

# CPA CLIENT

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# TAX LETTER

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### Correction

In an article on IRAs, on page 2 of the April/May/June 2007 *Client Tax Letter*, we stated the deadline for 2006 IRAs as April 17, 2006; that date should have been stated as April 17, 2007. We apologize for any inconvenience or confusion this may have caused.

CPA<sup>SM</sup>

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## Time to Renew Attention to Estate Tax

With the Democratic majority now firmly entrenched in Congress, it appears that the prospect of an estate tax repeal is less likely than it was with a Republican majority.

Therefore, it seems that the federal estate tax will remain in effect, at some level. Tax planning can reduce the burden your heirs may face. To plan efficiently, you should know the basics of the current law.

### Repeal and reappearance

A tax credit now exempts amounts up to \$2 million from federal estate tax. That was the level in 2006 and it is scheduled to remain through 2008.

Under current law, the exempt amount will rise to \$3.5 million for estates of decedents who die in 2009. In 2010 the federal estate tax is slated to be repealed—but the tax will appear again in 2011, with an exempt amount of \$1 million.

Practically speaking, it appears unlikely that the exemption will revert to \$1 million; it might be set at \$2 million or at some higher level. Similarly, in 2001, the maximum tax rate on estates, now 45%, is scheduled to go back up to 55% (60%, including a surtax on some estates); but it may not go that high. In fact, there have been proposals to drop the estate tax rate below 45%.

Faced with such uncertainty, planning is difficult. One approach is to plan as if death will take place this year, with the current exempt amount and tax rate. Then your plan can be modified if and when the law changes.

### The exemption

Under current as well as prior law, you can leave unlimited amounts to a spouse and to charity, free of estate tax. The exemption refers to the amount you can leave to other heirs and beneficiaries. At present, the first \$2 million is tax-free while excess assets are taxed at 45%.

For example, if someone dies in 2007 and leaves \$3 million to his child, his bequest is \$1 million over the exemption amount, and his estate would owe \$450,000 in federal estate tax (45% of \$1 million). The estate might owe state estate tax, too. (State estate tax payments are deductible on a federal estate tax return.)

### Prudent planning

Therefore, under current law, a married couple can leave up to \$4 million to their heirs (who might be their children), free of estate tax.

Suppose a couple has \$4 million worth of assets: a house, IRAs, securities, and so on. The first spouse to die could leave \$2 million to the children.

If the survivor also dies with \$2 million in assets, the children could wind up with the entire \$4 million, and no federal estate tax would be due.

### Title tactics

There are, however, several obstacles that could interfere with this type of planning. One obstacle might be the ownership of assets.

Suppose, for example, \$3 million of the couple's assets are held jointly, with right of survivorship, while each has a \$500,000 IRA. Say the husband, Carl, dies first.

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His spouse, Diane, will automatically become the sole owner of the joint assets, in addition to her IRA. If she dies soon after Carl, she will thus have a \$4 million estate.

Assuming today's laws are still in effect, her estate will be \$2 million over the exemption amount and will owe \$900,000 in federal estate tax, at the 45% rate.

Therefore, part of a successful estate tax plan is seeing that assets are owned in such a way that they can pass to intended heirs and utilize the federal tax exemption.

**A matter of trust**

Another obstacle that may arise is a desire to provide adequately for the surviving spouse.

Suppose in the above example Diane is much younger and healthier than Carl. He is concerned that she

will outlive him by many years. Even if Diane has \$2 million in assets after Carl's death, that might not be enough to assure her of a comfortable lifestyle for decades.

One popular estate planning strategy is the use of a "bypass" trust. In our example, Carl leaves \$2 million to the trust. The trust beneficiaries include Diane and the couple's children.

This trust can use up Carl's \$2 million estate tax exemption. At Diane's death, the trust assets will not be included in her estate so they will "bypass" estate tax altogether. Diane can leave another \$2 million to the children, so the entire \$4 million can pass to the next generation, tax-free.

In the meantime, the trustee of the bypass trust will be able to provide Diane with trust assets, if necessary, so that Diane is less likely to face any financial stress.

