August 1, 2002

COMMENTS - AUGUST, 2002

MONEY, BANKING AND CREDIT

- Even if you bounce just one check, you are likely to be turned down if you tried to open a checking account at another bank. The reason is most banks report bounced checks to a central agency known as the interbank ChexSystem. Since it retains the bounced check data for five years, even if you attempt to open a new account at another bank, your application may be rejected throughout the 5 year period, even though you have not bounced any other checks. One way of avoiding these consequences is to establish an overdraft protection arrangement with respect to your checking account. Here, the bank will honor checks which exceed the checking account balance up to a prescribed amount, and will usually require you to maintain another account at the bank. The overdraft on the checking account will then be treated as a bank loan and will be subject to interest. You may be upset at the thought of paying interest on a bank loan when you have funds in another account at the same bank, but remember you will be avoiding fees in the range of $25 associated with bounced checks, and you will be protected against a negative credit report.

PENSION AND ESTATE PLANNING

- The use of trusts can be an effective tool in providing a surviving spouse with flexibility about distributions from retirement plans while preserving tax deferral. In one recent situation, the taxpayer's husband died before reaching the required age for taking distributions from his retirement plan which was set up with a trust as beneficiary of the decedent's retirement income. Upon the husband's death, the trust was divided into two subtrusts, a marital and a remainder subtrust, with the widow as sole trustee. In general, if a decedent's retirement plan interest is payable to a trust and is paid to a trustee who, in turn, distributes it to the surviving spouse, the survivor is deemed to receive the proceeds from the trust instead of the decedent. This would make the surviving spouse ineligible to roll over or transfer the proceeds to his or her IRA and would eliminate any opportunity for further tax deferral. There is an exception to this rule if the survivor spouse is the sole trustee and pays the plan proceeds to him or herself after demanding payment in compliance with trust language, since then, the proceeds must be transferred into an IRA set up and maintained in the survivor's name. To avoid loss of tax deferral, the widow as sole trustee, and pursuant to the terms of the trust, proposed allocating a portion of the decedent's retirement plan interest to the marital subtrust. Subsequently, she, as surviving spouse, would demand payment of the retirement plan amounts allocated to that subtrust and roll the amounts over into an IRA in her own name. The rollovers would occur within 60 days of the distributions to the subtrust. According to the IRS, the plan proposed by the survivor satisfied the exception to the general rule, enabling her to defer income tax on distributed amounts from the decedent's retirement plan. With proper professional advice, taxpayers can achieve a variety of tax favorable objectives in connection with pension plan distributions.

- The Pension Benefit Guaranty Corporation has made it clear it will not raise pension insurance premiums for defined benefit plans in the near future. Currently, employers with these plans pay a premium of $19 per participant (more if the plan is underfunded) to the PBGC. The reason the Agency has provided this reassurance is there has been concern about premium increases because of a number of major bankruptcies where the PBGC has incurred pension liabilities. The Agency says that because there have been few situations in which it had to bail out participants in underfunded pension plans in recent years, it has ample reserves to meet its obligations without having to raise premiums. In a separate matter, the Agency has increased the maximum amount it guarantees for retirees in underfunded single-employer defined benefit plans by 5.5% to $3,579.55 per month or $42,954.60 per year. The adjustment is mandatory based on changes in factors used by the Social Security Administration to calculate benefits.

Defined benefit pension plans in which the pension payout is based on a formula which is applied to the final years' average earnings of the employee are probably the best employee benefit offered by employers because they assure workers a set annual income for life. However, these arrangements are quite costly when investment returns are poor since the amounts needed to be set aside to fund the pension have to be raised. In light of this, many companies are shifting their focus and adopting cash balance plans and 401(k) defined contribution plans where employers match employee contributions. Although employees are generally enthusiastic about 401(k) plans, the results are largely dependent on the employee's ability to select suitable investment options, and the ultimate pension is uncertain if funds are invested in fluctuating assets. According to recent data, employer matching of 401(k) plan contributions averages 3.6% of salary for employees whose average contribution is 6% of pay. About 35% of companies also provide a profit sharing plan independent of the 401(k). Profit-sharing contributions average 5.7% of workers' pay, according to a survey of 100 Fortune 500 company pension benefit executives. Many clients consult us regularly to review existing pension arrangements, and evaluate alternative options that may be effective in meeting pension objectives.

