

Financial Security by Design

Investment and Estate Planning

January 22, 2001

Dear Customers and Friends,

My first newsletter of the new millenium addresses the current investment environment, the coming blizzard of tax forms, California's ScholarShare program, tax law changes and adjustments including the five year holding period for capital gains, the overhaul of the IRA distribution rules, why pecuniary funding formulas may not work out as you intend, exchange traded funds, and the Internet.

Current Investment Environment

A diversified portfolio of mutual index funds, and how it can be used to guide investment decisions, were described in my May 1999 newsletter. This can be found at www.lingane.com/tax/newsletr.htm.

Over the past ten years, this portfolio has grown at an annualized rate of 16% while an investment in the S&P500 index, with dividends reinvested, has grown 17% a year. The S&P500 has been a little more volatile.

The portfolio was down 8% last year while the S&P500 index declined 9%.

Last year was the first down year in a long time. To quote *The Wall Street Journal* in late December, "... business executives, economic forecasters, Wall Street analysts and Federal Reserve officials are shocked at how much and how quick the slowdown materialized." The Democrats charge that George W. is talking down the economy. There is probably some truth to this charge since Bush doubtless wants any slowdown attributed to Clinton's watch.

But there are also signs that a slowdown is more than political. The fed's view of the economy shifted from bullish to bearish in December without the customary pause at neutral and there was that surprise cut in the discount rate in early January. While unemployment remains low, new jobless claims are up.

Energy prices are up, which is one reason inflation was 3.4% last year. Inflation is not excessive, but it is higher than in recent years.

Californians are especially vulnerable to soaring energy prices. Pacific Gas & Electric and Southern California Edison have both defaulted on payments and their debts have been downgraded to junk bond status. The financial markets have issued a credit watch on general obligation bonds issued by the State of California, a possible prelude to cutting California's AA bond rating.

Certified Financial Planner - Enrolled Agent - Registered Investment Advisor

852 Acampo Drive, Lafayette, CA 94549-5040

(925) 299 - 0472 FAX (925) 299 - 0473 lingane@post.harvard.edu www.lingane.com/tax

International stocks are weaker than the US market. The weaker market in Europe is partly exchange rate related, meaning that the situation could reverse when rates swing the other way, but some analysts are suggesting a bone fide recession in Japan.

All the news is not bad. Not one of the dozen economists who participated in Barron's year end survey is predicting that the markets will be lower a year from now.

What are you and I supposed to make of all this? First, a bit of humility is in order. If the experts are "shocked", whatever we do has to be a bit of a guess.

The best approach may be to prepare for both fair weather and foul. If you depend on your investments, draw down your rainy day fund rather than your stock portfolio until the market recovers. If you have a positive cash flow, re-invest in the beaten down sectors. As always, make changes gradually and invest tax efficiently.

See www.lingane.com/tax/newsletr/nov00.pdf and the references therein for more on investing in stormy weather.

January Blizzard

One forecast that you can take to the bank is that there will be a blizzard in late January. A blizzard of tax forms.

- W-2s and 1099s must be mailed by January 31.

There can be errors, which is why I ask my tax customers for brokerage confirmations and stock option summaries.

If your W-2 is wrong, contact your employer and, if necessary, call the IRS at 800-829-1040. Talking to the IRS will insure that you get proper Social Security credit.

- Form 1099-S reports the sale of personal residences and Form 1099-B reports brokerage transactions. Expect an inquiry from the IRS if the total sales reported on your Schedule D is less than what is reported on these forms.
- Form 5498 allows the IRS to track IRA contributions and account values. It is not due until the end of May but at least one brokerage firm includes this Form in their January mailing. They must have faster computers.
- Then there are those pesky K-1s. Don't be tempted to report the amounts distributed in lieu of the K-1 values. You could be reporting too much income.

ScholarShare, California's Section 529 Education Savings Plan

Many parents set aside money for college by opening a savings account in the child's name. The good news is that the first \$700 or so of investment income might be tax free but parents, remembering their own youth perhaps, worry that Junior will blow the savings as soon as he is old enough to gain access to the account.

