

# Tax Planning Ideas

2003, Number 2



## *Your Personal Imprint Here*

*Street Address  
City, State, Zip  
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As this year's April 15<sup>th</sup> tax deadline enters the history books, there are undoubtedly many taxpayers who have become full-fledged members of the "should've, would've, could've" club. Are you one of them? If so, it's not too early to begin thinking about the savings you can make on next year's returns.

Many Americans are literally giving away thousands of their hard-earned dollars, by not taking full advantage of many programs federal and state governments have put in place to make life "less taxing."

A Hewitt Associates survey last year found, for example, that most taxpayers don't take advantage of the limit for 401(k) contributions. In fact, the survey found that 25% of all employees don't even have a 401(k). As everyone has learned in recent months, there are no guarantees in life—balances in 401(k) accounts can go *down*, as well as *up*. . .but, by not participating fully in tax-advantaged programs, how will you give yourself any chance of financial success?

By the way. . .Does your employer offer a flexible spending account (FSA) for medical and childcare expenses? Couples in the 27% tax bracket can save \$1,350 in federal taxes alone by setting aside \$5,000 in an FSA for childcare. . .have you considered consolidating loans and paying them off with a home equity loan so you can deduct your interest payments?

*Your Signature Here*

## **"Gifting" Your Way to Estate Tax Savings**

If you have been fortunate enough to accumulate substantial assets during your lifetime, estate taxes could significantly reduce the amount you'll be able to pass on to your heirs. For estates larger than \$1,000,000 in 2003, federal estate tax rates can reach as high as 49%. Therefore, it is very important to develop an estate planning strategy that helps reduce the impact of estate taxes. By making gifts of existing assets *during your lifetime*, you can help reduce the size of your estate and lessen your family's future estate tax burden.

### **Gift-Giving Basics**

1) The **annual gift tax exclusion** allows a donor to give away up to \$11,000 (for 2003), per calendar year per recipient without incurring a gift tax liability. If the donor is married and his or her spouse consents to "splitting" the gift, the annual gift tax exclusion increases to \$22,000, even if only one spouse actually makes the entire gift. For the years to come, the exclusion amount is indexed for inflation and, as a result, may continue to enhance annual gifting programs.

2) Making gifts during one's lifetime shifts future appreciation of gifted property to the recipient.

3) Taxable income may be shifted from the high tax bracket of a donor to the lower tax bracket of a recipient, age 14 or older.

4) No gift tax is paid out-of-pocket until taxable gifts exceed the **applicable exclusion amount** (\$1,000,000 for 2003). The federal gift tax is cumulative.

5) Gift taxes on the current year's taxable gifts are calculated by adding the total amount of taxable gifts made since December 31, 1976, to the total taxable gifts for the current year. Only cumulative taxable gifts in excess of \$1,000,000 (for 2003) will result in out-of-pocket gift tax payments by the donor. Under the

Economic Growth and Tax Relief Reconciliation Act of 2001, the applicable exclusion amount will gradually increase until it reaches \$3,500,000 in 2009.

### What About Life Insurance Gifts?

For many individuals, life insurance can be the single largest asset in their gross estate. If this is true in your case, you may wish to consider how to shield the death benefit proceeds from federal estate tax liability. If, at your death, you own a life insurance policy, the death benefit proceeds will be included in your gross estate and could be subject to federal estate taxes (depending on the size of your estate).

An **irrevocable life insurance trust (ILIT)** can be set up to be the owner and beneficiary of a new policy. The use of this type of trust has been widely regarded as an effective means for removing life insurance policies from the taxable estate of the insured. When properly drafted, this trust can eliminate the death benefit proceeds not only from your gross estate, but also from the gross estate of the trust's beneficiary.

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**If a transferred policy has a cash value exceeding the annual exclusion allowance, a federal gift tax may apply.**

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If you plan to use an existing policy, you must live for more than three years following the transfer. Otherwise, the policy proceeds will be included in your taxable estate. Also, keep in mind that if the transferred policy has a cash value exceeding the annual exclusion allowance, a federal gift tax may apply. For a new policy, the *trust* should be designated as the owner and applicant.

