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WORDS OF INVESTING WISDOM FROM A MASTER

I have read several books on investing. Few of them have stirred me as much as the words from Warren Buffett and Benjamin Graham. Over the decades, the beliefs, understanding and strategy of these men have proven themselves through the tests of time. They are viewed as bearers of valuable insight within the investment world.

There are many methods of investing. To provide some insight into one of the better investors we are providing the following collection of excerpts from Buffett's writings. As you read, you may note that his words are often timely and timeless. The remarkable part is that all his wisdom is found, in large part, within the shareholder letters in the annual reports for Berkshire Hathaway (NYSE: BRK.A), the company that Mr. Buffet runs.



This article is not intended to belittle the contributions to investment literature by notables such as Dodd, Philip Fisher and Peter Lynch. However, I do believe that if a person reads, understands and follows the teachings of Warren Buffet, they are better grounded in the investment process and potentially more likely to succeed.

The Keys To Investment Success:

"To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing, or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses: How to Value a Business, and How to Think About Market Prices.

"Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher 5, 10, and 20 years from now. Over time, you will find only a few companies that meet these standards -- so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for 10 years, don't even think about own-





Dear Howard

ing it for 10 minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."

-- 1996 Shareholder Letter

Ignore Macroeconomic Factors:

"We try to price, rather than time, purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"

"We purchased National Indemnity in 1967, See's in 1972, Buffalo News in 1977, Nebraska Furniture Mart in 1983, and Scott Fetzer in 1986 because those are the years they became available and because we thought the prices they carried were acceptable. In each case, we pondered what the business was likely to do, not what the Dow, the Fed, or the economy might do. If we see this approach as making sense in the purchase of businesses in their entirety, why should we change tack when we are purchasing small pieces of wonderful businesses in the stock market?"

-- 1994 Shareholder Letter

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%.

"But, surprise: None of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak...

"A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify





Dear Alice

businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results."

-- 1994 Shareholder Letter

Keep It Simple:

"Our investments continue to be few in number and simple in concept: The truly big investment idea can usually be explained in a short paragraph. We like a business with enduring competitive advantages that is run by able and owner-oriented people. When these attributes exist, and when we can make purchases at sensible prices, it is hard to go wrong (a challenge we periodically manage to overcome).

"Investors should remember that their scorecard is not computed using Olympic-diving methods: Degree-of-difficulty doesn't count. If you are right about a business whose value is largely dependent on a single key factor that is both easy to understand and enduring, the payoff is the same as if you had correctly analyzed an investment alternative characterized by many constantly shifting and complex variables."

-- 1994 Shareholder Letter

Argument For Buying Great Businesses:

"We continually search for large businesses with understandable, enduring and mouth-watering economics that are run by able and shareholder-oriented managements. This focus doesn't guarantee results: We both have to buy at a sensible price and get business performance from our companies that validates our assessment. But this investment approach — searching for the superstars — offers us our only chance for real success. Charlie and I are simply not smart enough to get great results by adroitly buying and selling portions of far-from-great businesses."

-- 1991 Shareholder Letter

Welcome Market Declines:

"[Many] investors who expect to be ongoing buyers of investments throughout their lifetimes... illogically become euphoric when stock prices rise and unhappy when they fall. They show no such confusion in their reaction to food prices: Knowing they are forever going to be buyers of food,





Dear Berkshire

they welcome falling prices and deplore price increases. (It's the seller of food who doesn't like declining prices.) Similarly, at the Buffalo News we would cheer lower prices for newsprint — even though it would mean marking down the value of the large inventory of newsprint we always keep on hand — because we know we are going to be perpetually buying the product.

"Identical reasoning guides our thinking about Berkshire's investments. We will be buying businesses — or small parts of businesses, called stocks — year in, year out as long as I live (and longer, if Berkshire's directors attend the seances I have scheduled). Given these intentions, declining prices for businesses benefit us, and rising prices hurt us.

"The most common cause of low prices is pessimism — some times pervasive, some times specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.