There is a new alternative for education savings which allows a parent to control the funds indefinitely. It is authorized under Section 529 of the Internal Revenue Code - hence the name - and each state has their own program. California's program is administered by TIAA/CREF, the respected educator's pension people.

Total fees are 0.8%. This is probably less than what you would pay if you contracted for management independently but more than you need pay using index funds.

Large sums can be set aside without triggering gift tax but you may have to file gift tax returns and there are generation skipping transfer (GST) tax issues. The following is a synopsis of proposed Regulation 1.529-5.

The rules changed upon passage of the 1997 Taxpayer Relief Act. Contributions after August 5, 1997 are treated as completed gifts and are eligible for the annual gift and generation-skipping transfer tax exclusions.

A donor may elect to contribute a substantial sum and average a contribution over a five year period, or at least that portion of a contribution which does not exceed five times the gift tax exclusion. This election is made by filing a gift tax return. Any excess over the five times amount is a taxable gift in the year of contribution.

Example. In Year 1, when the annual exclusion is \$10,000, P makes a contribution of \$60,000. P elects to account for the gift ratably over a five year period. P is treated as making a gift of \$20,000 in Year 1 and gifts of \$10,000 in Years 2 through 5. After reducing each gift by the annual exclusion, there is a \$10,000 taxable gift in Year 1.

This excess gift in Year 1 would be subject to the 55% GST tax if made to a grandchild.

By Year 3 the annual exclusion has increased to \$12,000 and P makes an \$8,000 contribution for the same beneficiary. P is treated as having made a total gift of \$18,000 in Year 3. \$6,000, the excess over the annual exclusion, is a taxable gift in Year 3.

A change in beneficiary or a rollover to the account of another is considered a transfer by the beneficiary to someone else. We might expect these transfers to be gifts. However, they are not gifts so long as the new beneficiary is a member of the same generation of the same family. See the Regulation for further explanation.

If the new beneficiary is one generation younger, the transfer is a gift regardless of whether the new beneficiary is a member of the same family. If the new beneficiary is two or more generations removed, the transfer is subject to the generation-skipping transfer tax. Five year averaging may be applied to these transfers.

Example. In Year 1, P makes a contribution on behalf of P's child, C. In Year 4, P directs that a distribution be made to an account for the benefit of P's grandchild, G.

This rollover distribution is treated as a taxable gift by C to G. C needs to file a gift tax return. GST tax does not come into play because G is only one generation below C.

Question. Can C exclude the annual exclusion amount when computing the taxable gift?

The donor's gross estate does not generally include prior contributions. However, if the deceased donor elects to average contributions and dies before the close of the five year period, that portion of the contribution allocable to calendar years beginning after the date of death is included in the decedent donor's gross estate.

The gross estate of a designated beneficiary includes the value of their account.

Income tax is deferred until funds are used for education. Withdrawals are taxed as ordinary income at the student's marginal rate. These tax benefits mean that ScholarShare provides 5 - 10% more money for education as compared to an account in a child's name, assuming that you make large gifts to relatively young children.

Let's discuss further if the ScholarShare program sounds attractive.

Calendar Year 2001 Tax Law Changes and Adjustments

The complexity of the tax rules and our legislators' proclivity to make changes mean that I devote many hours a year to continuing professional education.

The following 2001 tax changes and threshold adjustments may be of interest to you.

Five year capital gains rates. Beginning in 2001, persons in the 15% tax bracket will pay 8% rather than 10% federal tax on gains from assets held *for more than five years*.

If you are in a higher tax bracket, the rules are different. Assets held for more than five years are taxed at a lower capital gains rate, 18% rather than 20%, but only if the assets were purchased after December 31, 2000.

You can elect to treat assets that you already own as having been sold and re-acquired on January 1, 2001. (Use January 2nd for securities since the markets were closed on the first.) All gain to date is included in income for calendar year 2001 but further gains realized more than five years down the road will be taxed at 18% or less.

Marking to market is not a way to get rich but there is a small benefit if your unrealized gains are not too large. For example, if you own \$10,000 worth of stock with a basis of \$9,000, marking to market might give you \$58 more five years hence.