An **outright gift** is another method of removing life insurance from your gross estate. You can accomplish this by gifting ownership of your policy to a third party (such as a child or favorite charity). If the transferred policy's value exceeds the annual exclusion allowance, federal gift tax may be incurred. Please bear in mind, as is the case with any transfer of policy ownership, the donor must live for more than three years after the transfer. If the donor dies within three years of the transfer, the proceeds of the policy will be included in the gross estate of the decedent.

### Estate Planning Pointers

A well-structured estate plan is invaluable. Through it you can control the distribution of your assets and possessions, as well as name guardians for your children or plan care for other dependents.

While the process of planning your estate can raise some difficult emotional and personal issues, your heirs will be glad that you did so, and you will be comfortable knowing that your wishes are assured.

### How Should You Begin?

Your first step should be to assemble a competent, professional, estate planning team. Your attorney, financial professional, insurance professional, bank trust officer, and/or accountant are all possible members of your team, depending on the size and complexity of your estate.

### What needs to be Gathered?

A thorough estate analysis requires the gathering of any and all materials involving current or future income, property ownership, insurance policies, and any legal arrangements already in place. Once assembled, a complete analysis can begin, giving you the basis for a solid estate plan.

### Steps to Estate Preservation

If you begin planning in a timely fashion, there are clear, legitimate methods that allow you to *preserve* your estate and help *minimize* estate taxation while satisfying both the Internal Revenue Service (IRS) and the courts. Such steps would include:

- **Draft a Will.** A will is a formal, legal document instructing your survivors in the settlement of your estate. It is crucial to the success of your estate plan that your will be properly written by a qualified, experienced, legal professional and witnessed simultaneously by two parties.

- **Establish Trusts.** Utilizing trusts can be an excellent method of accomplishing long-term estate planning goals. Trusts, while seemingly complex, are powerful tools designed to help individuals handle a variety of family and tax-related problems.

- **Use Your Estate Tax Exclusion Amount to the Fullest.** Each individual can pass \$1,000,000 (for 2003) to his or her heirs free of estate or gift taxes. Married couples, who structure asset ownership correctly, may pass \$2,000,000 (for 2003) to their heirs free of estate or gift taxes.

- **Plan a Gifting Program.** Further tax shielding is gained through the use of the **annual gift tax exclusion**. This allows the gifting of up to \$11,000 each, indexed for inflation (for 2003) to any number of donees annually without the payment of gift tax. (When a spouse is involved in the gifting program, the annual exclusion increases up to \$22,000 per donee, for 2003.) Provision must be made for the immediate use of the gift by the donee; gifts of future interest will not qualify.

- **Plan Your Charitable Bequests.** The value of all property transferred for "charitable" or "public" purposes is deductible, with certain limitations, when determining valuation of an estate for tax purposes.

- **Utilize Life Insurance to Its Fullest Advantage.** Life insurance can fulfill two important functions in your estate planning. First and foremost, it can help provide for the immediate cash needs of your spouse or other beneficiaries.

Second, and of equal importance, the use of an **irrevocable life insurance trust (ILIT)** can prevent inclusion of your life insurance proceeds in your estate and help your executor pay your estate tax bill without having to sell estate assets.

■ **Title Assets Properly.** The simplest and least expensive estate planning technique for married couples may be to take title of assets as “joint tenants.” This will exclude assets from probate and may eventually save legal costs.

[*Note:* Residents of community property states should remember that all income and assets acquired by a married couple living in those states—except for individual gifts and inheritances—are considered **community property**, half of which is included in each spouse’s estate valuation.]

## Life Insurance— How Much is Enough?

You probably are aware it is important to have enough life insurance coverage to handle the financial contingencies that may affect your family in the event of your death. However, determining the necessary amount of life insurance can be complicated. One general rule of thumb is that you should have enough life insurance to equal five to seven times your annual salary. However, to be more specific, you may want to determine the “right” amount of life insurance coverage with a careful “Needs Analysis,” rather than using an arbitrary formula.

The Needs Analysis approach incorporates an evaluation of a family’s most important financial obligations and goals. This includes insurance coverage for mortgage debt, college expenses, future family income, and liquidity for meeting future estate tax liabilities.

### Mortgage Debt

The first point worthy of consideration is whether your life insurance proceeds will be sufficient to help pay the remaining mortgage on your home. If you are carrying a large mortgage, you may need a sizable amount. If you own a second home, the mortgage on that home should also be factored into the formula.