"None of this means, however, that a business or stock is an intelligent purchase simply because it is unpopular; a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling. Unfortunately, Bertrand Russell's observation about life in general applies with unusual force in the financial world: 'Most men would rather die than think. Many do.'"
 -- 1990 Shareholder Letter

Don't Confuse Growth With Sustainable Competitive Advantage:

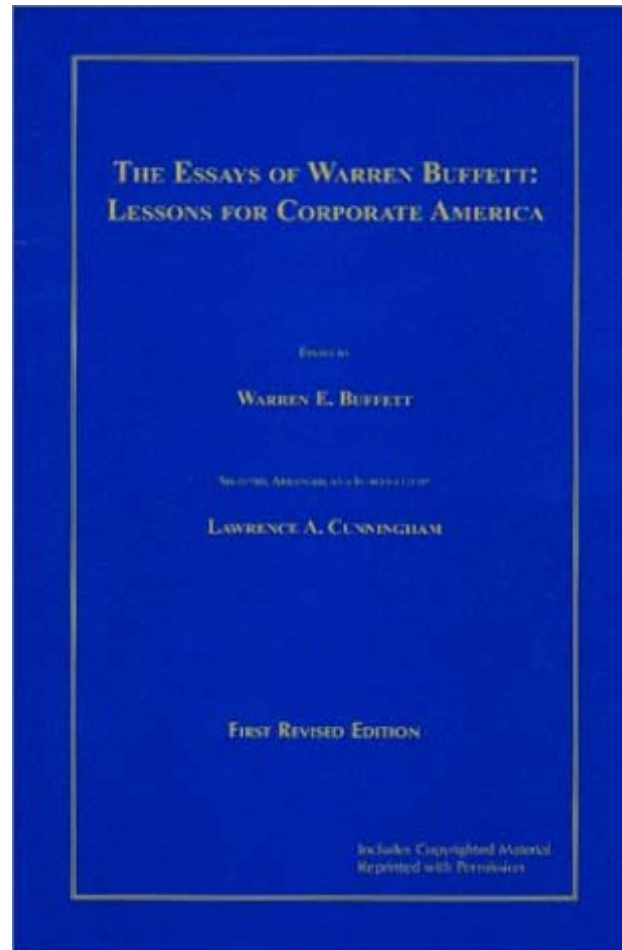
"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.
 -- Fortune magazine, 11/22/99 - Not from a shareholder letter



Conclusion:

Buffett's words are often timely as well as timeless. If there's one sentence I'd urge you to keep in mind during these tumultuous times, it's this one, from the 1994 letter: "Fear is the foe of the faddist, but the friend of the fundamentalist."

For those who wish to expand their study of Buffett's writings, his letters, dating back to 1977, are available for free on the website of Berkshire Hathaway (NYSE: BRK.A). I also recommend *The Essays of Warren Buffett: Lessons for Corporate America* as a more organized, efficient way to read them.



PLANNING FOR FINANCIAL HARD TIMES

A shaky stock market, job layoffs and a weakening economy are raising financial fears among many households that only a year ago were flowing with optimism. Even in good times, bad things can happen to families that cause a personal financial hardship. Here are some ideas for how to prepare financially for tough times.

Hold realistic expectations. Before high-tech stocks, and the stock market in general, took a nosedive in 2000, many people had come to believe that we had entered a "new economy" in which the stock market only went up and the economy was no longer subject to business cycles. How quickly reality threw cold water on that viewpoint. Simply understanding that stocks have been returning well above the historical average of around 11%, and that at some point they would fall to or below those averages, goes a long way in preparing for tougher times. Families who believe that stocks will return 20% or 30% or 50% every year are less apt to curb their personal spending and more apt to take chances on risky investments-both patterns that can come back to haunt you when the market drops and the economy sours.

Diversify, diversify, diversify. This is a cliché, but nonetheless one that's still true. People most frequently think of this advice with regard to investing: spread your portfolio among a variety of asset categories, and investments within those categories. Executives heavy in company stocks and business owners whose wealth is mostly tied up in their company are especially vulnerable. But diversification also applies to other financial arenas. Spouses who both work for the same company or in the same industry face greater financial risk in a downturn. Diversifying job skills so that you can be more flexible, should you lose your job, can help when hard times hit.

Diversification can apply to estate planning, where oftentimes it saves taxes to get assets out of the estate through lifetime gifting or irrevocable trusts.

Know your financial worth. Most people either don't know their net worth (assets minus liabilities), or think they know it and are wrong. Your net worth provides a useful benchmark for how well you are doing, in good times and bad.



Keep emergency funds. Tying up all your money in stocks and illiquid investments may force you to sell some of those assets at fire-sale prices during hard times-in short, "locking in" losses. Keeping adequate cash resources in money markets, short-term bond funds and certificates of deposit gives you flexibility to see you through a job layoff, down market or other financial crisis.

