



Advanced Planning Strategies

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Dear Reader,

The Charitable Giving Act was still being hammered out in conference at the time this letter went to the printer. There will probably be some action on this by the end of the year. There are some parts of the legislation that are costly and may require revenue-raising offset provisions, and this type of compromise may delay or defeat the legislation. One general problem for tax-reduction provisions is the deficit. Although estimates of the 2003 fiscal year deficit have been reduced, the CBO forecasts the deficit at \$374 billion. This is not only an all-time high but also double last year's figure.

Democratic presidential hopefuls are beginning to debate and provide a glimpse of their tax policy thoughts. One common theme is the rollback of the recent tax cuts for the higher-bracket taxpayers. The tax-reduction proposals do not have a common theme, but priorities include incentives for health insurance, energy conservation, and education. Obviously, proposals to create employment will become part of the platform in an election year. IRS data indicate a reduction in the share of income taxes paid by the highest earners from 2000 to 2001, although these individuals continue to pay a substantial portion of total income tax receipts.

Some estimates have been released concerning next year's inflation-indexed tax figures. These estimates have proved reliable in most years. The personal exemption and standard deduction are expected to rise to \$3,100 and \$4,850, respectively. The phase-out of itemized deductions is expected to begin at \$142,700 of adjusted gross income for most filers (\$71,350 for married filing separately). Selected income tax brackets would begin as follows: (25% at \$48,500 for joint filers, \$29,050 for single filers; 28% at \$117,250 for joint filers, \$70,350 for single filers; 33% at \$178,650 for joint filers, \$146,750 for single filers; and 35% at \$319,100 for all filers except married filing separately [\$159,550]). We should have more estimates and maybe final figures to report in the next letter.

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

YEAR-END TAX PLANNING TIPS FOR 2003

There is always a plethora of ideas to make some last-month adjustments to reduce taxes at the end of a calendar year. The discussion below offers some food for thought based mostly on new developments for 2003. The efficacy of the following items for tax reduction will depend on individual facts and circumstances and estimates of future income levels and taxes.

Using Capital Losses. For sales of assets after May 5, 2003, there is a maximum tax rate of 15 percent applicable to long-term capital gains of individual taxpayers. For 2003, the maximum tax rate on ordinary income is 35 percent. If you have a net capital loss for the year or a net capital loss carryover, the capital loss can be used to offset up to \$3,000 of ordinary income in a given year. Of course, capital gains are first netted against any capital losses before remaining losses can be deducted from ordinary income. So if you have a \$3,000 capital loss and a \$3,000 long-term capital gain for the year, the loss eliminates taxation on the gain, which otherwise would have produced a tax of \$450 ($\$3,000 \times .15$). However, if you have \$3,000 of capital loss and no capital gain for the year, the capital loss is deducted against ordinary income, taxable at rates up to 35 percent. At the maximum rate, the capital loss produces a tax savings of \$1,050 ($\$3,000 \times .35$). This is \$600 more than the savings that result if the capital loss is absorbed by long-term capital gains. Therefore, if you have capital losses or a loss carryover this year, try to limit your capital gains for the year, at least to the extent that you will have \$3,000 of capital losses left over to deduct against ordinary income taxable at higher rates. Deferring an asset sale that would produce taxable gain into 2004 might accomplish this result, depending on your overall situation.

Lower Tax Rates on Dividends. As you probably know, most corporate dividends are now taxable at a maximum rate of 15 percent for individual taxpayers. What you may not know is that for taxpayers whose marginal rate does not exceed 15 percent (that is, taxpayers whose taxable income does not exceed the 10 or 15 percent tax bracket amounts), the tax rate on dividends is now 5 percent! This presents an opportunity for income shifting by means of transferring dividend-paying stocks to lower-bracket family members who are not subject to the kiddie tax (that is, not under the age of 14). For 2003, single taxpayers with taxable income up to approximately \$28,000 will have a marginal tax rate of 15 percent and therefore will get the benefit of the 5 percent tax on dividend income. To effectively transfer taxation of income, however, the ownership of the asset itself must be transferred to the lower-bracket taxpayer (unless an appropriate form of trust is used), rather than just an income interest in the asset.

First-Year Cost Recovery Deductions for Business Autos and Other Vehicles. One component of the 2003 tax law changes was the introduction of 50 percent first-year “bonus” depreciation. This provision increases the 30 percent first-year bonus depreciation (which is still available in lieu of the 50 percent bonus if the taxpayer so elects) that was enacted last year. The bonus provisions enable taxpayers to add 50 percent of an asset’s cost to the regular depreciation deduction that is available for the first year an asset is placed in service. For a business automobile, the regular first-year deduction is 20 percent. This means that up to 70 percent of a car’s cost can be depreciated in the first year without even using the Sec. 179 expensing election discussed below. However, there are dollar amount limits on the annual cost recovery for business automobiles. These limits apply to total cost recovery deductions for a given vehicle, including Sec. 179 expensing, bonus depreciation, and regular depreciation. The first-year dollar amount limit for autos placed in service in 2003 is \$10,710 if the taxpayer uses the 50 percent bonus depreciation (\$7,660 if the taxpayer uses the 30 percent bonus). There are somewhat higher limits for vans and light trucks.

Assuming the auto is used 100 percent for business and the 50 percent bonus is used, taxpayers can combine the expensing election, bonus depreciation, and regular depreciation to currently deduct virtually all of a new car’s cost up to the \$10,710 limit. Cost in excess of that number is deductible over the rest of the 5-year recovery period, subject to lower annual limitations (for example, \$4,900 in the second year).