Since losses are not recognized, it doesn't make sense to mark losing positions to market. It probably does not make sense to mark short term gains to market. Since gains are forgiven at death, don't mark to market an investment that you plan to hold until death. The deemed-sale-and-repurchase election is irrevocable.

Bracket testing is done in the year of sale. Therefore, don't mark to market if you expect to be eligible for the 8% rate in the year of sale.

Can you mark to market for federal purposes only, and continue to defer unrealized gains for California income tax purposes? Probably not; California law generally conforms to federal tax legislation enacted before January 1, 1998. Remember that California does not have a preferential rate for capital gains.

Can you mark to market specific lots of stock or specific mutual fund purchases? Probably. *Selective marking to market of those lots of securities and mutual funds with small gains may be the best way to take advantage of the lower five year rates. Keep good records lest your profits are eaten up by tax preparation fees!*

Deduction for student loan interest. You can deduct up to \$2,500 of interest paid, versus \$2,000 in 2000. This deduction is not available unless your income is relatively low. It is not available to individuals who can be claimed as a dependent on someone else's return. It is not available after you have made sixty loan payments.

Estimated tax payments. The "safe harbor" federal tax payment is 100/110% of your 2000 taxes. The larger percentage applies if your adjusted gross income was over \$150,000 last year (\$75,000 if married filing separately.) What is not paid through withholding must be paid in estimated taxes, one fourth each quarter. Making estimated payments based on last year's tax is a good approach if your income is likely to be higher this year than last.

If your income will be less than last year, you may prefer to pay 90% of the actual tax for calendar year 2001, rather than the larger safe harbor amounts. What is not withheld is paid one fourth each quarter.

If your income fluctuates and you want to make the smallest possible estimated payments, you may have to repeat the calculations each quarter, paying an amount of tax based on your cumulative income and withholding through that quarter. This is not cost effective if your income is moderate but quarterly calculations can save real money if your non wage income is high, especially when most of this income occurs late in the year.

The corresponding factors for California are 100%/105% and 80%.

Pension Limits (IRS Notice 2000-06)

- The maximum annual benefit that can be funded in a defined benefit pension increases to \$140,000, versus \$135,000 in 2000.
- Additions to a defined contribution plan continue to be limited to 25% of compensation (20% if self employed) and the compensation limit remains \$170,000. The dollar cap increases to \$35,000, up from \$30,000 in 2000.
- The 401(k)/403(b) plan contribution limit will remain \$10,500 but the limit on the maximum contribution to a 457 plan will increase from \$8,000 to \$8,500.
- Maximum deferral to a SIMPLE plan increases to \$6,500. It was \$6,000 in 2000.
- There are minor adjustments to the income caps for deductible IRA contributions. The maximum IRA contribution remains at \$2,000.

There are rumors that the IRA and 401(k)/403(b) contribution limits will increase to \$5,000 and \$15,000 in any new tax bills. No changes seem to be in the works, unfortunately, to the \$100,000 Roth conversion ceiling.

\$179 Deduction. Up to \$24,000 can be expensed in 2001, instead of being depreciated over a period of years. The limit had been \$20,000. This deduction phases out dollar for dollar if the total property placed in service exceeds \$200,000.

Mileage rates. The standard deduction for business travel is 34.5¢ per mile, up from 32.5¢ for 2000. The medical rate is unchanged at 10¢. The charitable rate rises to 14¢. Tolls and parking are also deductible when using these standard rates.

Gift and Estate Tax. The \$10,000 annual exclusion and the \$675,000 applicable exclusion amount are unchanged from 2000. The lifetime GST exemption increases by \$30,000 to \$1,060,000. The applicable exclusion amount is likely to be increased substantially by any tax legislation this year.

A New Box to Check. You can authorize your preparer to resolve issues which would otherwise delay the processing of your 2000 Federal income tax return. Common problems are mismatches between names and the Social Security numbers, estimated tax payments, IRS keypunching errors and missing schedules.

You can check the box even if your preparer is not admitted to practice before the IRS.