Minimize debt and establish budget. Even the affluent often does a poor job of minimizing debt and budgeting. You might get away with this in good times, but excessive debt and poor use of your money become an albatross when financial times toughen. Reducing high-interest debt, budgeting, strategic tax planning and buying smart (from insurance to autos to groceries) frees up money to bank for those emergencies.

Insure against tough times. You can't insure against layoffs, but you can insure for another common work disaster: a disability. Yet disability (income-replacement) insurance is one of the most overlooked types of insurance. Business owners also are commonly underinsured. Consider an umbrella liability policy-lawsuits are a common source of personal financial crisis these days.

Educate yourself financially. Perhaps there is no better way to prepare for hard times than to educate yourself-and your spouse-about how to wisely manage your money. It's often not so much the financial successes we have than the financial mistakes we avoid that keep us financially healthy in difficult times.

Actively manage your money. People tend to let circumstances dictate their financial decisions, not the other way around. Some want to abdicate their roll to others instead of learning to delegate and take charge of the finances. Using delegation effectively leads you toward planning and saving for tomorrow. You are also more prone to follow through on the advice of your financial advisor or your own planning. This could make the difference between suffering through hard times or riding through them with confidence.



IS THE BEAR AS BAD AS HE APPEARS?

Over the course of the past year and a half, many investors, for the first time, have shaken hands with the bear, after riding the bull through nearly the entire 1990s. Although the overall market has rebounded somewhat from its recent lows, the bear remains a gloomy presence for many investors. But just how bad is this bear market? How does it compare with other bear markets, and with bull markets? How long do bear markets last?

Before answering these questions, let's begin by defining a bear market. Definitions vary among investment experts, but typically it's considered a 20% drop in the market (usually the Dow Jones Industrial Average benchmark) over a period of two months or more. Smaller drops, or sharper drops that are very short, are commonly viewed as "corrections." Some calls are close. The gut-wrenching plunge of the Dow in October 1987 is usually called a bear market, though the decline of 36.1%, which actually began in August 1987, lasted slightly less than two months.

Many investors new to the markets during the 1990s may not realize it, but bear markets are a rather common phenomenon. In fact, there have been 14 of them in the last half century, occurring roughly every 3.5 years. According to figures from Crandall Pierce & Company, these declines in the Dow have lasted an average of 12 months and suffered a median decline (half more, half less) of just under 23 percent. Of course, averages can be misleading. A bear market in mid-1990, the last one before the long bull market began in October of 1990, hung around a mere 2.8 months. At the other extreme, the 1973-74 bear market lasted a grueling 22.8 months and knocked off 45% in stock values.

The current bear market started in mid-January 2000 and had declined 19.9 percent by late March 2001. While it has recovered much of that it won't officially end until the market recovers to its mid-January 2000 high, according to Crandall Pierce.

During the same half-century, there have been as many bull markets as bear markets. These bull markets averaged twice as long as the bear markets and ran up 65% in value on average. The shortest bull market was 11 months, the longest 111 months. The smallest gain was 22.3%, the largest was 396%.



Yet, even these numbers don't tell the full story about bear markets, let alone their impact on your portfolio. Take the 1973-74 decline, considered the worst since the Great Depression. If you didn't sell out during the decline, you recovered nearly all you lost on paper by the end of 1976.

Take even a longer view. Consider the 1966 to 1982 stretch. By 1982, the S&P 500 was still 22% below its 1966 high. Yet, according to Ibbotson Associates, the S&P 500 returned an annual average of 5.1% during those years. That's below its historical average, but not nearly as bad as many view that period. What accounted for that average -- reinvested dividends, which made up a much larger portion of total return than dividends do today.

Another somewhat misleading aspect of bear markets is that they are usually measured by either the Dow or the S&P 500--both benchmarks for large company stocks. For example, small stocks from 1966 to 1982 returned an annual average (including reinvested dividends) of 12.7%. Treasury bills returned seven percent, and international stocks also outperformed U.S. large-cap stocks during the same period.

None of this is to say that bear markets aren't rough on portfolios. The toughest part is coming back from large drops. Say your portfolio loses 45% in a 73-74 type bear market. To recover that loss (without investing any more money), you'll need to earn 81%. That's because you're working with a smaller amount of money than what you had when the decline started.

The best strategy for recovering from bear markets is to minimize the impact of a market decline in the first place. Review your goals and objectives, stay diversified and don't panic. Avoid overloading in a single sector (such as technology) and invest for the long term so you don't have to sell, or sell as much, during a down market.



