



# Advanced Planning Strategies

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Dear Reader,

There were no legislative developments to report at the time Congress broke for the election. It will be difficult to predict the impact of the election and time will be short to pass significant tax legislation before the end of the year. There are still some extender provisions that are very important to many taxpayers and those may be postponed until 2007. This creates a burden on the taxpayer, return preparers, and the IRS since the tax forms for next April are in the process of development and subsequent legislation affecting the 2006 return will result in some scrambling.

The IRS announced that they were downsizing the estate tax examination division during the summer. This prompted some concern from Congress considering the relative effectiveness of the enforcement productivity of this division. It was estimated that they collect about \$2,200 in additional taxes for each hour spent on returns. We've heard some rumors from practitioners that recent estate tax return audits have been more thorough. Perhaps the division is further proving its effectiveness. In any event, experience has illustrated that well-planned and organized estates will have lower tax and compliance costs.

Some estimates have come out concerning the inflation-indexed numbers for tax year 2007. The IRS isn't required to announce actual numbers until December and the potential for extender legislation may delay the release until the last minute. However, estimates have proven accurate in the past. The standard deduction is expected to rise to \$10,700 for joint filers (\$5,350 for single taxpayers). The personal exemption will increase to \$3,400. The itemized deduction phaseout will begin at adjusted gross income of \$156,400 for most taxpayers. The 28 percent marginal bracket will be reached for taxable income over \$128,500 for joint filers (\$77,100 for single taxpayers); the 33 percent bracket will be reached at taxable income over \$195,850 for joint filers (\$160,850 for single taxpayers); and the 35 percent maximum bracket will be reached at taxable income over \$349,700 for most taxpayers.

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

## YEAR-END TAX PLANNING TIPS FOR 2006

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 for this year and some new changes affecting all taxpayers for next year.. 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.

**AMT Exemption Increased...for Now!** The Tax Increase Prevention and Reconciliation Act of 2005 passed this past May simply increased the AMT exemptions for 2006 (e.g., \$62,550 for a married couple filing a joint return and \$42,500 for single taxpayers) through the end of 2006. Barring new legislation, the AMT exemption amounts will revert to the significantly lower AMT exemptions of 2000 (e.g., \$45,000 for a married couple filing jointly and \$33,750 for single taxpayers). Although several Congressional leaders are seeking repeal of the AMT, the potential loss of revenue to our government is staggering. According to the Joint Conference Committee on Taxation, repeal of the AMT would deprive the government of \$611 billion of revenues over the next decade.

Please keep in mind that many common deductions are added back in calculating the AMT. Some of the itemized deductions that are added back include state and local income taxes (including sales taxes), real estate taxes, and miscellaneous itemized deductions in excess of 2% of adjusted gross income. In addition, for those taxpayers claiming the standard deduction in lieu of itemizing their deductions, the standard deduction is added back to taxable income in calculating the AMT. Furthermore, both personal and dependency exemptions are not allowable in computing the AMT. In planning the timing of year-end deductions (i.e., taxes), what may seem tax deductible may prove to be an illusion due to an AMT issue.

**The “Not So Kiddie Tax.”** The Tax Increase Prevention and Reconciliation Act of 2005 will also force more teenagers (or their parents) to pay higher tax in 2006 on unearned income. The age when the kiddie tax no longer applies has been increased from 14 to 18. The Act minimizes the benefits of gifting income-producing investments to children. The Act forces our thinking to focus on more appreciation-oriented assets in selecting gifts for our children.

**Charitable Contributions under The Pension Protection Plan Act of 2006.** Under the new law, the requirements for substantiating charitable contributions tighten for 2007. For example, contributions of cash, checks, or other monetary gifts (i.e., cash in a church basket) will be disallowed as a deduction unless the donor has a cancelled check or written documentation from the charity that meets specified requirements. For 2006, this requirement applies only to individual contributions of \$250 or more. However, for non-cash donations after August 17, 2006, the Act imposes an immediate restriction. Deductions are disallowed for clothing and household goods that are not in “good or better used condition.” But even here there is an exception: a deduction is permitted for single non-cash contributions that are not in “good or better used condition” if the item is appraised at more than \$500.

In addition, the new law permits an individual who is 70 1/2 or older to direct a distribution from a traditional or Roth IRA to a qualified charity without tax consequences. Although the charitable contribution is not deductible, the IRA distribution is not taxable. The result equates to a 100% deduction. The new rule is effective for tax years 2006 and 2007 but limits the IRA distribution/contribution to \$100,000 in each year.

**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 2006 is \$12,000 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 2006, 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 2007 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 18). For 2006, single taxpayers with taxable income up to \$30,650 and married taxpayers filing a joint return with taxable income up to \$61,300 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 2006, the deductible premium limits are \$530

for taxpayers aged 40 to 49, \$1,060 for ages 50 to 59, \$2,830 for ages 60 to 69, and \$3,530 for ages 70 and above.

**Social Security Wage Base.** The wage base for 2006 is \$94,200. The amount for 2007 will be \$98,400. Taxpayers who have some control over how much money they make may wish to receive additional earned income in excess of \$94,200 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 \$94,200 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

### TRANSFER OF LIFE INSURANCE TO GRANTOR TRUST IGNORED FOR INCOME TAX PURPOSES

The taxpayer owned a variable life insurance policy on his life. For estate planning reasons, he and his advisers determined that it was appropriate for the insurance to be transferred to an irrevocable trust. The taxpayer executed the irrevocable trust with his wife named as trustee. The beneficiaries of the trust are the couple's children, and the principal and income of the trust are to be distributed to the children under the sole discretion of the trustee.

Under the general rule, a transfer of life insurance for consideration would result in adverse income taxes at the time the death benefit is paid unless an exception to the general rule is available. The IRS held that the transfer avoided any adverse tax consequences since the trust was a grantor trust for income tax purposes (Ltr. 200636086). The grantor trust rules provide a unique opportunity here since the policy placed in the grantor trust can be designed to be a completed gift for gift tax purposes. What's more, the policy will be excluded from the grantor's gross estate if the grantor-insured survives three years following the gift.

Some added commentary not in the private ruling is appropriate. First, the grantor should file a federal gift tax return for the transfer reporting the value of the policy at the date of the assignment. Both gift and generation-skipping transfer taxes should be addressed on the Form 709. In addition, the ruling doesn't discuss the ages of the children. If the children are minors, a co-trustee should be named to avoid the trustee-spouse running afoul of the general power of appointment trap of IRC Secs. 2514 and 2041.

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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