Current Estate Tax Law		
Year of Death	Estate Tax Exempt Amount	Tax Rate on Excess Assets
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A	N/A
2011	\$1 million	41%-60%

Sources: IRS, Center on Budget and Policy Priorities

The above example is necessarily a simplified description of what is certainly a very exacting planning process. To get the desired results, it is crucial to work with knowledgeable legal and tax professionals. Our office can help you develop a plan that is specific to your circumstances.

## Savvy Giving Can Help Your Heirs Thwart the Tax Collector

If estate tax is a possibility, giving away some assets during your lifetime can reduce the burden your heirs may face.

**That uncertain feeling**

As mentioned in the previous article, under current law, unlimited amounts can be left to a spouse and to charity, free of federal estate tax. Other heirs can receive a total of \$2 million, tax-free, when deaths occur in 2007 or 2008. Excess amounts are taxed at 45%.

Suppose, for example, John Smith died several years ago and left his entire estate to his wife Jane. In 2008, Jane dies with an estate worth \$3 million. She leaves \$100,000 to various charities and the \$2.9 million balance to the couple's children.

As a result, Jane's taxable estate is \$900,000 over the \$2 million exempt amount. Thus, the estate will owe \$405,000 in federal estate tax: 45% of \$900,000. Depending on where Jane lived at her death, state tax also may be due.

Planning is difficult because there is no knowing how much the estate tax exemption will be in the future, or what the rate will be. Under current law, there will be a \$1 million exemption for deaths after 2010, with rates as high as 60% in some situations.

Your best strategy is to keep track of all your assets, including real estate, retirement accounts, life insurance death benefits, securities, and bank accounts. If the total is likely to run into seven figures, con-

sult our office about tax reduction techniques.

**Pay medical and education bills**

If you are reasonably certain that you and your spouse can live comfortably without some of your current assets, consider making gifts to loved ones. Astute tactics will reduce your taxable estate yet not expose you to any gift tax (explained below).

Among those tactics, you can make unlimited payments for someone else's medical bills or education tuition. No gift tax will be due.

Suppose Tom Brown has three children. In 2007, they incur a total of \$10,000 in unreimbursed medical bills. Tom can pay those bills, reducing his estate by \$10,000, and not incur any gift tax consequences.

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In this scenario, suppose that Tom also has five grandchildren: one in private elementary school, two in private high school, and two in college. Their total tuition bills are \$75,000 in 2007. Again, Tom can pay those bills, reducing his estate by \$75,000, and not have to worry about gift tax.

To take advantage of the gift tax exceptions for medical and tuition payments, Tom must send checks directly to the health care providers and the schools.

In fact, Tom can pay multiple years of tuition directly to his grandchildren's schools, if he wants to get more assets out of his estate immediately. The IRS has approved this tactic in a private letter ruling. In its ruling, the IRS said this maneuver would be acceptable as long as the child has been accepted at the school.

Private rulings cannot be relied upon by all taxpayers but they do provide some comfort if you want to follow a similar strategy. However, if you make such an advance payment, be aware that no refund is likely if the child stops attending that school.

**Employing the exclusion**

In addition to medical and tuition bills, you can make unlimited gifts to a spouse and to charity without worrying about the gift tax. Beyond such gifts, an annual gift tax exclusion allows you to make other transfers, tax-free.

Currently, the exclusion is \$12,000 per recipient per year. This amount

**Loss Harvesting, Year-Round**

Year-end tax planning often includes selling securities at a loss. However, this tactic need not be limited to November and December.

Instead, investors can and should take losses throughout the year. One study concluded that ongoing loss harvesting over 25 years could produce 14% more wealth for a top-bracket investor than a passive approach, thanks to the effect of reinvested tax savings.

increases periodically in \$1,000 increments, to keep pace with inflation.

Thus, beyond medical and education payments, Tom Brown in the above example can give up to \$12,000 worth of assets to his son Paul this year, \$12,000 to his son Rick, and \$12,000 to his daughter Sally. He also can give \$12,000 to each of his five grandchildren.

Thus, Tom can reduce his estate by as much as \$96,000 this year, with eight gifts of \$12,000. Married couples can give away up to \$24,000 per recipient, in 2007.

**Higher math**

Gifts made via contributions to 529 college savings plans can be front-loaded, up to five years' worth of gifts. Thus, if any of his grandchildren is the beneficiary of a 529 plan, Tom can contribute up to \$60,000 (five times \$12,000) to the plan this year. Such gifts effectively use up his gift tax exclusions, in advance.