Checking this box does NOT authorize the preparer to represent you in an audit nor will the IRS send your preparer copies of the notices that it sends to you. To authorize representation, you will still need to sign a power of attorney.

Checking the box could mean that you won't find out about errors on the tax return that you signed. So, insist that your preparer tell you of all IRS contacts.

Social Security Numbers. For several years, the IRS has been checking the Social Security number of the first listed taxpayer on joint returns. This year they plan to test the numbers for both taxpayers. I expect a lot of returns to be rejected for innocuous errors like using one's married name on a tax return without telling the folks at Social Security of the name change. (See A New Box to Check above.)

Required Minimum Distribution Rules Overhauled

You must begin taking annual distributions from your traditional IRAs, 401(k)s, and employer-sponsored pension plan at about the time that you reach age seventy.

Just his past week, the IRS simplified and liberalized the regulations that determine the minimum required distribution. They were published in the Federal Register on January 17. A copy is also available at www.lingane.com/tax/ira_regs.pdf.

In general, you'll have to withdraw less each year under the revised rules. Also, your IRA custodian has to calculate the minimum required distribution for you beginning in calendar year 2002. The IRS is probably hoping that these steps will reduce errors.

For the first time, your trustee has to tell the IRS how much you have to take out. The IRS probably suspects that some have not been taking their full required distributions. There is a 50% penalty for taking too small a distribution, by the way.

Please be aware that some of the IRA discussions on my web site are now outdated.

Income Taxation of a Decedent's Revocable Trust

The tax rules allow each of us to give approximately \$600,000 to anyone we want and to give an unlimited amount to a US citizen spouse without having to pay estate taxes. With this in mind, the estate plan at the first death of a married couple usually involves a bequest to a by-pass trust (B trust, credit shelter trust) with everything else passing to the surviving spouse or to a marital trust.

The documents will say how the decedent's assets are to be divided. Usually, one trust gets a certain amount and the other gets the residue. The certain amount is called the pecuniary share and the residue is called the residuary share.

When the estate plan is implemented by will, there is a probate administration. California's Probate Code says that income, taxes and other expenses during this interim period, and gains and losses on funding, are allocated to the residuary share. The income tax return for the estate is prepared using this allocation. No returns are prepared for the by-pass and marital trusts prior to their actual funding.

The estate plan can also be implemented using a revocable living trust. Even in uncomplicated situations, it takes a while to determine the amounts due to each share and how the assets are best divided. California's Probate Code says that income and expenses during this interim period are allocated to the residuary share.

Some tax professionals report income during this interim period on a return for the decedent's revocable trust and prepare no returns for the by-pass and marital trusts. Income and expenses and gains on funding are allocated to the residuary trust.

Other tax professionals reconstruct the accounting as if the decedent's assets were divided on the date of death. There is no interim period, no gains on funding, no tax return for the revocable trust and income and expenses are shared between the by-pass and marital trusts from the date of death.

Thus, the approach used to prepare the tax returns has consequences on the sharing of income and expenses prior to the actual division of the decedent's assets.

The income tax rules for estates allow for several attractive options which are not available to revocable trusts, even though this trust functions as an estate substitute. The 1997 Taxpayer Relief Act removed this dichotomy and a revocable trust can now elect to be taxed, during the interim period, as an estate.

In making this new election, the fiduciary foregoes the opportunity to treat the decedent's assets as if they were divided on the date of death. If the by-pass or marital trust is funded by a pecuniary formula, income and expenses are not shared. Income, expenses and gains and losses flow exclusively to the residuary share.

Whether or not income and expenses are shared between the by-pass and marital trusts may have limited practical implications. However, the new election could mean that the surviving spouse is not entitled to any of the income earned during administration, that gains could be realized on funding, that losses could be allocated to one share even if there would be a greater benefit by sharing losses and that management expenses could become non deductible per the new Hubert regulations.

Seek competent advice if your estate plan involves a pecuniary funding formula.

A discussion of this and other changes affecting the income taxation of a decedent's living trust is posted at www.lingane.com/tax/seminars/645election.pdf. This article ~~will be~~ was published in the ~~March~~ April issue of *The California Enrolled Agent*.

