Price & Farrington's Estate and Tax Planning *Fast* Faxts

October, 2002

Estate, Tax and Wealth Planning For Advisors and Clients

Price & Farrington

Attorneys and Counselors at Law

12501 Bel-Red Road, Suite 215

Bellevue, Washington 98005

425-451-3583

Email: pricefarr@aol.com

Fourth Quarter Planning in These Terribly Tricky Times

Happy Halloween!

With the economy stumbling and the stock market still struggling to rebound, the resources you have to provide for your own future and that of your family may have been reduced. If so, here's how our clients can improve their estate planning and use fourth-quarter financial moves to lower their 2002 tax bills.

Taking Stock. Investors should perform a "portfolio cleanup" to sell some holdings that have declined, along with some winners. Many people have held onto stocks for a long time because they do not want to pay the capital gains tax. But capital losses offset capital gains dollar for dollar, so selling portfolio losers may let shareholders recognize their gains in the same year with no tax liability.

What's more, if you have a net capital loss of up to $3,000 it can offset ordinary income. For a middle-class taxpayer, that can mean total savings of more than $1,000 on federal and state taxes. Anything over $3,000 is carried forward indefinitely to future years.

Many people don't want to abandon quality stocks that are down in price. But it is possible to hold on to the stock yet recognize the loss for tax purposes by buying an equal number of shares of the same issue before Nov. 29 and selling the original holding before Dec. 31. You can't just sell the stock and buy it right back. That would run afoul of what is known as the wash-sale rule, under which a loss will not be recognized for tax purposes if a taxpayer buys the same issue within 31 days. Still, if you are holding a losing position you might consider selling now and buying back into it after 31 days if you don't have the idle cash to double up.

Giving. charitable gifts can also reduce taxes. If you give appreciated securities to charity, you can deduct the fair market value and owe no capital gains tax on the appreciation. You should be sure the securities are out of your account and into the charity's account by the end of the year to get the deduction. If a stock is down, however, as many are this year, it is better to sell it, take the capital loss and then donate the proceeds to charity.

Strategies for gifts can be used to lower estate and income taxes. This year, individual gifts of up to $11,000 per recipient have no gift or estate tax consequences. Up to five years' worth of gifts can be made at once to a state-sponsored Section 529 college savings plan. This means that a married couple could put $110,000 into a plan for a child or grandchild with no gift-tax consequences. The money would be out of their estate and when it was distributed for qualified college expenses the earnings on the money would be tax-free.

Parents who have invested over the years for their children's education often sell securities to pay tuition and other expenses, and then owe taxes of up to 20 percent on any long-term capital gains. As an alternative, they can give up to $11,000 in stock to a student who has little or no other income, and the student can sell it to pay the expenses himself or herself. He or she will be taxed at just 8 percent on gains on stocks the parents held at least five years.

"Market trauma – lots of it going around."

529 Plans: Yeah or Nay? Consider managing children's college savings yourself. While there are significant tax advantages to giving money to a Section 529 plan or to a custodial account, be sure the tax advantages outweigh your economic uncertainty. If you put college savings in a child's name – such as through a Section 529 plan or Uniform Transfers to Minors Act account – you make a completed gift, although you can get the money back from a 529 plan by paying a penalty. This can be especially risky if your job is in jeopardy or your earnings and savings declined dramatically. You can't foretell what your own needs will be then, and the child might not even go to college.

It's more conservative to manage the funds yourself in case you need them – and you can still get tax advantages by doing so. If you save using capital gain assets (such as mutual funds), you can cash in gains at favored long-term tax rates.

Poking fun...

Lawyer: An individual whose principal role is to protect clients from other members of the profession.

He's a real lawyer. In fact, he even named his daughter Sue.

My attorney is brilliant. He didn't bother to graduate from law school; he settled out of class.

-Milton Berle

I think I have to get a higher-priced lawyer. The judge said I was exonerated and my lawyer appealed.

I broke a mirror in my house, which is supposed to be seven years' bad luck. My lawyer thinks he can get me five.

-Steven Wright

Even better, you may be able to cash in the gains at the child's lower or zero tax rate, making a gift of the investment assets to the child and letting the child cash them in to finance his/her own expenses. Children age 14 or older aren't subject to the kiddie tax and currently can take as much as $750 of investment income tax-free. After that, their first $6,000 of ordinary taxable income is taxed at only 10 percent.