YEAR-END 2001 TAX PLANNING

INDIVIDUAL TAX PLANNING

General Overview. One of the basic tenets of year-end tax planning is to “time” income and deductions to your tax advantage. Typically, it makes sense to push taxable income into the next year to defer payment of tax for at least one more year. Similarly, you might accelerate deductions into the current year to reduce the income tax bill you must pay by April 15th. Of course, your personal circumstances may require a different approach.

Income Deferral. Thanks to the across-the-board income tax cuts in the new tax act, there is an extra incentive to use this traditional strategy of deferring taxable income and accelerating deductions. Income deferred into 2002 will be taxed at a lower rate, while 2001 deductions offset income taxed at a higher rate. All taxpayers will benefit from the creation of a new 10% bracket carved out of the existing 15% tax bracket. Here are the scheduled income tax rates for individuals in the highest tax brackets.

| Tax Year | Tax Rate | | | |
|-----------|----------|---------------------|---------------------|---------------------|
| | 2001* | <u>28%</u> 27.5% | <u>31%</u> 30.5% | <u>36%</u> 35.5% |
| 2002-2003 | 27% | 30% | 35% | 38.6% |
| 2004-2005 | 26% | 29% | 34% | 37.6% |
| 2006 | 25% | 28% | 33% | 35% |

* Original rate followed by blended rate reflecting 1% reduction effective July 1, 2001. Source: P.L. 107-16 § 601 (a)

Year-end strategy: All things being equal, you should follow the traditional strategy of deferring taxable income to 2002 and accelerating deductions into 2001. Be sure to coordinate your strategies with your professional tax adviser.

Charitable Donations. In the usual case, you can deduct the full amount of your donations of cash or checks made out to qualified charitable organizations. This includes contributions to qualified organizations providing aid after the September 11th tragedy. However, you cannot deduct donations made to



a charity designed to benefit only one individual or family. You can deduct a pledge made by credit card this year on your 2001 return—even if you don't pay the charge until 2002. This is a good example of accelerating deductible items into the current year. If you donate property to a qualified charitable organization, your deduction is generally limited to your basis in the property. However, if the property would have qualified for long-term capital gain if it had been sold (i.e., you've held it for more than one year), you can deduct the fair market value of the gift on the date of the donation.

Interest Expenses. The deductibility of interest expenses generally depends on the use of the loan proceeds. For instance, the deduction for interest expense of funds used for investment purposes is generally limited to the amount of your investment income, while personal interest expenses such as for most credit card charges are completely nondeductible. On the other hand, qualified mortgage interest expenses may be fully deductible, regardless of the use of the proceeds. When it is appropriate, you might arrange a home equity loan or line of credit to reduce the after-tax cost of borrowing. This strategy does not apply for homes in Texas. The deduction for "home equity debt" is limited to interest paid on the first \$100,000 of debt. By using this strategy, you can convert otherwise nondeductible personal interest into deductible mortgage interest.

For 2001, taxpayers can also claim an above-the-line \$2,500 deduction for student loan interest. The deduction is phased out for joint filers with a modified adjusted gross income (AGI) between \$60,000 and \$75,000 (\$40,000 and \$55,000 for single filers). Among other changes, the new tax act increases the phase-out range for student loan interest to \$100,000 and \$130,000 for joint filers (\$50,000 and \$65,000 for single filers). You may also arrange to pay student loan interest in 2002, instead of 2001, to benefit from the new tax act changes.

Alternative Minimum Tax. The alternative minimum tax (AMT) applies if a special tax calculation exceeds your regular tax liability. As part of the computation, you're entitled to a special exemption based on your filing status. The AMT is designed to ensure that individuals who benefit from an overabundance of "tax preference" items and certain other tax breaks pay their fair share of overall tax. Although the new tax act slightly increases the AMT exemption amounts, the tax rates remain unchanged. The rate is 26% for the



first \$175,000 of AMT liability; 28% on any excess above that amount. To avoid the AMT in 2001, try to postpone tax preference items to 2002, when it's possible. However, if you're certain you will have to pay the AMT this year, you might accelerate income into 2001 if you're in a high regular tax bracket.

Medical and dental expenses are deductible only to the extent the annual total exceeds 7.5% of your AGI. If you expect to clear the threshold in 2001, any additional costs you incur this year will be deductible. By scheduling routine exams and non-emergency procedures before year-end, you can increase your deduction for 2001.