Suppose, for example, that Tom gives \$60,000 to a 529 plan for his grandson Wayne and dies the same year. The current year's \$12,000 gift will be excluded from Tom's estate but the other \$48,000 will be included.

**Above the limit**

To continue the previous example, suppose Tom writes a \$25,000 check to his son Paul this year. Assume he makes no other transfers to Paul in 2007.

Of that \$25,000, the first \$12,000 is covered by the annual gift tax

**The 10% solution**

One strategy calls for taking losses immediately, every time a stock or mutual fund registers a 10% loss. If you invest \$10,000 in a growth fund, for example, and it dips to \$9,000 on a market drop, you can take the \$1,000 loss.

You can immediately reinvest that \$9,000 in another growth fund, maintaining your asset allocation. This maneuver won't trigger the "wash-sale" rule and your tax loss will not be disallowed.

Taking repeated tax losses will work best if you invest in no-load

**Current Gift Tax Law**

Year of Gift	Gift Tax Exempt Amount	Tax Rate on Excess Gifts
2007-2009	\$1 million	41-45%
2010	\$1 million	35%
2011	\$1 million	41-55%

*Sources: State Farm Insurance, Bankrate.com*

exclusion but the other \$13,000 is not. That \$13,000 must be reported on a gift tax return, IRS Form 709.

In addition to the exclusions mentioned above, each taxpayer is entitled to a \$1 million lifetime gift tax exemption. As long as Tom has not used up his \$1 million exemption, he just reports this \$13,000 taxable gift. No tax need be paid.

If Tom has not made any taxable gifts before, his \$13,000 gift reduces his \$1 million gift tax exemption to \$987,000. Once Tom exceeds \$1 million in lifetime taxable gifts, future gifts will generate a tax obligation for Tom to pay, at rates from 41% to 45%.

At Tom's death, all the taxable gifts he has made will reduce his estate tax exemption.

Suppose Tom dies in 2008, when the federal estate tax exemption is \$2 million. Tom has made \$200,000 in taxable gifts. Thus, his estate tax exemption effectively will be \$1.8 million, not \$2 million.

mutual funds or if you trade through a discount broker. If you pay full-service commissions, you should take losses only if the value of the tax savings outweighs the transaction cost.

**Building a bank**

By taking losses regularly, you will build up a bank of losses. Each year, \$3,000 worth of net capital losses can be deducted from your taxable income, providing tax savings.

Excess net capital losses can be carried forward indefinitely. These accu-

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## When Fringe Benefits Are Deductible and Not Taxable

As defined in the tax code, "fringe benefits" can be any property or service that an employee receives, besides regular compensation. Examples include professional association dues, educational assistance, free coffee or soft drinks in the employee lounge, merchandise discounts to employees, or the use of a tennis court or other athletic facility that the employer provides for employees. Generally, outlays made by an employer for fringe benefits are deductible by the company, as long as such expenses are considered ordinary and necessary for the business.

### Best of both worlds

Some fringe benefits are doubly blessed—they are tax-deductible for the employer, and untaxed for the employee.

Employer-provided health insurance coverage is a familiar example. If your company pays all, or part, of the premiums for its employees, the company receives tax deductions, while the employees appreciate no taxable income. This occurs even if employees benefit from thousands of dollars worth of medical care during the year.

What's more, even though a company health plan is an important part of an employee's compensation package, neither Social Security nor Medicare tax is payable.

### S corporation complications

The above discussion of health insurance applies to regular C corporations. If your company is an S corporation, shareholders owning more than 2% of

the stock have to jump through some hoops to get the same deduction-without-taxation result.

In essence, health insurance must be acquired by the corporation, which can take the deduction for premiums paid as compensation rather than as a fringe benefit. That compensation is reported on the 2%+ owner's W-2 statement as taxable income. The 2%+ owner can then take an above-the-line deduction for that amount, as self-employed health insurance. The outcome: the 2%+ owner's adjusted gross income is not increased, but Social Security and Medicare tax is due.

Further difficulties may be encountered if the S corporation has only one employee, who is the 100% shareholder, in a state where such companies may not buy health insurance for that one employee. It may make sense to add a participating employee, such as the shareholder's spouse, which qualifies the company for group coverage.

