



Advanced Planning Strategies

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Dear Reader,

The inside report contains an analysis of the “Jobs and Growth Tax Reconciliation Act of 2003.” The tax changes are aimed primarily at individual income taxes with some immediate and welcome relief. However, several important tax proposals that have been discussed over the last couple of years were not incorporated. Notably, substantial retirement savings and charitable bills have yet to be approved.

The retirement savings bills have taken several forms. The President’s proposal would consolidate many of the current complex competing retirement alternatives into a few savings account choices with features similar to Roth IRAs. Another proposal would increase the tax-favored contribution limits to currently available mechanisms, such as IRAs, Section 401(k) and 403(b) plans, and simplified employee pension (SEP) plans. Finally, a proposal has been discussed that would greatly simplify the administration of employer pension plans and further increase portability for employees who change jobs. The charitable incentive package has been discussed here several times and is an attractive bill to most constituencies, but has been held up by revenue offset issues.

Any further tax relief legislation this year will have to survive significant political hurdles. The House will probably continue to pass more tax cuts and will resist compromise proposals that offset cuts with revenue raisers. Legislation that is not revenue neutral will have a difficult time in the Senate. To overcome procedural challenges in the Senate on tax cuts that are not offset, a 60-vote total would be required. We’ll keep you abreast of any proposals that gain momentum.

A quick update is appropriate concerning an interesting tax case. We discussed the *Hackl* decision of the Tax Court last year. The 7th Circuit Court of Appeals upheld the Tax Court’s findings in early July. The case involves the gifts of limited liability company (LLC) interests to family members. The court determined that the gift tax annual exclusion (currently \$11,000 per donee) could not shield the gifts from tax because the ownership interests did not give the donees a present interest. The LLC agreement effectively prevented the donees from selling their interests currently. The court also rejected the argument that a gift of all the donor’s rights to the property interest automatically constitutes a present-interest gift.

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

THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003

The tax bill enacted earlier this summer provides relief in the form of individual income tax reductions and business tax savings. The tax reductions total \$350 billion and would be much larger if the cuts were permanent. In some instances, the new tax law accelerates the provisions of EGTRRA (enacted in June 2001), but generally does not eliminate the act's 2010 sunset provision. (As a reminder, EGTRRA provided for many tax reductions, but procedural requirements caused the provisions to be returned to 2001 law after 2010.) In some instances, the 2003 relief provisions are even more short-lived.

INDIVIDUAL INCOME TAX RELIEF

Income Tax Rate Reductions. The new law accelerates the individual income tax rates provided in EGTRRA and brings the rates to the level that would not have been reached until 2006. Thus, the 10 and 15 percent brackets are retained, but they are adjusted to apply to higher levels of income. The 10 percent bracket is adjusted upward by \$1,000 (to \$7,000) for single taxpayers and marrieds filing separately and by \$2,000 (to \$14,000) for married joint filers for 2003 and 2004. The 15 percent bracket is also adjusted to offer relief against the marriage penalty as discussed below.

The remaining tax brackets are lowered from 27 to 25, 30 to 28, 35 to 33, and 38.6 to 35 percent, respectively, applicable in 2003. Thus, individual income taxes are lowered immediately and will remain at these reduced levels, subject to the EGTRRA sunset provision that will reinstate the 28, 31, 36 and 39.6 percent marginal rate brackets after 2010 with the appropriate inflation adjustments to the brackets. The lower rates will result in over \$2,000 in tax savings for a married couple with taxable income of \$100,000 and over \$4,000 for a couple with taxable income of \$200,000 during the current year.

The lower income tax brackets also affect other provisions. For example, income tax rates for trusts and estates are similarly reduced without adjustment to the income thresholds for the brackets. The maximum income tax rate on trust or estate income is reduced to 35 percent for 2003, but the maximum rate continues to apply for taxable income in excess of \$9,350.

Marriage Penalty Relief. The income thresholds for the 15 percent bracket will be double the threshold for single filers in 2003 and 2004. The married joint-filer 15 percent bracket will be adjusted back to EGTRRA levels in 2005 to 2007 and will not be double the single-bracket threshold again until 2008. The standard deduction for married couples filing jointly is increased to double (\$9,500) that of single filers for 2003. It will remain double the single-filer amount (as adjusted for inflation) in 2004. The married joint-filer standard deduction amount reverts to EGTRRA levels after 2004 and will not be double the single-filer amount again until 2009. These marriage penalty relief provisions will also sunset to pre-EGTRRA levels in 2011.

Dividend Tax Relief. The tax imposed on dividends is reduced to the rate applicable to capital gains (see new rules below) rather than the ordinary income tax rates imposed on dividends under prior law. Thus, dividends will be taxed at 5 percent for taxpayers in the 10 or 15 percent brackets and at 15 percent otherwise. A rate of zero will be imposed on dividends for taxpayers in the 10 or 15 percent bracket in 2008 only. Corporate dividends received will be added to net capital gains to determine the tax. Note that dividends will not be used to determine net capital gain and thus cannot be used to offset capital losses.