Miscellaneous expenses are deductible only if the annual total exceeds 2% of your AGI. You might move up certain expenses (e.g., un-reimbursed employee business expenses) if you expect to clear the 2% mark in 2001.

Dependency exemptions can be claimed for certain relatives if you provide more than half of their annual support. Unless the relative is a child who is under age 19 at the end of the calendar year or a full-time student under age 24 at the end of the calendar year, the relative cannot have more than the personal exemption amount (projected to be \$2,900 for 2001) in taxable income.

Estimated tax penalties can be avoided if your 2001 payments, including withholding payments at a job, equal at least 90% of your current tax liability or 100% of the previous year's tax liability (110% if your AGI was more than \$150,000).

Joint Filers with an AGI below \$130,000 (\$65,000 for a single filer) can claim the new \$3,000 deduction for higher education expenses. If you're currently working and thinking about going back to school, you may want to wait until 2002 so you can claim the new deduction.

Transferring Investments. With the new 10% tax bracket, there is an even greater tax incentive to transfer investment property to young family members. If you're in the 35.5% bracket and your child is in the 10% bracket, you can save \$255 on \$1,000 of investment income. Caution: annual investment income above \$1,500 received in 2001 by a child under age 14 is taxed at your top marginal rate under the "kiddie tax."



BUSINESS TAX PLANNING

General Overview. With the new lower tax rates for individuals, if you are starting a new business, it is more important than ever to consult a tax professional. By accelerating deductible expenses, you can increase your deductions for 2001.

Corporate Income and Deductions. Although there is less flexibility in year-end tax planning for corporations than there is for individuals, opportunities do exist. As with your personal situation, it is generally advantageous for a corporation to defer income to 2002 and to accelerate deductions into 2001. For example, you might stock up on routine supplies and postpone billings in late December. However, unlike individuals, there are no tax rate cuts in store for corporations this year or next year. The tax rates for C corporations are as follows:

| Taxable Income | Tax Rate* |
|---------------------------|-----------|
| \$50,000 and under | 15% |
| \$50,000-\$75,000 | 25% |
| \$75,000-\$100,000 | 34% |
| \$100,000-\$335,000 | 39% |
| \$335,000-\$10,000,000 | 34% |
| \$10,000,000-\$15,000,000 | 35% |
| \$15,000,000-\$18,333,333 | 38% |

* Personal service corporations are taxed a flat 35% rate

Since tax rates for individuals are being reduced, you might want to elect S corporation status if your company is taxed at a high tax rate. Unlike C corporations, where income is effectively taxed twice (once on the corporate level and once to the individual), there is no corporate level tax on S corporation shareholders. You have until 2 ½ months after the close of the tax year to make a valid S corporation election for the current year.

Depreciation Deductions. Under the “half-year convention,” you can claim the equivalent of a half-year’s depreciation deduction for an asset placed in





Taxing matters

service this year—regardless of when the asset is actually placed in service. This creates a tax incentive to purchase equipment and other business assets at the end of the year. Watch out for a potential tax trap. If the cost of business assets placed in service during the last quarter of the year exceeds 40% of the cost of all assets placed in service during the year, you must follow the mid-quarter convention. This calculation generally results in smaller depreciation deductions for the year. In lieu of claiming depreciation deductions, you may be able to use the “Section 179 election” to currently write off some or all of your annual cost. Under this special election authorized by Section 179 of the Internal Revenue Code, the maximum allowance for 2001 is \$24,000 (up from \$20,000 for 2000). Best of all, the Section 179 election can be claimed for assets placed in service anytime in 2001. Result: the election can be coordinated with depreciation deductions to avoid the last-quarter tax trap.

Travel and Entertainment Deductions. The IRS tends to scrutinize deductions for travel and entertainment (T&E) expenses. As a result, you must take extra care to ensure that you follow all the special rules in this area. Deductions for entertainment and meal expenses are limited to 50% of the cost. However, this restriction does not apply to a company party for all employees.

Un-reimbursed T&E expenses are treated as miscellaneous expenses that are deductible on the employee’s tax return and subject to the usual 2% limit.

Car expenses for business travel. Be aware that depreciation deductions are reduced for “luxury cars.” In lieu of deducting actual expenses, you may claim a standard mileage deduction of 34.5 cents per business mile. Caution: if you elect the standard mileage method for a car this year, you can’t reverse it next year.

