



Advanced Planning Strategies

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Dear Reader,

Consideration of important tax legislation will begin in earnest now that the elections are over. The general downturn in the equity markets has caused Congress some concern. One bill that has been discussed includes a provision to permit taxpayers who suffered capital losses to increase the amount that those losses can be used to offset ordinary income from \$3,000 to \$8,250 (H.R. 1619). The upper limit would be indexed for inflation. This provision would somewhat ease the sting of incurring a capital loss.

A second bill, the "Protecting America's Saving Act" (H.R. 5553), would increase the amount that workers could save in retirement plans by accelerating the contribution increases that are currently phased in more slowly under the provisions of the "Economic Growth and Tax Relief Reconciliation Act of 2001." For example, the IRA and Section 401(k) contribution limits would increase from \$2,000 and \$10,000 to \$5,000 and \$15,000, respectively, in 2002. The advocates of these proposals feel that Congress should do something immediately to help workers shore up retirement accounts that have dropped in value. Even the IRS has shown sympathy for investors. Read the ruling discussed at the end of this letter to see how some relief has been given to early retirees who face a 10 percent penalty for reducing withdrawals from retirement plans.

The recent interest rate reductions will have a dramatic impact on several estate planning techniques. The interest rate mandated by law for valuing income interests, annuities, remainder interests, and reversionary interests is 3.6 percent this month. This is the lowest rate for these purposes in the history of this statute since its initial effective date of May 1989 (incidentally, the rate was 11.6 percent at that time). The low interest rate has a positive effect on such estate and tax planning techniques as private annuities, grantor-retained annuity trusts (GRATs), charitable donations of remainder interests in residences or farms, and charitable lead annuity trusts.

The Social Security wage base will rise to \$87,000 and the benefits received by retirees will increase by 1.4 percent in 2003. We'll provide the remaining inflation-indexed tax numbers next month as they are announced by the IRS.

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

YEAR-END 2002 TAX PLANNING TIPS

Excise Tax on Purchase of High-Priced Vehicles. For 2002, there is a federal excise tax of 3 percent on the portion of the purchase price of a car that exceeds \$40,000. For example, buying an \$80,000 automobile would result in an excise tax of \$1,200 $[(\$80,000 - \$40,000) \times .03]$. However, this tax will not be imposed after 2002. Therefore, prospective purchasers of expensive cars can save a fair amount of money by waiting until after the new year to buy, even though their salespeople may not have as joyful a holiday season as a result.

Cost Recovery Deductions for Business Automobiles. As discussed in a previous letter, under 2002 tax legislation, the first-year limit on cost recovery deductions (including first-year expensing) for business automobiles has increased from \$3,060 to \$7,660 for the 2002 tax year. Since the first \$7,660 of the car's cost can be recovered for tax purposes in the year of purchase by using a combination of the expensing allowance and depreciation, it may be a good idea to purchase a business vehicle before the end of the year (but consider the expiring excise tax just discussed).

Business Property Expensing Allowance. For 2002, the maximum annual first-year expensing allowance for tangible personal property used in a trade or business is \$24,000. For 2003, it will be \$25,000. Taxpayers who plan to place a substantial amount of such property in service in the near future may benefit from splitting such purchases between 2002 and 2003 to take advantage of both years' allowances. Remember also that the \$24,000 or \$25,000 maximum amount is reduced dollar for dollar to the extent that the taxpayer places more than \$200,000 worth of such property in service for any one taxable year. Therefore, splitting purchases between 2 years can also avoid the \$200,000 ceiling.

Medical Expenses. If a taxpayer's deductible medical expenses (including eyeglasses, smoking cessation expenses, deductible weight loss expenses, and other expenses not covered by insurance) are already in excess of the 7.5 percent floor of adjusted gross income for this year, the technique of "bunching" additional medical expenses into the same tax year is advisable because the additional expenses will be 100 percent deductible. If, on the other hand, a taxpayer has had little or no medical expenses this year but may have substantial expenses next year, it's advisable for tax purposes (although perhaps not for health purposes) to defer additional expenses to next year and bunch medical expenses in that year. In general, careful timing of both income and expenses can save a significant amount of tax dollars.

Long-Term Care Insurance Premiums for Self-Employed Taxpayers. Sole proprietors, partners, and S corporation owner/employees may claim an above-the-line deduction for 70 percent of qualified long-term care premiums paid on behalf of themselves, their spouses, or their dependents during 2002. Those eligible for the deduction include taxpayers who are full-time employees but who have a moonlighting business for which they file a Schedule C with Form 1040, as long as the taxpayer or his or her spouse is not eligible for any employer-sponsored subsidized long-term care insurance plan.

Beginning in 2003, however, the above-the-line deduction increases from 70 to 100 percent! Therefore, if such taxpayers are contemplating the purchase of long-term care insurance, they can gain an additional tax savings by paying the first premium in 2003 rather than in 2002. Remember, though, that the deductible amount is also subject to the same age-based premium limitation that applies to the Schedule A (or below-the-line) deduction for long-term care insurance premiums. The premium limitations are adjusted annually for inflation. For example, in 2002, the deductible premium limit for a taxpayer over age 70 is \$2,990, and for 2003, it is expected to be \$3,130.

Utilizing Capital Losses. Even though 2002 has not been a good year for the stock market, taxpayers can make use of tax benefits for losses. Basically, capital losses (whether from individual stock sales or the redemption of mutual fund shares) are used first to offset an individual taxpayer's capital gains, if any. Capital losses in excess of capital gains may offset up to \$3,000 of ordinary

income in a given year, and any excess losses are carried over to future years and treated the same way.