Exchange Traded Funds (ETFs)

The Big Boys contribute a portfolio consisting of large blocks of stocks to a custodian who then sells a fractional interest in the portfolio to investors. If the ETF tracks the S&P500® index and if the price of the ETF is higher than the *pro rata* cost of the underlying securities, the Big Boys can make a profit by buying the securities in the S&P500® index and contributing them to the custodian. Since purchases drive up the prices of the securities and contributions drive down the price of the ETF, this arbitrage realigns the price of the ETF with the value of the underlying securities.

International ETFs deviate by wider margins from the value of the underlying securities because of the Big Boys have more difficulty hedging these transactions.

Using computers, all of this arbitrage happens almost instantaneously. State Street Global Advisers, which introduced the popular SYPders back in 1993, updates prices every fifteen seconds. I'm told that this is not often enough for the Big Boys and that they do their own calculations after every stock transaction!

An index mutual fund must sell the old stocks and buy the new whenever the composition of the underlying index changes. In contrast, the ETF custodian distributes the old shares in kind and the Big Boys get stuck with gains and losses. Since the custodian does not buy or sell, there are few capital gains to distribute.

This is an advantage for the ETFs. For example, Vanguard's Small Cap Index Fund, which tracks the Russell 2000® index, distributed 15% of the fund in capital gains last year. Barclay's iShares Russell 2000 ETF distributed only 0.2%.

This huge a difference is atypical since there was a 45% turnover in the composition of the Russell 2000® index on June 30 of last year. But it makes my point nicely.

ETFs are not bit players. SPYders represent about one fifth the value of the giant Fidelity Magellan or Vanguard Index 500 funds and Barclay's iShares Russell 2000 ETF is already one tenth the size of Vanguard's Small Cap Index fund even though the first Barclay shares only went on sale last May. ETFs are usually the most actively traded issues on the American Stock Exchange.

ETFs trade like stocks. This means that there are commissions. They can be sold short, margined and traded interday. Some ETFs can be optioned.

ETFs offer advantages for the buy and hold investor beyond a lower risk of capital gain distributions. For example, you may have a good relationship with a full service broker who does not offer low expense, index funds. If you purchase ETFs, you achieve an index investment with low ongoing costs and no contingent deferred sales charges. You also maintain your relationship with a valued broker.

ETFs allow you to diversify your portfolio much as the Fidelity Sector® Funds would. Suppose that you have too much low basis employer stock acquired through options or during a long career. How do you reduce your sector exposure without the tax hit which results if you sell your stock? One possibility is to buy those ETFs which, historically, have a low correlation to your employer's stock or market sector.

For more on ETFs, check out www.morningstar.com, www.iShares.com and www.streettracks.com. See www.fidelity.com for information on Sector® Funds and www.vanguard.com for information on Vanguard's index funds.

The Internet

www.lingane.com/tax is almost three years old. I use the site to post educational materials and new developments in the tax and financial areas where I practice. Give it a try. Please let me know which parts you find useful.

I find that I'm using the Internet more and more as a source of information. For example, the Internet allowed me to compare performance and fees on exchange traded funds, review prospectuses and make a recommendation in a matter of hours.

Do you know the difference between a "tax exempt" and a "municipal" bond fund? Do you know why yields often soar in December? Read "Muni-Bond Funds Have Appeal - and Risks" by Ken Brown (*The Wall Street Journal*, January 19, 2001.) My point is that this article is available on the Internet at www.wsj.com. Sign up for the free trial.

While you are there, check out Barron's "The Best Websites for Investors" at <http://interactive.wsj.com/public/current/articles/SB957605462934801648.htm>. Sign up for the free e-mail service which alerts you to significant market events.

Check out the thoughtful articles on investment and estate planning at sites like www.fidelity.com, www.troweprice.com or www.vanguard.com. (Caution: the authors who write about estate planning are not always familiar with California living trusts.)

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I hope that these periodic communications are useful to you. Please call with questions or if I can assist you towards financial security.

Sincerely,



Peter James Lingane

References: jan01.doc, jan01.xls