



Advanced Planning Strategies

Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services

July/August 2005

Dear Reader,

There are a significant number of tax and economic reform agendas facing Congress before the August recess. Despite promises to bring the legislation forward, it is unlikely that much will receive serious consideration prior to the fall. There are too many differences between the House and Senate in both the structure and substance of proposed legislation to see any quick compromises.

The recent news concerning the stability of the Pension Benefit Guaranty Corporation (PBGC) had a part in the proposed "Pension Protection Act of (2005) (H.R. 2830)." The large liability for underfunded pension plans has placed the PBGC in some difficulty concerning the long-term solvency of the program. The details are not completely finalized but the proposed legislation would

- increase the PBGC premium to \$30 (from \$19) over 5 years (3 years if the plan is less than 80 percent funded)
- permit employers to give participants access to investment advice without incurring liability
- revise actuarial requirements with respect to assumptions such as interest and mortality rates

The Senate is considering a compromise regarding the federal estate tax repeal scheduled for 2010. The estate tax is slated to have increased exemptions (to \$2 million in 2006 and \$3.5 million in 2009) before full repeal for one year only in 2010. The tax would return as enacted prior to the 2001 amendments in 2011. Most practitioners believe that the law will not be permitted to remain as structured much longer without further reform. It is quite possible that repeal will not occur and a compromise with substantial exemptions and some reduction in the maximum rate will receive consideration before the end of the year.

Of course, there is ongoing discussion concerning Social Security reform, but it is hard to imagine any action in the near future. As always, we'll provide a complete report of any important legislation that is enacted.

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

THE ALTERNATIVE MINIMUM TAX (AMT) NOT AN “ALTERNATIVE” FOR MANY TAXPAYERS

It is time to break the news to many middle-income taxpayers: You may be wealthier than you think. In fact, you may be paying (or will soon be paying) taxes originally meant only for upper-income taxpayers. In the instance of the AMT, or alternative minimum tax, a growing number of taxpayers are reporting and paying this tax as a result of using “tax-preference” items. When the AMT legislation was originally enacted into law in 1969, only a few hundred taxpayers actually paid the additional tax. However, as the definition of AMT preference items has been expanded to include ordinary and commonplace deductions, the number of taxpayers subject to the AMT has skyrocketed. Recent studies indicate that over 3 million taxpayers are subject to the AMT, with middle-class families bearing a portion of the burden. Not only does the AMT create additional taxes, but it also adds significant complexity to the process of complying with federal income tax reporting. In fact, a federal government report listed the repeal of the AMT in its top 10 suggestions for simplifying the tax code.

WHAT IS THE PURPOSE OF THE AMT?

Historically, the AMT has been a separate method of calculating income tax liability. The original minimum tax was an add-on tax; however, the current AMT is a separate and parallel system of income taxation. Taxpayers are required first to compute their regular income tax liability prior to calculating their potential tax under the AMT system. The AMT is imposed if the calculation for the “tentative minimum tax” results in a higher tax liability than the calculation for the regular income tax. The AMT represents the excess of this tentative minimum tax over the taxpayer’s regular tax computation. The original legislative intent behind the AMT was to ensure that all taxpayers would pay at least some minimum amount of income tax. Therefore, when calculating the AMT, certain tax benefits available under regular tax rules are limited or prohibited. Consequently, the AMT was determined under a different set of rules than for regular tax purposes, resulting in the disallowance of these so-called tax-preference items.

HOW IS THE AMT DETERMINED?

The AMT is a complex system, and this discussion will be limited to an identification of the issues that create exposure to the tax. The AMT calculation starts with a taxpayer’s taxable income, which is then modified to reflect the impact of tax-preference (technically *adjustments* and *preferences*) items by eliminating or reducing certain deductions. Certain items of tax-exempt income (i.e., certain private-activity bond interest) are added back for the AMT calculation.

It appears that middle-class taxpayers with \$75,000 to \$125,000 of adjusted gross income are experiencing an increase in exposure to this “alternative tax,” partly as a result of the decrease in the regular income tax rates. The increase is due primarily to a handful of preferential items. Although the present day AMT system applies to individuals, corporations, estates, and trusts, more and more middle-income individuals are being subjected to the AMT. The overwhelming majority of individual taxpayers subject to the AMT live in cities and states that impose an income tax (or are individuals who deduct sales taxes) and have children.

Although the AMT computation provides a rather generous exemption (\$58,000 for couples filing a joint return), the exemption quickly disappears when alternative minimum taxable income (AMTI) exceeds a specified threshold (between \$75,000 and \$150,000, depending on filing status). The exemption is reduced by 25 percent of AMTI in excess of the threshold. (Note: Both the exemption amount and the threshold vary by filing status.)