Go direct. If you pay tuition on behalf of a child directly to an educational institution, gift tax doesn't apply at all. So, you can make an $11,000 (or $22,000) gift to the child using your annual exclusion and pay any additional amount of tuition for the child directly to the school, free of gift tax. But placing wealth in a child's name can also reduce the child's eligibility for tuition assistance, compared with having the same funds held by parents or grandparents. Rules vary by the kind of arrangement – and may well change in the future, so this is something else to consider with an advisor before putting savings in a child's name.

Retirement planning. Tax-deferred retirement plans are a good way to lower tax bills, and the contribution limits are higher this year. Employed people may put up to $11,000 in a 401(k) or 403(b) plan; those 50 and older can put in an extra $1,000 under new catch-up provisions. Contribution limits for Individual Retirement Accounts are now $3,000, or $3,500 for those 50 and older. Many self-employed people could put away more for retirement because the income limits upon which the contributions are calculated have risen this year. For a SEP I.R.A. the limit is $200,000.

Other plans for self-employed people are money-purchase and profit-sharing plans. And don't overlook learning more about little-known, but powerful 412(i) plans, which allow up to $300,000 in tax-deductible dollars to be contributed to the plan each year! By law, all of these plans must be set up before Dec. 31, although people can wait until the due date of their tax returns to put the money into the account. The wait gives taxpayers or their tax preparers time to complete the complex calculations needed to figure the right amount.

The Roth way. Another way to take advantage of the market's downturn is to convert a traditional I.R.A. to a Roth I.R.A. These conversions are allowed for taxpayers whose adjusted gross incomes are below $100,000, but taxes must be paid at conversion. (That's because pretax money has gone into a traditional I.R.A., while after-tax money goes into a Roth I.R.A., allowing retirement distributions to be free of tax.) In previous years many people who wanted to convert to Roth I.R.A.s felt that they could not afford the tax bite. Now people can use the depressed value to their advantage, taxwise.

Other tax savings are available to people aged 70½ or older who are required by law to take distributions from I.R.A.s and retirement plans. The minimum distributions rules were recently revised downward to reflect longer life expectancies, allowing more money to accumulate in the account tax-deferred.

Don't bypass the "bypass" trust. A married couple can use two estate tax exemptions of up to $1 million each (in 2002 and 2003) to pass up to $2 million to heirs free of estate tax. To do this, the first spouse to die must make separate bequests of up to $1 million into a "bypass trust" to use up his/her exempt amount, before leaving the rest of his estate to the surviving spouse.

The "bypass trust" can pay income to the surviving spouse for life if the spouse needs it, and then distribute its proceeds to children or other heirs. If your wealth has declined, directing a full $1 million into the bypass trust might leave *too little* to your spouse. Even if the assets are placed in a bypass trust that can pay income to the spouse, the payouts may place the spouse in conflict with other heirs. Instead, increase outright (non-trust) bequests so your spouse is well-provided for first. Reduce other bequests and amounts left to a bypass trust accordingly.

Rebalancing. Bequests to different heirs of different assets that once had equal value

"Do we have a place for our portfolio's ashes?"

now may have very different values – such as if one was funded with shares of stock that have lost value and another was funded with real estate that has gained value. If you still want to make equal bequests, rebalance them now and take steps to keep them in balance in the future. As an example, after bequests of specific property are provided for, give your executor or trustee the power to distribute your remaining cash and liquid assets among heirs in a "balanced" manner.

"Sprinkle trust." If your wealth has been significantly reduced, bequests of equal value to several heirs may not be sufficient in size to assure the welfare of all when heirs are in different financial circumstances. Leave assets in a "sprinkle trust" that gives the trustee the power to distribute its assets and income in accordance with personal needs and according to your instructions. That way, your more limited funds will be better targeted to heirs who need the money.

Funding bequests with life insurance. People who purchase life insurance to finance expected future estate taxes should think hard before letting the insurance lapse if their estates have diminished to the point where estate tax is no longer an issue. If you have such insurance, consider keeping it to finance bequests to heirs, now that you will be able to fund only smaller bequests from your estate. The insurance proceeds may offset the reduction of the rest of your estate. And remember, if insurance is properly held in a life insurance trust, the proceeds will avoid estate tax.

Don't hesitate to contact us if you think we can be of help.

Lack of education doesn't excuse estate taxes increased by poor estate plan. Earl Koester had only an eighth-grade education, but amassed more than $1million in wealth. When he died, more than $100,000 of estate tax became due. His estate argued that the tax was unfair because a sophisticated individual could have planned to avoid tax on an estate that size, while someone with Koester's limited education couldn't. *Tax Court:* Koester could easily have afforded expert tax advice, and in fact had an attorney draw up his estate plan. So the tax remains due.

Estate of Earl C. Koester, TC Memo 2002-82