### Working things out

Beyond health insurance, other types of fringe benefits are specifically excluded from income under the tax code. They include working condition fringes, de minimis fringes, no-additional-cost services, qualified employee discounts, qualified moving expenses, qualified transportation fringes, and qualified retirement planning services.

Working condition fringe benefits are those allowed as deductions to an employee who paid for them directly. Examples include employer-paid subscriptions to business periodicals, employer expendi-

tures for employee training, and the use of a company car for business purposes.

In one case (*Townsend Industries*, 8th Cir. 2003), an appeals court ruled that company-sponsored fishing trips qualified as working condition fringe benefits. These annual trips, open to all employees, involved four days at a resort in Canada, known for its fishing.

The IRS wanted the value of these trips to be included as taxable compensation, but the court decided that the company expected business benefits from interaction among employees. If your company sponsors a similar form of employee entertainment, their tax position will be stronger if you schedule regular business meetings with agendas and attendance requirements.

### Favored fringes

Other types of fringe benefits won't trigger taxable income. The de minimis exception, for example, refers to items too small for the records, such as doughnuts and coffee available to workers.

No-additional-cost services could include free passes for airline employees. Qualified employee discounts, such as those offered to department store employees, are not counted as taxable income.

Reimbursements for a work-related home move, and expenses for qualified transportation, such as transit passes, are also not taxable. A relatively recent change in the law allows outside professionals to provide untaxed advice to participants in an employer-sponsored retirement plan, provided that highly-compensated employees do not get more advice than other participants.

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culated losses may allow you to take capital gains when you wish, without owing any tax.

What's more, net capital losses can offset gains that occur elsewhere, out-

side of securities trading. Hedge funds, for example, can generate taxable gains each year.

Other gains might result from the sale of a business or investment prop-

erty. Losses that you've harvested from stocks or mutual funds can offset taxable gains from such activities.

## Learn the Limits of Mortgage Interest Deductions

You probably believe that mortgage interest payments are deductible; however, this is only true when it is up to tax-code limits.

There are two types of debt that can generate home-loan deductions:

**Acquisition debt:** This term refers to debt that was incurred to buy, build, or improve a home. You can borrow up to \$1 million for such purposes, and deduct the interest you pay.

**Home equity debt:** These loans are also secured by a home, but not necessarily to buy, build, or improve it. For ~~home equity loans, debt up to~~ \$100,000 will yield deductible interest.

### Debt as determining factor

Keep in mind that the \$1 million and \$100,000 totals refer to *the amounts you have borrowed*—they do not refer to home equity, or to the amount of interest you pay.

Suppose you borrow \$200,000 on a home equity line of credit. At an 8% interest rate, you pay \$16,000 in interest this year; however, only the interest on \$100,000 worth of home equity debt is deductible, which is \$8,000 for the year.

### Good news, bad news

The interest on \$100,000 worth of home equity debt is deductible, no matter how the money is used. You might, for example, use such a loan to pay off credit card debt, which does not generate tax-deductible interest and, which usually, has a higher interest rate.

There is a further limit; you can only deduct interest on a home equity loan to the extent that you have home equity. If your home is worth \$300,000 and acquisition debt is \$250,000, you can only deduct interest on \$50,000 worth of home equity debt.

Moreover, home equity debt is secured by a home. Remember that you could lose the home if you fail to make payments. Be sure that your ability to repay the loan is certain before putting your family home on the line.

### Double domiciles

The \$1 million and \$100,000 amounts for acquisition and home equity debt are aggregate totals. They can be applied to one or two residences.

A “home,” for the purpose of taking these interest deductions, can be ~~any property with sleeping accommodations, a toilet, and cooking facilities;~~ thus, you may be able to get deductions for loans secured by a mobile home, a recreational vehicle, or a boat, as long as those three tests are passed.

## Be Charitable With Concentrated Positions

Many investors find themselves heavily concentrated in one security, perhaps employer stock. Thus, they are vulnerable to weakness in that particular company.

One solution is to sell the shares and reinvest in a diversified portfolio. However, this may generate a large capital gain, if the shares have appreciated sharply.

### Sweet charity

Another approach is to donate some of the concentrated position to a donor-advised fund. Such funds are offered by

many local community foundations and by most large financial institutions.