Dividends for this purpose include dividends paid by domestic corporations and qualified foreign corporations and will include dividends paid to investors from mutual funds, partnerships, or REITs that would ordinarily be categorized as dividend income. The special rate applies to corporate dividends, regardless of whether

the amount distributed was ever taxed at the corporate level. The new rates apply to dividends received after 2002 but will sunset after 2008.

One additional change that results from the reduced tax rates on dividends is a change to the accumulated earnings and personal holding company tax rates applicable to regular (not Subchapter S) corporations. These rates have traditionally been set at the maximum individual tax rates to discourage accumulation of excessive earnings within corporations. For example, the accumulated earnings tax could be imposed on accumulated earnings and profits in excess of \$250,000 for business corporations (\$150,000 for service corporations) unless the accumulation had a business purpose. The rate on these taxes is now set at 15 percent.

Reduced Capital Gain Rates. Long-term capital gains that were previously taxed at a 20 percent rate will now be taxed at 15 percent. A 5 percent rate will apply to long-term gains for taxpayers in the 10 or 15 percent ordinary income tax bracket. (Again, the long-term gains of such lower-bracket taxpayers will be taxed at a rate of zero in 2008.) The rates, which also pertain to gains for the purposes of the alternative minimum tax calculation, apply to capital gains realized after May 5, 2003, and before 2009. Special transition rules apply for calculating capital gain taxes in 2003 that will greatly complicate this year's capital gains schedule.

Unfortunately, the reduced capital gain and dividend rates do not apply to distributions from qualified retirement plans or IRAs. Taxable amounts distributed from such plans will continue to be taxed at ordinary income tax rates, regardless of the character of the income in plan investments.

The new dividend and capital gain rates may offer an opportunity for owners of closely held corporations to remove earnings and profits from a corporation at lower rates. Traditionally, dividend distributions were taxed at ordinary rates to the extent that the corporation had accumulated earnings and profits. This could occur even in an S corporation that had accumulated earnings and profits prior to making the subchapter S election, assuming the accumulated adjustments account (AAA) had been distributed. The closely held corporation could also distribute earnings and profits on a selective basis by redeeming stock from certain shareholders. If the redemption qualifies under IRC Section 302, the shareholder would incur long-term capital gain taxes at 15 percent for amounts received in excess of basis. For a redemption that does not qualify as a Section 302 redemption, the amount distributed would be taxed as a dividend (again at 15 percent) to the extent of the corporation's earnings and profits.

SMALL BUSINESS TAX RELIEF PROVISIONS

Increase in the Section 179 Expense Limitation. The amount of business capital investment expenditures that can be expensed currently is increased from \$25,000 to \$100,000 for 2003 to 2005. This current deduction has been extended to off-the-shelf computer software placed in service in 2003, 2004, and 2005. This maximum amount deductible as a current expense is decreased dollar for dollar to the extent the investment exceeds \$400,000 (this threshold is adjusted for inflation). This provision is generally considered one of the best stimulus items for small businesses.

Expansion of the Bonus Depreciation Provisions. Bonus depreciation is a concept that was spawned by tax stimulus provisions after September 11, 2001, and permitted greater first-year expensing of depreciable property used in a trade or business. This bonus depreciation was increased from 30 to 50 percent in the first year and will apply to property acquired after May 5, 2003, and placed in service before 2005. This allowance is available for new property that is (1) depreciable under the modified accelerated cost recovery system (MACRS) and has a recovery period of 20 years or less, (2) a MACRS water utility property, (3) qualified leasehold improvement property (defined in Section 168(k)), or (4) off-the-shelf computer software that is depreciable over

3 years (Section 167). The 50 percent first-year bonus depreciation is not mandatory. Taxpayers who elect out cannot use the bonus depreciation on any property of the same class in the tax year.

RECENT CASES AND RULINGS

IRS CLARIFIES RETIREMENT PLAN RULES FOR EXPLANATION RECEIVED FROM THE PLAN AFTER ANNUITY STARTING DATE

The IRS issued final regulations (Treas. Reg. Sections 1.417(e)-1(b)(3)(iv & v)) that offer guidance concerning a situation in which a qualified plan furnishes the participant with a written explanation about the qualified joint and survivor annuity (QJSA) election after the annuity starting date. The written explanation provides information on the QJSA, the rights of the nonparticipant spouse to a survivor annuity, and the right of the participant's spouse to waive the survivor annuity. Tax law permits the explanation to be furnished after the normal annuity starting date only if the period for the election is extended for 30 days after the time the explanation is furnished. The regulations clarify the procedure that must be followed to comply with this law.

A retroactive annuity starting date may be provided at the participant's election if the explanation is furnished after the normal annuity starting date. The participant (and his or her spouse if required) has 90 days to make the election to take the retroactive annuity. If the election is made, annuity payments will be determined as if the retroactive annuity starting date was the actual starting date. Thus, the payments will be made under valuation and mortality assumptions at the retroactive date. A make-up amount (including applicable interest) will be provided for the payments not yet received at the time the retroactive election is made. The nonparticipant spouse must consent to the retroactive election if the survivor annuity at the retroactive date is less than the required survivor benefit at the date the plan provides the explanation to the participant and his or her spouse.

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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