That's not too bad: Recent tax changes have liberalized the rules for writing off business cars. But there is a *large* loophole here that involves two different tax rules. The first rule is the increase in the annual amount of the first-year expensing election. The amount has been increased from the old limit of \$25,000 per taxpayer per year to \$100,000 per year for 2003, 2004, and 2005. Basically, the expensing election allows taxpayers to currently deduct the cost of tangible personal property (including autos) used for business rather than depreciating the cost over a longer recovery period. Any cost left over after the expensing election is used is then depreciated over the normal recovery period, which for cars is 5 years.

The second rule involves exceptions to the dollar amount limits for cost recovery of autos discussed above. If the business vehicle is a light truck or van specially modified for business use, *or* if the vehicle weighs more than 6,000 pounds, the annual dollar amount limits on cost recovery *do not* apply. This means that taxpayers can expense up to \$100,000 of the cost of such a vehicle, then apply the 50 percent bonus depreciation, then add the regular 20 percent bonus depreciation to the total first-year cost recovery for the vehicle.

Example: Billy purchases a new model year 2004 SUV in December 2003. Billy is subject to a marginal tax rate of 35 percent. The SUV weighs 6,500 pounds and Billy will place it in 100 percent business use. Billy pays \$150,000 for the vehicle. Billy can use the expensing election to deduct \$100,000 of its cost. Next, Billy can claim the 50 percent bonus depreciation to his remaining \$50,000 of cost basis, for a bonus deduction of \$25,000. Finally, Billy can apply the regular 20 percent first-year depreciation to the remaining \$25,000 of his cost basis (\$5,000), for a total cost recovery amount of \$130,000 in the first year! His total tax savings in the 35 percent bracket is \$45,500 ($\$130,000 \times .35$). This leaves Billy with only \$20,000 of his \$150,000 cost unrecovered for tax purposes.

Remember that the expensing election limit of \$100,000 applies cumulatively to all qualifying property that the taxpayer places in service for the year, not on a per property basis. Also, if the taxpayer places in service more than \$400,000 of property qualifying for expensing in one year, the \$100,000 limit is reduced dollar for dollar as the total amount of such property increases. So it is advisable to keep purchases of such property at or below \$100,000 per year if that works from a business standpoint.

Long-Term Care Insurance Premiums for Self-Employed Taxpayers. Sole proprietors, partners, and S corporation owner/employees may claim an above-the-line (not subject to the floor on itemized deductions) deduction for 100 percent of qualified long-term care premiums paid on behalf of themselves, their spouses, or dependents during 2003. Those eligible for the deduction include taxpayers who are full-time employees but who also have a moonlighting business for which they file a Schedule C with Form 1040, so long as the taxpayer or his or her spouse is not eligible for any employer-sponsored subsidized long-term care insurance plan. Note, however, that the deductible amount is subject to the same age-based premium limitations provided by statute.

Tax Timing with Checks and Credit Cards. For most income tax purposes, an expense made by credit card is deemed to be made at the time of the transaction. For example, a charitable contribution or business expense made by a cash-basis taxpayer is deductible in the year the charge is made, regardless of whether the bill is actually paid in the same year. A payment by check is also deemed to be made when the check is physically delivered, or when it is postmarked if sent by mail. Be warned, however, that this rule does not apply for gift tax purposes. Gifts made by check must actually be presented for payment in the current year in order for the gift to be treated as being made this year for gift tax or annual exclusion purposes. The amount of the gift tax annual exclusion for 2003 is \$11,000 per donee (twice that if a joint gift is used by a married couple).

Social Security Wage Base. The wage base for 2003 is \$87,000. The amount for 2004 was recently announced as \$87,900. Taxpayers who have some control over how much money they make may wish to receive

additional earned income in excess of \$87,000 this year rather than next, especially if the taxpayer expects that income will drop below the wage base next year. Earned income in excess of \$87,000 is not subject to the 12.4 percent OASDI tax (6.2 percent for employees). However, the 2.9 percent Medicare tax (1.45 percent for employees) applies, regardless of income level.

RECENT CASES AND RULINGS

IRS DENIES CHARITABLE DEDUCTION FOR CHARITIES' POWER TO WITHDRAW FROM IRREVOCABLE TRUST

The grantor created an irrevocable life insurance trust (ILIT) that provided benefits to both individual family members and four charities. Pursuant to normal gift tax planning, each beneficiary, including the charities, was permitted to withdraw up to \$10,000 per year from the amount of the annual contribution to the trust. The right to withdraw expired after 30 days. While the grantor was alive, the income and principal of the trust could be distributed to the family beneficiaries for their education, health, maintenance, or support. After the grantor died and the death benefit was paid, the charities would receive 40 percent of the trust estate.

The IRS ruled (Ltr. 200341002) that the charitable deduction was denied for the amount that could have been withdrawn each year. The Service reasoned that no withdrawal right was exercised and nothing was distributed during each year to charity. In addition, the annual gift tax exclusion was denied because the charities did not withdraw and could have had the potential future distribution eliminated by distributions to the family beneficiaries during the grantor's lifetime. The IRS questioned the validity of the withdrawal rights for future-interest beneficiaries whose rights are not certain. This same argument concerning the withdrawal rights and the annual exclusion has failed in Tax Court in noncharitable irrevocable trusts.

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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