



Advanced Planning Strategies

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Dear Reader,

Tax reform unrelated to Hurricane Katrina got sidetracked for a while. There is still a possibility that some changes will be enacted before the end of the year. The Small Employer Tax Relief Act of 2005 (H.R. 3841) was introduced in the House recently. Among the proposed provisions are (1) making the \$100,000 Sec. 179 expense limit permanent, (2) increasing the meals and entertainment expense deduction to 80 percent, (3) increasing the SIMPLE pension plan contribution limits, (4) phasing out the individual AMT until 2010, and (5) simplifying (and reducing in some cases) the safe harbor amounts for avoiding estimated tax underpayment penalties.

There has recently been a significant increase in the “think tank” releases concerning tax reform. The President’s tax reform committee may have released its recommendations by the time you read this letter. The Tax Foundation’s data about taxes indicated that the top 20 percent of taxpayers paid over 80 percent of income taxes and, certainly, all of the estate taxes. In fact, only two out of three income tax returns filed had any tax due at all as a result of deductions and credits. However, none of these reports include the payment of payroll (FICA) taxes. This tax is flat or even somewhat regressive because there is a wage base limit on all but the Medicare tax. There is ordinarily no refund of this tax imposed on wage earners and employers, and the total tax is a big number. In the most recent fiscal year reported by the IRS, the FICA tax collections represented over 35 percent of the collections on all federal returns.

Some estimates have been released concerning next year’s inflation-indexed tax figures. These estimates have proved reliable in most years. The standard deduction is expected to rise to \$5,150 for individuals and \$10,300 for married filing jointly. The personal exemption will rise to \$3,300. The phaseout of itemized deductions is expected to begin at \$150,500 of adjusted gross income for most filers (\$75,250 for married filing separately). Selected income tax brackets would begin as follows: 25% at \$61,300 for joint filers, \$30,650 for single filers; 28% at \$123,700 for joint filers, \$74,200 for single filers; 33% at \$188,450 for joint filers, \$154,800 for single filers; and 35% at \$336,550 for all filers except married filing separately (\$168,275). We should have more estimates and maybe final figures to report in the next letter.

For some tax-planning tips (including some unique opportunities) for the remainder of 2005, read the inside letter.

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

YEAR-END TAX PLANNING TIPS FOR 2005

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 provides some food for thought and includes some new developments solely available for 2005. The efficacy of the following items for tax reduction will depend on individual facts and circumstances and on estimates of future income levels and taxes.

Charitable Contributions under Katrina Emergency Tax Relief Act. Charitable donations are normally deductible only up to certain percentage limitations provided by the Code. For example, cash contributions to public charities are limited to 50 percent of the taxpayer's contribution base (adjusted gross income without certain net operating loss carrybacks). For cash contributions to most private foundations, the deduction limit is 30 percent of the taxpayer's contribution base. For contributions of long-term capital gain property, the percentage limits are 30 and 20 percent respectively. In addition to these limits, a taxpayer's itemized deductions (including charitable donations) are subject to a phaseout rule that reduces the benefits of itemized deductions if adjusted gross income exceeds \$145,950 (2005 indexed amount for all but married taxpayers who file separately). The new tax provision removes both the percentage limits and the itemized deduction phaseout for "qualified contributions" to charity between August 28 and December 31, 2005.

A qualified contribution must be a cash gift to a charity, other than a supporting organization or donor-advised fund. Note that it is not required that the donation be provided to a charity to be used for hurricane relief. The committee report indicates that a charitable remainder trust will not qualify unless the remainder is distributed in cash to a charity within the time period. Unfortunately for tax simplification purposes, donations made in 2005 before August 28, or donations of property other than cash, remain subject to the percentage limitations and phaseout.

This provision gives certain taxpayers a one-time opportunity to accomplish a couple of otherwise unavailable tax objectives if they also have charitable goals. First, a taxpayer could potentially make the income tax system voluntary for 2005. For example, a taxpayer who does not need current income for living expenses could contribute an amount equal to 100 percent of adjusted gross income to favorite charities before the end of the year and eliminate income tax liability. Of course, the taxpayer would need to make the gifts in cash and should be mindful of the tax implications of converting assets to cash and the impact of state income taxes.

