



Advanced Planning Strategies

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Dear Reader,

There has been considerable activity in Congress recently in the area of tax law changes. Much of the activity concerns the “sunset” provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. The provisions of EGTRRA end in 10 years, and pre-EGTRRA tax law would be reinstated after 2010. The House is likely to vote to permanently enact the EGTRRA tax relief. However, due to Congressional procedural rules, it will require 60 votes in the Senate to eliminate the sunset and make the EGTRRA provisions permanent. Recently, the Senate failed (by a six-vote margin) to remove the sunset of the repeal of the federal estate and generation-skipping transfer (GST) taxes. Thus, the federal estate and GST taxes will return in 2011, after a one-year repeal, with a maximum marginal rate of 55 percent and an exemption equivalent of \$1 million (the GST exemption would be indexed for inflation).

The House voted 308 to 70 to remove the sunset from the retirement savings and pension reform proposals. This proposal would make permanent the IRA and 401(k) contribution increases, as provided by EGTRRA, to \$5,000 and \$15,000, respectively. The sunset provision would return IRA and 401(k) contribution limits to \$2,000 and \$10,000, respectively, in 2011. We cannot predict whether the Senate will vote to permanently increase the retirement savings provisions.

The Senate Finance Committee approved a version of the long-debated charitable giving legislation first introduced in the House as “The Community Solutions Act.” The bill would permit the rollover of an IRA to a charitable vehicle, such as a charitable remainder trust, at age 59½ without penalty. In addition, the bill would permit nonitemizers to deduct charitable contributions up to \$250 (\$500 on a joint return). The bill’s cost is partially offset by bills to limit corporate tax shelters and expatriation of corporate profits to offshore entities. It is possible that this bill may require 60 votes in the Senate if the revenue raisers do not offset the cost of the charitable tax incentives. We’ll keep you posted on any progress on the legislation.

Knowledge is not power. Only knowledge in use is power.

INCREASED COST RECOVERY DEDUCTION LIMITS FOR AUTOMOBILES

The Job Creation and Worker Assistance Act of 2002 provides a first-year 30 percent depreciation “bonus” for depreciable property with a recovery period of 20 years or less if the property is acquired after September 10, 2001, and before September 11, 2005. Concomitant to that change is a change in the rules for passenger automobiles that increases the overall dollar amount cost recovery deduction limitation for the year a vehicle is placed in service under Code Sec. 280F. The first-year limit was previously \$3,060 for the 2002 tax year as adjusted for inflation. The new law has increased that limit by \$4,600 to \$7,660. The overall dollar amount limit applies to the sum of depreciation deductions and any first-year expensing claimed for a vehicle under Code Sec. 179. Therefore, the expensing allowance cannot be used to avoid the dollar amount limitation. Also, under the new law the increased limit cannot be used if the taxpayer elects out of the 30 percent bonus depreciation.

An Interesting Example. What is perhaps most interesting about this increase in the passenger car limit is how it affects first-year cost recovery deductions for more inexpensive cars when combined with the Sec. 179 first-year expensing allowance. Note that first-year expensing under Sec. 179 is allowable for automobiles, as long as the overall dollar amount limitation is not exceeded. Suppose, then, that a taxpayer purchases a car this year that is used 100 percent for business (if it isn't, other tax complications arise). The cost of the car is \$8,000. Let's look at what happens if the normal depreciation rules are used. The bonus first-year depreciation is applied to the basis of the automobile before the regular 20 percent first-year depreciation for automobiles is applied to the remaining basis. If the taxpayer uses only the bonus and regular depreciation allowances, total depreciation will be \$3,520 (original basis of \$8,000 x 30% = \$2,400, plus the reduced basis of \$5,600 x 20% = \$1,120 for a total of \$3,520).

However, suppose instead that the taxpayer elects to claim a first-year expensing allowance of \$7,392 for the car (which is below the current Sec. 179 annual per-taxpayer expensing limit of \$24,000). Now the taxpayer has remaining basis in the car of only \$608 (\$8,000 – \$7,392). The 30 percent bonus depreciation could then be applied, resulting in a bonus deduction of \$182 (\$608 x 30%). The remaining basis of \$426 would then be subject to the regular first-year depreciation of 20 percent, or \$85. Total cost recovery deductions would equal \$7,659 (\$7,392 + \$182 + \$85), which is one dollar below the dollar amount limit of \$7,660. In this way, the taxpayer can claim total cost recovery deductions of almost 96 percent of the car's cost in the first year! There appears to be nothing in the new law that would prohibit such an approach.

MEDICAL EXPENSE DEDUCTIONS FOR WEIGHT LOSS AND CESSATION OF SMOKING

In Revenue Ruling 2002-19 (issued April 22, 2002), the IRS modified its position concerning the deductibility of weight-loss expenses under the medical expense deduction rules. Some commentators have said that this new ruling treats weight-loss expenses in the same way as expenses for quitting tobacco. However, this is not so. Although in many cases the result may be the same (that is, deductibility), these two areas have rules that are distinct because they are based on different concepts.