Spouse Accompaniment. No deduction is allowed for a spouse who travels with you on business. However, if you hire your spouse as an employee to assist you (in a bona fide business purpose) on a business trip, his or her expenses are deductible.

Accountability for Records. Both employers and employees must observe strict record keeping and reporting rules. The rules are simplified if your company uses an “accountable plan” to reimburse employees.





Taxing matters

Year-End Bonuses. Compensation is deductible by the employer and taxable to the employee in the year it is paid. However, there is a special rule for year-end bonuses paid by an accrual-basis company. If the corporation pays a bonus to an employee within 2 ½ months after the close of the tax year, it is deductible on your corporation's current tax return - even if it's still taxable to the employee in the following tax year. If your company is a calendar-year corporation, determine bonus amounts for employees in 2001 and arrange to pay them in 2002. The reasons for the bonuses should be spelled out in the corporate minutes. Note that this technique does not work for majority shareholders of a C corporation, employee-shareholders of an S corporation or employee-owners of a personal service corporation. In these cases, the bonus is deductible in the year it is paid.

Maintenance. If your company takes care of repairs before the end of the year, the repairs are deductible on your 2001 return. The cost of "improvements" that add to a property's value or prolong its useful life must be capitalized. Caution: if improvements and repairs are made simultaneously as part of an overall plan, the entire cost is capitalized. To avoid potential problems, handle repairs and improvements separately.

Charitable Contributions. If your company donates assets to charity, the deduction is generally limited to your basis in the property. However, if a company (other than an S corporation) donates inventory-type property to certain charities, it may deduct its basis for the property plus one-half of the asset's unrealized appreciation. The deduction can't exceed twice your basis in the property. Charitable contributions are limited to a percentage of earnings - perhaps it might be better to advertise in their publications.

Inventory Accounting. When the cost of goods rise, using the LIFO (Last-In, First Out) method of inventory accounting may be favorable. This method can result in a larger deduction for cost of goods sold, in turn, creating a lower taxable income. The tax benefit continues as long as costs continue to increase.

Bad Debts and Non-Collections. Your business can claim a bad debt deduction in the year a debt becomes totally worthless. Take steps to collect bad debts at year-end and keep track of your efforts to prove the worthlessness of debts.



FINANCIAL TAX PLANNING

General Overview. The ultimate goal of tax planning is to hold on to as much of your money as possible. Year-end financial tax planning represents a valuable opportunity to accomplish your goals. The following information offers a few practical methods to keep more of your hard-earned dollars.

Capital Gains and Losses. The end of the year provides a unique opportunity to “time” capital gains and losses, especially for securities. As a general rule, capital losses can offset capital gains plus up to \$3,000 of ordinary income. The maximum tax rate for capital gains is 20% if the asset has been held for more than one year.

Important Year-End Evaluation. Due to the market decline, particularly in the wake of the terrorist assault on September 11th, you may be holding securities showing paper losses. As a result, you might realize capital losses that can offset gains realized earlier in the year. Conversely, any gains you realize now may be absorbed by losses realized in 2001. This also includes mutual funds that may have recognized gains or losses.

The “Wash Sale” Rule. If you are selling stock or mutual fund at a loss, you must watch out for the “wash sale” rule. Briefly stated, you cannot deduct a loss on the sale of securities if you buy back substantially identical securities within 30 days of the sale. The wash sale rule also applies to purchasing the same mutual fund you sold at a loss within 30 days. One way to avoid the wash sale rule without dramatically affecting the asset allocation of your portfolio is to immediately purchase a similar security or mutual fund to the one you sold at a loss. Another way to avoid the wash sale rule is to double up on your shares now and sell the original shares 31 days later. Make sure the transaction is completed in 2001.

Traditional IRA Plans. The new tax act doesn’t change the basic rules for traditional IRA contributions. You cannot fully deduct contributions if your annual AGI exceeds a specified dollar limit AND you’re an active participant in an employer-sponsored retirement plan. The limit for joint filers in 2001 is \$53,000; \$33,000 for single.

Whether or not your contributions are deductible, you may contribute up to



\$2,000 to an IRA for 2001, in addition to any qualified plan contributions made on your behalf. Under the new tax act, however, you can contribute up to \$3,000 for 2002 plus an extra \$500 “catch-up contribution” if age 50 or over. These limits will increase as shown below.

| Year | Regular contribution | Catch-up contribution | Total |
|-----------|----------------------|-----------------------|---------|
| 2002-2004 | \$3,000 | \$500 | \$3,500 |
| 2005 | \$4,000 | \$500 | \$4,500 |
| 2006-2007 | \$4,000 | \$1,000 | \$5,000 |
| 2008* | \$5,000 | \$1,000 | \$6,000 |

* Limit will be adjusted for inflation after 2008 Source: P.L. 107-16 § 601 (a)

You may make a \$2,000 contribution in December for the 2001 tax year and a \$3,000 contribution in January for the 2002 tax year. The sooner you make the contributions, the sooner you start earning tax-deferred income.