Roth IRA Conversions. If a traditional IRA has been invested in stocks whose value has sharply dropped, this may be the year to convert the IRA to a Roth IRA. If the contributions to the traditional IRA were 100 percent deductible, a conversion to a Roth IRA causes the full value of the IRA to be taxable as of the date of conversion. Correspondingly, the funds in a Roth IRA will accumulate tax free after a conversion, are tax free when distributed, and are not subject to minimum-distribution requirements. If it is expected that the value of the investments in an IRA will rebound after the end of the year, conversion may be timely. The taxpayer's adjusted gross income must be \$100,000 or under (not counting the IRA) to convert to a Roth IRA.

Points on a Mortgage Refinancing. Unless all or a portion of refinanced home mortgage loan proceeds is used for renovations or improvements to the home, any points paid in connection with the refinancing are not immediately deductible but must be deducted ratably over the life of the refinanced loan. This treatment differs from the rule applicable to points paid when a home is purchased. These points are generally deductible, subject to certain requirements.

The general nondeductibility of points on a refinancing may make it more desirable to choose a zero-points option. The interest rate on a mortgage loan will generally increase by between 1/8 and 1/4 of a percentage point for each point that the borrower does not pay. For example, a loan with a 5.25 percent interest rate with 3 points might increase to, say, 5.75 percent if no points are paid. The interest portion of the refinanced mortgage payment should be fully deductible unless the borrower has refinanced more than the principal balance of the old loan plus \$100,000.

Filing Status. An individual taxpayer's filing status is determined as of the last day of the taxable year. For example, a couple who marry on December 31, 2002, will be eligible to file jointly for the year 2002. Likewise, a divorce or legal separation that becomes final before the end of the year will generally result in either single or head-of-household filing status for former spouses. However, a taxpayer whose spouse has died during the year may still file a joint return for the year of death. Depending on the relative income and tax bracket levels of prospective spouses (or prospective former spouses), a change in filing status before the end of the year may save some money, or cost some.

Reducing Adjusted Gross Income. Many, many tax deductions and credits are reduced as a taxpayer's adjusted gross income (AGI) increases. This is accomplished in the tax law by limiting or reducing tax benefits using either a floor equal to a percentage of AGI (so that only the amount in excess of that percentage is deductible) or a phaseout of a deduction or credit (so that all or a part of the deduction or credit is lost when AGI exceeds specified incremental amounts). Just a few examples of benefits subject to these rules include the medical expense deduction, the deduction for casualty losses, miscellaneous itemized deductions, deductions for IRA contributions, eligibility for claiming personal and dependency exemptions, and the tax credits for children, adoption, child-care expenses, and higher education. One great way to reduce AGI is to maximize contributions to qualified retirement plans and IRAs. Another is to defer income into the next tax year. The ability to defer income will depend on the accounting method the taxpayer uses; constructive receipt of the income in the current tax year must be avoided.

RECENT CASES AND RULINGS

NEW IRS REVENUE RULING PROVIDES RELIEF FOR EARLY RETIREMENT PLAN WITHDRAWALS

The downturn in the stock market created an unanticipated tax burden for individuals who elected to receive benefits from their qualified retirement plans or IRAs. Under existing rules, individuals are subject to

a 10 percent penalty tax for taxable withdrawals from qualified retirement plans or IRAs. The penalty tax applies to all taxable amounts of withdrawals. An exception was created for distributions under “substantially equal periodic payments,” explained by the IRS in Notice 89-25, 1989-1 C.B. 662. Once substantially equal periodic payments have begun, the taxpayer must continue to take withdrawals under the method selected until the later of 5 years or the attainment of age 59 1/2. Any change to the amount of payment determined under the method chosen by the taxpayer will result in an imposition of the 10 percent penalty tax plus applicable interest charges for the withdrawal period.

Three methods may be used to determine a taxpayer's substantially equal periodic payment. Two methods, the fixed amortization method and the fixed annuitization method, provide for a fixed annual withdrawal amount. The third method, the required minimum distribution (RMD), provides for an annually redetermined payment based on the size of the account balance on the valuation date and the life expectancy table chosen for the applicable year. Thus, under the RMD method, payments will vary each year to reflect changes in the account balance. The problem created by the downturn in the stock market is that account balances may have dropped substantially. If payments are determined under the first two methods above and the account balance has dropped in value, the fixed payment required by these methods could potentially exhaust, or dramatically diminish, the taxpayer's retirement plan or IRA account balance.

The IRS released Revenue Ruling 2002-62 (2002-42 IRB) in October and provided an additional exception to alleviate the problem of diminished account balances. The ruling permits taxpayers to make a one-time switch from the fixed amortization or fixed annuitization methods to the RMD method. Because the RMD method annually redetermines the payment as a result of changes in the account balance, the account balance should never be completely exhausted during the withdrawal period unless all plan investments drop to zero in value.

In addition, for payments that have begun prior to 2003, the taxpayer can use a different life expectancy table at the time the switch to the RMD method is made. This offers some flexibility in determining the payment amount. One of the life expectancy tables that can be used is the Uniform Lifetime Table (the same table used to provide for RMDs at the required beginning date at age 70 1/2), which provides for a joint life payout assuming the taxpayer's age and a beneficiary 10 years younger. The taxpayer can also use a single life expectancy table, which would yield the largest distributions under normal assumptions. Both of these tables are included in the Revenue Rulings. Finally, the taxpayer can use a joint life expectancy table (which uses the beneficiary's actual age) provided in the retirement plan regulations. Thus, the taxpayer using the joint life expectancy table could alter payments annually by selecting a beneficiary each year with a different age. Of course, there is extreme danger in changing beneficiaries because the taxpayer could die with an unintended final choice of beneficiary.

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.

***Positioning our clients
for the future***



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