Second, the provision creates the possibility of removing cash from a qualified retirement plan or regular IRA and making charitable donations on a potentially more favorable basis. Withdrawals from such accounts are treated as distributions and, as such, increase the taxpayer's income. With the temporary removal of the percentage limitations for donations, it is possible to make a qualified contribution of the amount withdrawn and take the full amount as a deductible donation. (Of course, the taxpayer should be above age 59 ½ or a 10 percent penalty may apply to the withdrawal.) For an individual who is charitably inclined, this is an excellent opportunity to reduce the size of retirement accounts that will otherwise remain subject to income taxes whenever distributions are taken and could also be subject to estate taxes at the account owner's death if such individual's estate exceeds the exemption amount.

The withdrawal from a qualified retirement plan or IRA followed by the qualified donation to charity might have a small tax cost. If the addition of the amount withdrawn to adjusted gross income places the donor in the phaseout income range, the donor's other itemized deductions subject to the phaseout may be reduced. The impact on state income taxes for retirement distributions and charitable donations must be also be considered. Preliminary calculations reveal that an affected taxpayer may be subject to a tax of approximately .5 to 2 percent on this transaction, certainly far less than the taxpayer's marginal bracket.

Tax Timing with Checks and Credit Cards. For most income tax purposes, a credit card expense is deemed to be incurred at the time of the transaction. For example, a charitable contribution or business expense 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 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 2005 is \$11,000 per donee (twice that if a joint gift is used by a married couple). Remember, the annual gift tax exclusion is the simplest method for reducing an estate potentially subject to estate taxes, and you lose an opportunity if the gifts aren't made in any given year.

Using Capital Losses. For sales of assets, there is a maximum tax rate of 15 percent applicable to individual taxpayers' long-term capital gains. For 2005, 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'll 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 2005 might accomplish this result, depending on your overall situation.

Lower Tax Rates on Dividends. Most corporate dividends are 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 2005, single taxpayers with taxable income up to \$29,700 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.

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. 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, as 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.

Therefore, if such taxpayers are contemplating the purchase of long-term care insurance, they can reduce their current year's income by paying the premium by the end of the year. 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 2005, the deductible premium limits are \$510 for taxpayers aged 40 to 49, \$1,020 for ages 50 to 59, \$2,720 for ages 60 to 69, and \$3,400 for ages 70 and above.

Social Security Wage Base. The wage base for 2005 is \$90,000. The amount for 2006 will be \$94,200. Taxpayers who have some control over how much money they make may wish to receive additional earned

income in excess of \$90,000 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 \$90,000 is not subject to the OASDI tax. However, the 2.9 percent Medicare tax (1.45 percent for employees) applies regardless of income level.

RECENT CASES AND RULINGS

ESTATE TAXES COLLECTED FROM DECEDENT'S REVOCABLE TRUST PASSING TO SURVIVING SPOUSE

The decedent, part owner of two pro sports teams, established a revocable trust that created marital and nonmarital trusts at his death. The nonmarital trust was not funded, as the decedent had previously made lifetime gifts to use up his unified credit. The marital trust was funded with over \$88 million of assets from the revocable trust, and the estate claimed the estate tax marital deduction for the full amount. Trusts valued at over \$40 million created by powers of appointment held by the decedent during lifetime were included in the gross estate, creating a significant tax deficiency. The issue for the court was the source of payment for the tax. The court (*Lurie v. Commissioner*, 96 AFTR 3d 2005) held that the proceeds from the revocable (now marital) trust must be used to pay the tax deficiency. The problem this apportionment creates is that the marital deduction is reduced by the funds used to pay the tax, further increasing the estate tax.

The court reasoned that the revocable trust contained language that directed the payment of expenses to the extent that the residuary estate (about \$760,000) was insufficient. The tax and expense apportionment clause in the decedent's will recognized the existence of the revocable trust. The court refused to adopt the estate's argument that state law provided for equitable apportionment. This case, although the facts are not typical, indicates the importance of the tax and expense apportionment clause and the provision for appropriate liquidity for unexpected taxes or expenses.

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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