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Dear Client:

Many questions come up regarding how management fees are reported and how they are treated for tax purposes. The reporting and treatment are different for Qualified (eg. IRA's) versus Non-Qualified accounts. We wanted to provide an explanation of the various treatments. You will likely be issued a Form 1099-R if you have used a fee liquidation authorization to pay your management fees. As always, we suggest you consult your tax advisor regarding the following options for IRS reporting.

Management Fees Paid Directly from Your IRA Account

In Private Letter Ruling 8951010, the IRS determined that if management fees are paid directly from the IRA account, then such fees are not taxable to the owner. The IRS determined that the management fees would not be included in gross income and would not be subject to the additional tax (10% "penalty") on early distributions

If you receive a Form 1099-R on an IRA account for management fees paid directly, we suggest that your tax advisor consider the following explanation to remove the Form 1099-R reported income from personal taxation as follows:

Attachment to Form 1040 Line 16a:

“\$ _____ of the total of \$ _____ on line 16a and 16b is attributable to investment advisory fees paid directly by an Individual Retirement Account. The Internal Revenue Service has ruled that these are not includable in income under Internal Revenue Code Section 408 (a)(1) nor are they subject to additional tax under section 72(t).”

Management Fees Paid Directly from a Non-Qualified Tax Deferred Annuity

Unlike fees paid from IRA accounts, the IRS has not ruled that management fees paid directly from an account for investment advisor fees are not taxable.

Non-qualified tax deferred annuities are similar to IRA's in the following respects:

- Income and gains are tax deferred until withdrawn
- Withdrawals before age 59 ½ are subject to 10% additional tax on early distribution
- Contributions to the plan are not deductible for tax purposes (IRA's may be deductible or non-deductible)

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Management Fees

Page Two

Non-qualified tax deferred annuities are dissimilar to IRA's in the following respects:

- IRA contributions may be tax deductible
- IRA withdrawals must begin no later than age 70 ½

We suggest that you discuss with your tax advisor the most appropriate means for you to report non-qualified account investment advisory fees reported on your Form 1099-R. The options your tax advisor may want to review in addressing management fees paid in non-qualified tax deferred annuities would include:

Option A: Report the Form 1099-R income as taxable on line 16a and 16b (Form 1040). Take a deduction on Schedule A, line 22 (other miscellaneous itemized deductions) for the amount of the fee you report on line 16b (Form 1040). Further, if the recipient was under age 59 ½ at the time of the fee payment, complete Federal Form 5329 for the 10% additional tax on early distribution.

Option B: Report the Form 1099-R as follows:
“\$ _____ of the total of \$ _____ on line 16a and 16b (Form 1040) are attributable to investment advisory fees paid directly by a non-qualified tax deferred annuity. The fees were not paid to the taxpayer and the taxpayer is not including them in income. The IRS has ruled that such fees are not taxable under Internal Revenue Code Section 408(a)(1) nor are the fees paid subject to the additional tax under section 72(t). The taxpayer believes that non-qualified annuities are not dissimilar from IRA's in their taxation of distributions, and therefore are excluded from taxable income.”

Management Fees Paid from a Non-Qualified Account

We suggest you consult with your tax advisor regarding whether or not the management fees you have paid are tax deductible. IRS Publication 550's section on “Expenses of Producing Income” states the following:

You deduct investment expenses (other than interest expenses) as miscellaneous itemized deductions on Schedule A (Form 1040). To be deductible, these expenses must be ordinary and necessary expenses paid or incurred:

1. To produce or collect income, or

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Management Fees

Page Three

2. To manage property held for producing income.

The expenses must be directly related to the income or income-producing property, and the income must be taxable to you.

1. You **can** deduct fees you pay for counsel and advice about investments that produce taxable income (e.g. investment advisory services).
2. You **cannot** deduct any broker's fees, commissions, or option premiums you pay in connection with the purchase or sale of investment property, such as stocks or bonds. You must add the fee to the cost of the property used to figure the gain or loss from the sale.

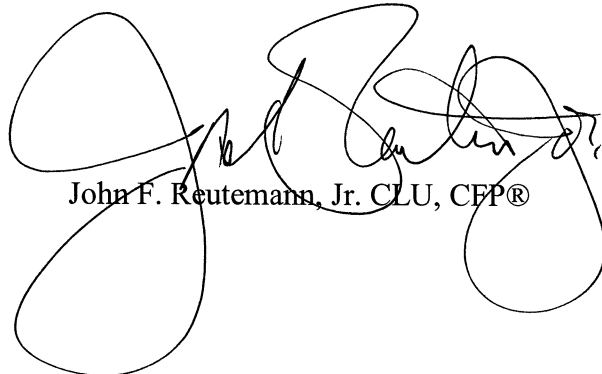
The deduction for most income-producing expenses is subject to a 2% limit that also applies to certain other miscellaneous itemized deductions. The amount deductible is limited to the total of these miscellaneous deductions that is more than 2% of your adjusted gross income.

We hope this information helps in your understanding of the tax treatment of management fees. If you have any questions, please feel free to call us. As always, we appreciate your business.

Sincerely,



Valerie L. Alexander, CPA



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