Roth IRA Plans. Basic rules for Roth IRAs also remain unchanged. Roth IRA contributions are nondeductible, but distributions may be tax-free for amounts held at least five years. The contribution limits for Roth IRAs are the same as the limits for traditional IRAs. Therefore, the deduction limit for 2001 is \$2,000. For 2002, you can contribute up to \$3,000 to a Roth IRA plus a \$500 catch-up contribution if age 50 or over. You can still convert a traditional IRA to a Roth IRA if your AGI is \$100,000 or less. Keep your AGI below the \$100,000 level to convert to a Roth IRA in 2001.

Qualified Retirement Plans. If you participate in a qualified retirement plan at work, the funds in your account can accumulate without any current tax erosion. Depending on the type of plan, contributions may be made by the employer or the employees - or both. Among other modifications, the new tax act increases the amounts that may be contributed to several types of qualified plans. Both employees and employers should assess current arrangements in view of scheduled increases for 2002:

401K Plans. For 2001, a participant can contribute up to \$10,500 to a 401(k) plan. Under the new tax act, the limit for 2002 is set at \$11,000. It will increase by \$1,000 annually until the limit reaches \$15,000 for 2006 and thereafter.



These increases also apply to 403(b) plans sponsored by tax-exempt organizations.

Defined Contribution Plans. Beginning in 2002, the annual limit on annual additions to a defined contribution plan is increased to \$40,000 (up from \$35,000).

Defined Benefit Plans. Effective in 2002, the annual limit for benefits in a defined benefit plan rises from \$140,000 to \$160,000.

SIMPLE Plans. Currently, the limit for contributions to a Savings Incentive Match Plan for Employees (SIMPLE) is \$6,500 a year. This limit will gradually increase in \$1,000 increments from \$7,000 for 2002 to \$10,000 for 2005 and thereafter.

Compensation Consideration. The maximum amount of compensation taken into account for qualified plan purposes is \$200,000 in 2002, up from \$170,000 this year.

Profit Sharing. Beginning in 2002, an employer's deductions for contributions to profit-sharing plans and stock bonus plans may equal 25% of compensation (up from 15%).

MISCELLANEOUS ITEMS

Bond Swaps. Depending on your situation, you might arrange to "swap" municipal bonds in the secondary market at the end of 2001. As long as the bond characteristics are not "substantially identical," there is no current income tax on the exchange.

Fund Sales. From a tax viewpoint, it's beneficial to sell shares before a mutual fund declares dividends at year-end and to buy shares after the fund declares dividends.

Passive Activities. Losses from passive activities such as rental real estate may only be used to offset income from other passive activities (with limited exceptions). You might invest in a passive activity to generate income to absorb existing losses, or you might sell rental property to offset losses that are



otherwise unusable.

New Cars. If you are buying a new car at year-end, you might save on taxes by waiting until 2002. Reason: the “luxury tax” on autos is decreasing from 4% of the amount above \$38,000 to 3% of the amount above \$40,000. For instance, on a \$60,000 car, you can save \$280 in luxury tax.

Charitable Planning. The IRS has cracked down on charitable remainder trusts (CRTs) that are considered “abusive” in nature or otherwise designed to skirt the tax laws. However, a CRT or other charitable gift transaction may still fit into your overall estate plan. For example, a gift to a charity might be combined with a “Wealth Replacement Trust” that uses life insurance to replace the amount gifted.

Variable Life Insurance and Annuities. You may re-align the investments within these contracts without any tax liability, and often at no expense. This may be an appropriate move, due to market volatility. When considering your entire portfolio, don’t forget the values in these plans, which may be substantial.

Estate Tax Issues. Although the new tax act repeals the federal estate tax, this change does not take effect until 2010 - if ever. Therefore, reducing the size of your estate through lifetime gifts is still critical.

Other Family Members. Don’t forget the need for tax planning by other members of your family. It might be a good idea for you to forward a copy of this Year-End Tax Planning Memo to them – or give us a ring, and we will be happy to do so for you.

