets — through lifetime gifts or bequests at death — to your spouse free of gift and estate taxes, so long as he or she is a U.S. citizen.

But if your spouse isn't a U.S. citizen, careful estate planning is a must to ensure that your assets pass to him or her according to your wishes and without being subject to excessive estate taxes.



Marital deduction restrictions

The law generally disallows the marital deduction for lifetime gifts or an inheritance received by a surviving noncitizen spouse to ensure that the assets won't escape U.S. federal gift and estate taxes. Annual tax-free gifts to noncitizen spouses are limited to \$125,000 for 2007. (This amount is indexed for inflation.)

Bequests to anyone, including a noncitizen spouse, can qualify for the \$2 million estate tax exemption. But assets that pass to a noncitizen spouse in excess of these amounts are subject to substantial estate taxes, which could diminish the surviving spouse's support.

For example, Jay, a U.S. citizen, dies in 2007 and leaves an estate worth \$3 million to his noncitizen wife, Maria. The estate tax bill is \$393,750 — that's 45% of the amount over the \$2 million exemption and \$125,000 marital deduction.



Create a QDOT

If your spouse isn't a U.S. citizen, consider setting up a qualified domestic trust (QDOT) for his or her benefit. A special marital deduction is allowed for assets that pass to a QDOT. If, in the example above, Jay set up a QDOT for Maria's benefit and left his \$3 million estate to it, no estate tax would be due on his death.

A QDOT typically is created in a will or in a separate trust document before the citizen spouse's death, but there is some flexibility to the rules. The executor of your estate or your surviving spouse can create a QDOT — within certain time limits — even after your death.

After your assets are transferred to the trust, your surviving spouse can receive income from the trust estate-tax free. When the trust terminates at his or her death, the QDOT must pay

estate tax calculated as if the QDOT assets were a part of the taxable estate of the first deceased spouse.

The trust principal may be distributed outright to surviving family members, friends or charities, or may remain in trust for such beneficiaries. The inherited property isn't subject to estate tax so long as it stays in the trust.

To qualify, a QDOT must:

- Have at least one trustee who's a U.S. citizen or a domestic corporation (for example, a bank or trust company),
- Require the trustee to approve all principal distributions,
- Be designated as a QDOT by an election on the U.S. citizen spouse's federal estate tax return, and
- Retain enough property in the United States to cover any estate tax payable at the noncitizen spouse's death.

If the QDOT's assets are worth more than \$2 million, the U.S. trustee must be a domestic bank or, alternatively, the individual U.S. trustee must furnish the IRS with a bond or letter of credit in an amount equal to 65% of the QDOT's value.

QDOT restrictions

Although a QDOT can distribute income estate-tax free, distributions of principal to him or her are subject to estate taxes — and the trustee must withhold funds equal to the amount of tax. The amount is the additional federal estate tax that would have been imposed on the citizen spouse's estate if it had been increased by the amount of the distribution.

Where do I begin?

Keep in mind that a QDOT serves to only *defer* payment of any estate tax liability on your estate, so it's not a perfect solution to the lost unlimited marital deduction. It will, however, allow you to maintain a larger fund that can generate income for a surviving spouse. Consult an estate planning professional experienced in international tax and estate planning to ensure that you maximize the amount of wealth you can transfer to your noncitizen spouse and minimize the amount that's taxed. ■

Ease your mind as you head toward retirement with an annuity

As you approach your retirement, you may have mixed feelings. On the one hand, you're looking forward to pursuing your favorite hobby or trying a new one. But on the other, you may be concerned that your retirement savings won't last long enough to support you and your family, what with life expectancies continuing to rise.

Fortunately you've worked closely with your financial advisor over the years, adjusting your portfolio's holdings to reflect the risk level you're comfortable with. One investment to consider to ease your mind as you prepare to retire is an annuity.

An annuity in action

Essentially, an annuity is an investment contract with an insurance company or financial institution. In exchange for a lump sum or annual premiums, the provider will make periodic payments to you for a specified term or for life.