You will get an immediate tax deduction for the donation. Over time, you can advise the fund to make gifts to specified charities.

Suppose, for example, you make a \$100,000 donation to such a fund. Assuming your AGI is large enough, you can take a \$100,000 tax deduction this year ~~and~~ save up to \$35,000 in income tax.

That \$35,000 can be invested in other securities, diversifying your holdings.

### Philanthropic future

Further suppose you are in the habit of donating \$20,000 per year to charity. For the next five years, your customary contributions can come from the donor-advised fund.

In the meantime, the money you would have sent to charity can be used to buy additional securities, further reducing the risk you have from ~~your concentrated position.~~

## Variable Annuities Offer More Than Just Tax Deferral

If 2006 was a good year for stocks, it was an even better year for sales of variable annuities (VAs). According to NAVA (the National Association for Variable Annuities, Reston, VA) “net flows” reached \$24.5 billion in the first nine months of the year, a 66.4% increase from the first three quarters of 2005. (Net flows are what are left after subtracting surrenders, with-

drawals, exchanges, and income payouts from total sales.)

Several reasons may help explain this surge.

### From bear to bull

The three-year bear market of 2000 to 2002 has now been succeeded by a four-year bull market, one that has sent the Dow Jones Industrial Average

to record levels. Variable annuities offer the chance to participate in stocks (chiefly, stock funds) while deferring income tax.

In most VAs, purchasers are offered a menu of investment accounts among which their premium dollars can be allocated. The menus generally include stock funds offered by highly regarded money managers and many investors

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choose to have their VA money heavily weighted in those equity accounts.

### Age-old appeal

In addition, demographics may account for increased interest in VAs. The oldest baby boomers turned 60 in 2006, which means that huge numbers of people are eyeing retirement in the foreseeable future.

VAs allow investors to accumulate funds now but pay tax later, perhaps after they retire and are in a lower tax bracket. Therefore, VAs may attract pre-retirees.

What's more, VAs can be annuitized, that is, converted to a lifelong income stream. This feature also may enhance the appeal of VAs to boomers who face the prospect of needing income over an extended life expectancy.

### Generous guarantees

In past years, the income tax deferral of VAs was a chief selling point. Today, though, tax benefits play a less important role in promoting VAs.

Instead, there is more emphasis on "living benefits," which can help alleviate investors' fears of outliving their income. These living benefits are actual guarantees of future income streams.

### Withdrawal benefits

Some VAs offer "guaranteed minimum withdrawal benefits" (GMWBs). Investors might be promised that they can withdraw a certain percentage—perhaps 5% or 6% or 7%—of their investment each year.

### Variable Annuity Premium Flows

	Quarter Ended		Nine Months Ended	
	9/30/06	9/30/05	9/30/06	9/30/05
Total sales	36,984	33,684	116,905	97,498
Net flows	9,317	4,698	24,521	14,741

Sources: NAVA and Morningstar Inc.

### Income benefits

Other investors choose VAs with "guaranteed minimum income benefits" (GMIBs) instead. These guarantees require annuitization: In order to get the guarantee you must sign a new contract with the issuer, agreeing to receive annuity payments.

If you choose this feature, you will get a minimum income, no matter how poorly your investment accounts have done.

### Paying the price

As might be expected, the win-but-not-lose guarantees of VAs come at a cost. There are fees paid to the issuer of any VA, fees paid to the managers of the investment accounts, and extra fees paid for the guarantees described above.

According to figures from Morningstar, the average VA investor has received annualized returns about one percentage point less than investors in comparable mutual funds over the past five years.

Those are averages, though. Some VAs are extremely expensive while others

have relatively low fees. VAs also vary in the severity of their surrender charges, the fees you'll pay if you pull specified amounts from a VA within a specified time period.

### Taxing issues

Besides surrender charges, you generally will have to pay a 10% penalty tax on VA withdrawals before age 59½. That penalty is in addition to ordinary income tax, which you'll have to pay on withdrawn earnings.

On the other hand, investors get some tax relief when they annuitize a VA. Part of the cash flow you'll receive will be taxed as ordinary income but some will be treated as a tax-free return of principal.

The bottom line is that VAs have drawbacks as well as desirable features. If you are interested in this concept, our office can help you evaluate the suitability of a VA, in your specific circumstances, and assist you in finding a cost-effective offering.

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