WHAT ARE THE TAX-PREFERENCE ITEMS THAT CAUSE AMT EXPOSURE?

Some of the most significant preferential items are noteworthy because they affect the majority of middle-class taxpayers. For individuals who itemize deductions on Schedule A of their Form 1040, the following deductions are eliminated or reduced for the purposes of calculating the AMT:

- state and local income taxes (or deduction for sales taxes)
- real estate taxes
- personal property taxes
- miscellaneous itemized deductions in excess of 2 percent of adjusted gross income (including unreimbursed employee expenses, the costs of tax preparation, and financial/investment fees)
- medical expenses in excess of 10 percent of adjusted gross income. Note, however, that for regular tax purposes, a 7.5 percent ceiling applies to medical expense deductibility.

In addition, the 3 percent reduction of itemized deductions of high-income taxpayers does not apply to the AMT.

For taxpayers who claim the standard deduction in lieu of itemizing deductions, the standard deduction is added back to taxable income in calculating the AMT. Personal and dependency exemptions are not allowed.

Although there are numerous other tax-preference items, the aforementioned are typically involved in an average individual tax return calculation. There is nothing preferential about the standard deduction or personal and dependency exemptions.

As more middle-class taxpayers fall prey to the AMT, they quickly discover that the promised tax relief under recent legislation was a mirage. The exemption against the AMT was increased by the 2001 Act and extended in the 2003 and 2004 tax legislation, but the increased AMT exemption expires again at the end of 2005 (the exemption drops to \$22,500, \$33,750, or \$45,000, depending on filing status). A 2004 study by the Urban Institute-Brookings Institution Tax Policy Center projects that about 30 million taxpayers will be subject to the AMT within the next 7 years, compared to the 3 million or so taxpayers currently paying the tax. This phenomenon is also caused by the reduction of maximum individual tax rates (39.6 to 35 percent) since the AMT system is not indexed for inflation.

An overhaul of the AMT would seem to be indicated if the original goals of the tax are to be achieved and simplicity is truly a priority for the federal tax system. However, repeal may be out of the question due to revenue constraints. The Joint Conference Committee on Taxation has estimated that repeal of the AMT would deprive the federal government of over \$611 billion over the next decade.

RECENT CASES AND RULINGS

IRS RULES FAVORABLY ON DISCLAIMER OF IRA

A recent Revenue Ruling (2005-36, 2005-26 I.R.B. 1368) clarified some troublesome issues concerning the disclaimer of a decedent's IRA by the designated beneficiary. The minimum distribution rules for qualified plans and IRAs and their estate planning implications are covered in a recent issue of this letter. The tax regulations provide that the minimum required distribution (MRD) must be taken from an IRA in the year of the account owner's death if the owner had reached the required beginning date (generally age 70 1/2) prior to his or her death to avoid the imposition of a 50 percent penalty tax. If the MRD is not taken by the decedent prior to his or her death, the amount must be distributed to the named beneficiary before the end of the year of the account owner's death. It is often recommended that disclaimer planning be employed to enhance the flexibility of IRA distributions during the postmortem period. The regulations permit the determination of a designated beneficiary to be delayed until September 30 of the year following the year of the account owner's death. A qualified disclaimer is effective in avoiding gift taxes by the disclaimant only if the rules of IRC Sec. 2518 are followed. Among these rules is a requirement that the disclaimant must not have accepted any benefits from the disclaimed property interest prior to the disclaimer.

The IRS looked at this issue and resolved the seemingly incongruous MRD and disclaimer rules favorably for

taxpayers. First, it is permissible for the disclaimant to receive the MRD and effectively disclaim all or a portion of the remaining IRA. However, the disclaimer will not be effective with respect to the portion of the income attributable to the MRD earned prior to the disclaimer. This portion of income is determined based on a ratio provided by the disclaimer regulations. In addition, if the IRA is to be distributed into separate accounts following the disclaimer, the distribution of the MRD solely to an individual designated beneficiary is permissible. This ruling clarifies some of the issues created by a disconnect between the retirement distribution and disclaimer regulations. However, some things must be kept in mind for disclaimer planning for an IRA. First, all of the state law probate rules concerning disclaimers must be followed. Second, the federal tax disclaimer regulations under IRC Sec. 2518 must be followed. Finally, the possibility of a disclaimer should be included in the beneficiary designation provisions in the IRA document.

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*



Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES

1288 Valley Forge Road, #53
Phoenixville, PA 19460

Tel. (610) 917-8940

Fax. (610) 917-8962

Email. algibbons@algibbons.com

Web. www.algibbons.com