### College Expenses

Many people want life insurance proceeds large enough to help cover their children’s college expenses and, possibly, graduate school. The amount needed can be roughly calculated by matching the ages of your children, against projected college costs adjusted for inflation. This calculation should be revised periodically as your children get closer to college age, and it may be a good idea to be as conservative as possible when estimating long-term savings goals.

## Continuing Income for Your Family

The amount of income you will need to help provide for your surviving spouse and dependents will vary greatly according to your other assets, retirement plan benefits, Social Security benefits, age, health, and your spouse’s earning power. Many surviving spouses may already be employed, or will find employment, but their income is based on education, training, and experience. Your spouse’s income alone, may be insufficient to cover the monthly expenses of your family’s current lifestyle. Providing a supplemental income fund can help your family maintain its standard of living.

### Estate Taxes

Life insurance has long been recognized as an effective method for establishing liquidity at death to both pay estate taxes and maximize asset transfers to future generations. However, this use of life insurance requires qualified legal expertise to help ensure the proper results.

### Existing Resources

If your current assets and retirement plan death benefits are sufficient to cover your financial needs and obligations, you may not need additional life insurance for these purposes. However, if they are inadequate, the difference between your total assets and your total needs may be funded with life insurance.

There are many factors to consider when completing a Needs Analysis. In addition to the areas already mentioned, some other questions you might want to address are:

1. How much will Social Security provide and for how long?
2. How do you “inflation-proof” your family income, so the real purchasing power of those dollars does not decrease?
3. What is the earning potential of your surviving spouse?
4. How often should you review your Needs Analysis?
5. How can you use life insurance to help provide retirement income?
6. How do you structure your estate to reduce the impact of estate taxes?
7. Which assets are liquid and which would not be reduced by a forced sale?
8. Which assets would you want your family to retain because of future growth possibilities or sentiment?

Life insurance can play a major role in any family’s financial protection. As you develop an insurance strategy, remember to analyze your existing policies. Calculate the additional coverage you may need based on your family’s financial obligations and any other resources, such as retirement benefits and savings.

## Items of Interest...

### Non-Itemizers Could Receive Charitable Tax Break

There's a legislative proposal within the Senate that, if ultimately adopted, would enable more people to claim tax deductions for charitable gifts.

The bill would let taxpayers—who don't itemize—claim up to \$250 of donations on a single return, and up to \$500 on a joint return. However, the tax provision would *not* apply to the first \$250 or \$500 given in gifts, but to the "second" \$250 or \$500 in donations.

Here's an example: A single taxpayer gives \$300 in charitable donations. The first \$250 is ignored for deduction purposes and only \$50 would be applicable. If \$500 were donated, the first \$250 is not counted, but the second \$250 would be. If a \$600 gift is made, then the first \$250 is ignored and the next \$250 could be deducted. The remaining \$100 could not be counted because it exceeds the \$250 limit.

In other words, to take maximum advantage of this proposal, single taxpayers could contribute \$500 and those filing jointly could contribute \$1,000. Since taxpayers who do not itemize get a deduction for donations as part of their standards deductions, the Senate proposal is intended to "reward" those who are more charitable. The bill would ultimately require a Treasury Department study of its impact on giving and compliance.

### ***Your Name Here***

*Street Address*

*City, State, Zip*

### Limited-Time Deductions for Hybrid Electric Vehicles

Anyone purchasing a hybrid electric vehicle (HEV) this year is eligible for a \$2,000 tax deduction, which translates into a tax savings of \$200–\$762, depending on tax brackets.

The HEV deduction is scheduled to decrease by \$500 per year, beginning in 2004. It will be completely phased out on January 1, 2007. HEVs combine a combustion gas engine with an electric motor. The hybrid models are currently being produced by Honda and Toyota.

To claim an HEV deduction, taxpayers report the \$2,000 deduction on line 34 of their Form 1040 and write "Clean Fuel" in the margin. Sole proprietors, who use a hybrid car for their businesses, can claim the deduction on their Schedule C.

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### Thanks for the referrals!

If you think this newsletter would be of interest or help to friends or associates, let us know and we will be happy to add them to our mailing list.

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