With an immediate annuity, payments begin right away; with a deferred annuity, payments begin at a later date. The payment amount is based on the amount you invest, your age and gender, and certain investment assumptions, such as current and expected future interest rates.

Life annuities can provide greater peace of mind than term annuities because they will continue to pay you. In fact, they're sometimes described as the opposite of life insurance: Life insurance protects you from dying "too soon" and leaving your loved ones financially insecure. A life annuity protects you from living "too long" and outlasting your savings.

Other options include annuity payments that continue over the remaining lives of both you and your spouse, or a life annuity with guaranteed



payments for a specified term. In other words, you receive payments for life, but if you die before the term ends, the remaining payments continue and shift to your beneficiary.

Annuity types

Annuities come in two basic types: fixed and variable. A fixed annuity provides fixed returns tied to the performance of the insurance company's general investment portfolio. In addition, it usually guarantees a minimum rate of return, 3% or 4%, for example. A fixed annuity is typically a good option for reduced risk and guaranteed lifetime income.

A variable annuity gives you more options than a fixed annuity. It allows you to select from a menu of stock and bond funds. The good news is that variable annuities tend to outperform fixed annuities over the long term; however, they typically don't guarantee a minimum return. Because you bear the risk of market volatility, a variable annuity may not be your best choice if you're averse to risk.

Annuities vs. other investments

After you invest in an annuity, your earnings grow tax-deferred: You don't pay income taxes until you receive a payment. A portion of each payment is treated as income and a portion as tax-free return of principal. In contrast, other

An annuity alternative: A CRT

You probably associate a charitable remainder trust (CRT) with estate planning. But did you know it can be structured to provide a lifelong income stream similar to an annuity?

A CRT transfers whatever assets are left in the trust at term's end to the charities you've designated. So when you fund the trust, you receive an income tax deduction for the current value of the amount expected to eventually go to charity, based on IRS tables.

You pay income tax on the annuity payments as you receive them, and the tax rate will depend on whether the payments are coming from the trust's ordinary income, short-term capital gains, long-term capital gains, nontaxable income or principal. (Distributions must be made in that order.)

If you own a large amount of highly appreciated stock, a CRT might be especially attractive. Why? The CRT can sell the stock and replace it with more diversified investments. CRTs don't pay taxes, so you avoid current capital gains tax while diversifying your portfolio.

tax-advantaged retirement vehicles, such as IRAs and 401(k) plans, offer both tax-deferred growth *and* current tax deductions (for the contributions to the plan).

Consider maxing out these accounts before investing in an annuity. Currently, the maximum contribution to an IRA is \$4,000 annually

(\$5,000 if you're 50 or older). For a 401(k) plan, you may contribute up to \$15,500 in 2007 (\$20,500 if you're 50 or older). Be aware that other rules may further limit your contributions.

If your retirement is still decades away, also consider stocks, bonds, mutual funds and other investments before an annuity. These alternatives typically can offer even greater diversification opportunities than annuities, and lower built-in fees. They also offer greater flexibility to withdraw or reallocate the funds. Once you invest in an annuity, you'll be subject to surrender charges if you withdraw too much or too early, and a 10% penalty tax on withdrawals before age 59½.

Ease your worries

Adding an annuity to your portfolio can help offset some of your riskier investments. Yes, annuities are no substitute for other retirement vehicles, but they're an investment alternative to consider. ■

Decisions, decisions

How to make the right one when the time comes to choose your successor

Choosing a successor is one of the most important decisions business owners must make. Yet many fail to implement a succession plan until they are on the verge of retirement or forced to step down because of a sudden illness or disability.

Even if you're far from retirement, implementing a succession plan now can help increase your chances of finding — either internally or

externally — the right successor. The timing may never seem quite right, but there are steps you can take to begin the process.

Needle in a haystack

The process of identifying a suitable successor can be daunting; the pickings for qualified leaders can be slim, especially if yours is a relatively small business. A succession plan can help you

to develop and implement strategies now for selecting your company's future leader later, rather than making a reactive decision that doesn't bode well for the organization.