Family Gifts. Anyone can give another individual up to \$10,000 annually without incurring any gift tax liability. The gift is excluded from income by the recipient and is not deductible by the donor. This is an excellent way to shift assets from a high-income parent to a low-bracket child. The recipient then pays tax on any earnings from the investment of the gift.

Furthermore, a direct payment of medical expenses or tuition for another person is not considered a gift for gift tax purposes. To qualify, payment must be made directly to the school or medical provider and not to the beneficiary.



For 2001, you can give away up to \$10,000 per recipient, to as many recipients as you like, without paying any gift tax. The gift maximum is doubled to \$20,000 for joint gifts made by a married couple). The annual gift tax exclusion is scheduled to increase to \$11,000 (\$22,000 for joint gifts) next year.

Note: This Year-End 2001 Tax Planning Memo is to be used as a general guideline and a stimulus for your review at this time. It distills thousands of pages of legislation and regulatory guidelines. Your personal circumstances may require special attention.

Conclusion. Many of the tax-saving moves outlined in this memo are subject to special rules. Professional help is strongly recommended for all your individual, business and financial tax decisions. We would be glad to schedule a year-end planning meeting to develop steps that meet your objectives.



DECIDING WHETHER TO ACCEPT AN EARLY-RETIREMENT OFFER

Amid a soft economy, and the ever-present possibility of a merger or acquisition, many workers age 50 and above are finding themselves forced to decide whether to accept a company offer to retire early. When the offer comes, you may not have much time to decide, so you'll need to sit down quickly with your financial advisor to review your options.

One of the first decisions you'll need to make is whether you'll be laid off anyway if you reject the early-retirement package. Reject it, and you could end up with something much less generous if you get laid off later.

This isn't always easy to gauge. A company looking to reduce its workforce in order to reduce costs or eliminate jobs as part of a merger may first offer a voluntary early-out package. If there are enough takers, the remaining jobs may be secure. If not, involuntary layoffs may occur. Sometimes companies announce that the offer is strictly voluntary, and no layoffs are planned. Others won't say. You'll need to weigh the strength of your specific job, your division, the company and the industry. If you think you'll get the boot in the end anyway, taking the early-retirement package will likely be the best deal, even if you don't want or can't afford to retire yet.

Assuming that you don't feel compelled to take the retirement offer, examine the details more closely to see whether it's worth accepting. Early-retirement packages come in all shapes and sizes. If the employer has a traditional company-paid pension plan, they may offer to add tenure and age. For example, a large telecommunications company recently offered to add five years of service to the retiring employees' tenure, and increase their age five years. The result is a higher monthly pension payout since payouts are usually based on a combination of the employee's age, years of service and wages.

However, unless you're very close to retirement, you probably won't end up with as high a pension payout as you would receive had you worked to full retirement age. You'll need to run some numbers with your financial advisor to determine how well you can live off the offered pension, coupled with Social Security and your other retirement savings, or whether you want to turn down the offer and keep working.



What are your other sources of income? What will be your expenses? What important benefits will you need to replace? Of course, if you feel compelled to take the offer, and it's not enough, you'll have to find a new job.

Many employers with pension plans may offer only lump-sum payments instead of sweetening the pension payouts. Traditional pension plans are less common today, too, so a lump sum may be your only choice.

Another critical factor in accepting or rejecting an offer is health benefits, because you're likely to be years away from being eligible for Medicare (age 65). The offer may or may not include full or partially subsidized health care benefits. If taking the early offer means loss of coverage, you'll either have to pay for it out of pocket or find coverage with a new employer. The main thing is, say financial planners, don't go without coverage.

What kind of severance payout do they offer? If they'll continue your salary for a while, you might take that option while you look for work. If you want to start your own business, a lump-sum payment is probably preferable. Also figure in the loss of such benefits as vacation and sick days, and life and disability insurance.

Consider less tangible factors, as well. Someone with marketable skills is in a better position to take the early out than someone without them. Someone who's been wanting to leave anyway will undoubtedly find the package very enticing.

You may have some room to negotiate, too, particularly if you occupy an executive position with a high salary and a long history with the employer. You might be able to get better health benefits or a larger pension payout. Consequently, don't rush to accept the initial offer until you've evaluated it carefully. Unfortunately, you probably will have only a month or two at the most to decide. That's why it's ideal if you can get wind of such an offer before it occurs, and run some preliminary numbers with your advisor.





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