Here is a reminder that there is a new "saver's" tax credit in effect for 2002, for low to middle income taxpayers who make contributions to an IRA or an employer-sponsored retirement plan. To be eligible, joint filers may not have more than $50,000 in adjusted gross income, and adjusted gross income can not exceed $25,000 on a single return. The credit ranges from $200 to $1,000 at the maximum income limit and dependents, full-time students and workers under age 18 are ineligible regardless of income. In general, the lower the adjusted gross income, the greater the "saver's" tax credit. Furthermore, eligible contributions for 2002 are reduced by taxable retirement plan distributions received between January 1, 2000, through April 15, 2003, as well as by any non-taxable Roth IRA distributions within the same period, unless they were rolled over. Since the credit is an additional tax benefit, eligibility is not affected by the fact that contributions to an IRA are deductible or that salary reduction contributions are excluded from gross income. The credit offsets both regular income tax and alternative minimum tax liability.

PERSONAL FINANCIAL PLANNING

Are you aware there are now 18% and 8% capital gains tax rates? The 18% rate applies to assets acquired after 2000 and held more than 5 years, by taxpayers whose tax bracket exceeds 15%. The 8% rate is applicable to taxpayers in the 15% or lower tax bracket, who have held assets for over 5 years regardless of when they were acquired. Taxpayers who want to avail themselves of the lower 18% capital gains tax rate will have to make a "deemed sales and purchase" election on their 2001 tax return. This involves changing the

purchase date of any of their stock market holdings to January 2, 2001, for tax purposes and paying the capital gains tax on any paper profits they have made up to the time of the election. In turn, the subsequent gains on the securities will become eligible for the 18% capital gains rateon sales after January 2, 2006. By making the election, the taxpayers increase the tax basis on the respective securities now and reduce the amount of appreciation which will be taxed at the 18% rate after 2005. In view of the lower 10% capital gains rate for those in the 15% or lower tax bracket, taxpayers should also consider making gifts of appreciated stock to children who will be in the 15% or 10% tax brackets and letting them sell the shares while being only taxed at the rate of 10%. Better still, if the securities already have been held over 5 years, the tax would only be at the rate of 8%. Whether it pays to lock in an extended holding period to lower the capital gains tax rate 2% is just one of the considerations you have to evaluate before making the election. You should also be aware the lower capital gains tax rates not only apply to stocks and bonds, but also to other types of capital assets such as investment property and shares in a closely held business.

Section 529 plans "state sponsored tuition savings programs" have become very popular because they permit parents and grandparents to fund a future college education for children and grandchildren and other relations in an amount of $11,000 per year, per beneficiary on a tax favored basis. The contributions reduce the size of the estate of the donor and are not subject to gift tax either, while the funds grow tax deferred in the account. Furthermore, the donors retain control of the funds and are able to make investment decisions with regard to them. Now, the plans have received some further sweeteners. Among them:

- Investments in one state's plan can now be rolled over tax-free into another section 529 plan once every 12 months.

- Taxpayers can now contribute to both a section 529 plan and an education IRA for the same beneficiary in the same year.

- The definition of qualified higher education expenses has been expanded to include the cost of room and board as determined by each institution.

- For the purposes of rollovers and beneficiary changes, first cousins of the original beneficiary are now considered family members.

- Effective with 2002, withdrawals for educational purposes are tax-free.

States may also provide added tax benefits for section 529 plans, making these even more desirable tax and education planning devices.

TAXATION

Here are examples of what the IRS focuses on in selecting returns for audit. The Agency evaluates tax returns in terms of their audit potential, i.e., conditions which would suggest there might be significant potential for increased tax liability upon audit.

- Computation errors.

- Factual errors such as transposition of a social security number.

- Unreported income which is included on information returns to the IRS.
- Repeated deduction of hobby losses as business deductions.
- Having income in excess of $100,000.

While there is no fool-proof way to insulate any tax return from an IRS audit, professional tax return preparation can go a long way towards avoiding situations which are audit triggers.

The IRS has announced a new audit based National Research Program to measure tax payment, filing and reporting compliance. Initially it will focus on individual tax returns, and eventually it will be expanded to corporate and other taxes such as employment and excise taxes. Under the program, which will go into effect in September, 2002, the IRS is planning to conduct slightly fewer than 50,000 audits using the following four basic approaches:

- No IRS contact - using data already provided to the IRS. (8,000 returns)
- Correspondence - using correspondence with the taxpayer. (9,000 returns)
- Partial audit - using IRS data and focusing on select parts of returns. (30,000 returns)
- Calibration audits - line-by-line examinations. (2,000 returns)

The IRS says the 50,000 returns will come from the pool of 600,000 to 800,000 individuals who would be audited in any event. In response to criticism about its intentions, the IRS has stated the new program will be considerably less intrusive than the former "taxpayer compliance audit program" which required taxpayers to substantiate every entry on the return. One reason for reinstituting a tougher taxpayer audit program was based on a survey by the IRS Oversight Board in which 76% of respondents felt they should cheat and an increasing number of Americans are cheating on their tax return. Clearly, taxpayers will be subject to closer scrutiny once the new program is implemented.