Deductibility of Weight-Loss Programs. Regarding weight-loss expenses, the Service's position in the past was that the expenses are deductible only if a weight-loss program is prescribed by a physician as treatment for a specific disease other than the taxpayer's weight. Obesity itself was not considered to be a disease for purposes of the medical expense deduction.

The major change brought about in Rev. Rul. 2002-19 is that the IRS now considers obesity itself to be a specific disease, not just a condition or an aspect of general health that may be a contributing factor to other diseases. Therefore, a physician's diagnosis of obesity, without the presence of another disease, is now enough to make expenses for a weight-loss program deductible as medical expenses. The ruling also states that expenses for weight-loss programs prescribed as treatment for hypertension (as distinguished from obesity) are deductible.

Deductible expenses include fees to join a weight-loss program and to attend periodic meetings. However, expenses for purchasing foods recommended or called for in these programs are not deductible because such foods are substitutes and simply fill nutritional needs that the taxpayer would have regardless of obesity.

The Service describes a weight-loss program as one in which the "participants develop a diet plan, receive diet menus and literature, and discuss problems encountered in dieting." For planning purposes, note that the ruling does not mention the cost of health club memberships, personal trainers, or other activities that may contribute to or maintain weight loss. The deductibility of these expenses is more questionable. As is often the case with medical expenses, having a doctor prescribe a specific program or activity to treat a specific disease goes a long way in establishing deductibility as a medical expense.

Deductibility of Cessation of Smoking. In contrast, the tax rules for smoking-cessation expenses are based on the conclusion that nicotine is an addictive drug (see Rev. Rul. 99-28, 1999-1 CB 1269). The IRS has traditionally allowed that expenses for either drug or alcohol addiction programs are deductible as medical expenses (see Rev. Rul. 72-226; Rev. Rul. 73-325). In allowing deductions for these expenses, the IRS made no legal conclusion that addiction is a specific disease. It is more correct to say that its conclusion in this area was based on a broad interpretation of what should be deductible as a medical expense. However, it did take the IRS until 1999 to include smoking in the arena of addictions that can be treated on a deductible basis.

The ruling on nicotine addiction states specifically that the costs of a smoking-cessation program and for prescription drugs to support it are deductible. However, nonprescription treatments (including nicotine gum and patches, according to the IRS) are not deductible because of the general rule under Code Sec. 213(b) that nonprescription drugs do not qualify as deductible medical expenses.

It is interesting to note some recent comments by IRS officials on the subject of nonprescription substances. IRS officials have recently made nonbinding comments on certain issues on which the IRS has not officially issued advice or a ruling. These include a surprising statement on the treatment of nutritional supplements. The officials indicated that the IRS may not consider such supplements to be "drugs" and therefore not subject to the general rule of disallowance for the cost of nonprescription drugs as mentioned above. This would mean that the cost of nonprescription nutritional supplements such as vitamins, herbs, and other such preparations could be deductible as medical expenses if they are taken on the advice of a physician to treat a specific disease suffered by the taxpayer. This position, if officially adopted by the IRS, would be a change from the current position stated in IRS Publication 502 regarding the tax treatment of vitamins and herbal supplements.

Finally, don't forget that medical expenses are deductible by individuals as an itemized deduction on Schedule A of Form 1040 only to the extent that the total of all deductible medical expenses exceeds 7.5 percent of adjusted gross income (10 percent for taxpayers subject to the alternative minimum tax).

RECENT CASES AND RULINGS

STATUTE OF LIMITATIONS WILL NOT PROTECT GIFT TAX RETURNS WITH OMITTED OR INADEQUATELY DISCLOSED GIFTS

Gift tax returns are subject to a 3-year statute of limitations for the purposes of the IRS's examination of the return. The statute can be extended to 6 years if the return fails to disclose gifts that exceed 25 percent of the amount of gifts stated on the return. Congress solidified the statute of limitations for gift tax returns in 1997, and the IRS promulgated extensive regulations with respect to the requirements necessary for gift tax returns to be protected by the statute of limitations. These regulations have been discussed in previous editions of this letter. The IRS recently issued a Chief Counsel Advice Memorandum (CGA 200221010) that demonstrates its interpretation of the requirements for an adequately disclosed gift tax return.

The taxpayer transferred interests in a limited liability company (LLC) to two family trusts. The gift tax return for the year of the transfer stated that class B units in the LLC worth \$200,000 were transferred to the trusts. The IRS determined that the description of the gifts was inadequate for the purposes of the protection of the statute of limitations. The IRS determined that the value of the LLC interests was actually \$14 million and, accordingly, that the statute of limitations should be extended to 6 years. Interpreting the regulations, the IRS determined that the taxpayer's gift tax return should have included the number of units in the LLC, a description of the class type, and the percentage of ownership that the gifted interest represents. In addition, the regulations make it clear that the gift tax return should indicate whether any valuation discount applies and should completely describe the underlying property in the LLC.

It is important to note that a gift tax return supported by a detailed qualified appraisal report will satisfy the substantiation requirement for the protection of the 3-year statute of limitations.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

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for the future*



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