Use the following guidelines to create — or enhance an existing — succession plan:

Build leadership pipelines. Identify your company's "star" candidates — those with high potential — early in their careers, regardless of their functional or geographical area. Develop their skills and regularly put them to the test. For example, create a new project or position that gives them responsibility for increasingly larger and more complex profit-and-loss centers to determine how they'll measure up.

Follow your candidates' careers. You should review the top five or so internal and external candidates at least twice a year. In addition, create formal and informal opportunities to get to know them better — both personally and professionally.

Set a list of criteria and stick to it. Develop a list of must-have attributes — pertaining to areas such as skills, character and experience — to measure candidates against. Focusing on these specifics can help prevent you from becoming smitten with one candidate's reputation or personal achievements when a critical skill is lacking.

The process of identifying a suitable successor can be daunting.

Make sure that recruiters know who's in charge. You and your board members drive your successor search process. Convey your criteria — and the reasoning behind them — to the executive recruiters who are assisting with the search. With good direction, recruiters can be invaluable to the process.



Managing change

When a company is planning and preparing for a transition in leadership, emotions can run high. Managers and other staff may feel some resentment about the impending changes, be defensive about their positions and even be fearful about the next phase in the life of the company.

Maintain open lines of communication to help calm uncertainty. Regularly inform managers of expected changes from scope and impact to timing and expectations to implementation and accountability. Remind all employees of their value and importance to the company and encourage them to work together as a team through the transition.

No time like the present

It may be years before you decide it's time to retire, but having a succession plan in place now helps guide the process for finding the right person at the right time — when the time comes. ■

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By working with our experienced team of advisors, you will benefit from the independent and objective perspective necessary to make your financial vision a reality.



**James W. Ferrell, MBA, CFP®, CPA, PFS, CIMC
President**

A Certified Public Accountant (CPA), Certified Financial Planner (CFP), Personal Financial Specialist (PFS) and Certified Investment Management Consultant (CIMC), Jim is the founding shareholder and President of Ferrell Wealth Management, Inc.

Jim is actively involved in local organizations including: Morning Star Charities, Inc. (President), Winter Park Chamber of Commerce, the University of Central Florida Foundation (Board of Directors), Winter Park YMCA (Board of Directors), on the Center for Entrepreneurship at Rollins College (Board of Directors) and is an Inductee in the UCF College of Business Administration Hall of Fame.



**Katie Miller, MBA
Vice President - Senior Financial Advisor**

A Certified Financial Planner (CFP) candidate with a Master of Business Administration Degree from Rollins College, Katie works as a financial advisor responsible for assisting clients set and achieve their long-term financial goals through investments, tax planning, asset allocation, risk management, retirement planning, and estate planning.

Katie is a member of the Winter Park Community Foundation Advisory Board and Investment Management Consultants Association (IMCA), and involved in such local organizations as the Central Florida YMCA, Orlando Chamber of Commerce, Winter Park Chamber of Commerce, and Camp Boggy Creek.



**Alex Negron, MBA
Senior Financial Advisor**

A Central Floridian for 20 years, Mr. Negron is a Certified Financial Planner (CFP) candidate with a Master of Business Administration Degree from Webster University. Alex is responsible for assisting clients with their financial plan, which includes retirement, estate, and tax planning. He develops asset allocation plans using various types of investments in order to properly diversify and reduce portfolio risk.

Prior to becoming a member of Ferrell Wealth Management, Inc., Alex worked for Charles Schwab & Co., Inc. as a VP- Financial Consultant in Orlando, FL.

Mr. Negron is involved with local organizations such as the Orlando Chamber of Commerce and Leadership Orlando Alumni. He holds the Series 7, 9, 10, 63, and 65 licenses.

Please call us today at 407-629-7008 to discuss your needs, or visit www.Ferrellwm.com for more information on our services.

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