

Financial Security by Design

Tax, Investment and Estate Planning

June 5, 2001

Updated June 24, 2001.

Dear Customers and Friends,

This newsletter addresses my firm's privacy policy, my take on the new tax legislation, some suggestions for managing your rainy day fund and responding to the upcoming changes in the Russell 2000® index.

Privacy Policy. We have all been receiving mailings entitled "Protecting Your Privacy." What's up? The Gramm-Leach-Bliley Act (Public Law 106-102] requires financial institutions, and registered investment advisers like myself, to notify our customers of our privacy policies at least annually, beginning July 1st of this year. The following comments fulfil my obligation under this Act.

My bottom line is that I know you would be furious if I sold your information or if I disposed of your information in a careless manner. Your anger would be justified. I am embarrassed that we needed a law to remind a few of my colleagues of their professional responsibilities.

What am I doing to protect your privacy? I do not collect information about visitors to my web site at www.lingane.com/tax. More importantly, I have revised my engagement letters to clarify the conditions under which I may share your information with third parties, with your spouse and with the tax authorities. The privacy language controlling my engagements is as follows.

Confidentiality, Conflict of Interest and Privilege. You authorize me to use your information, including any information originally provided for tax preparation purposes, within the scope of this contract. "Information" is construed broadly and includes Social Security and account numbers which have been included with your documents.

I will keep your information confidential indefinitely except where

- You authorize me in writing to share your information with another.
- Disclosure is required by law, by a court or governmental regulatory agency or by a professional organization pursuant to a disciplinary review process.
- Disclosure is necessary for professional consultation, so long as the other party agrees to keep your information confidential.

I will not use your information to support an unsolicited sales promotion.

The best interests of spouses are in conflict when, for example, rolling over a pension to an IRA, when there are separate assets or multiple families or marital discord. When there is the possibility of conflict, each spouse should be separately represented.

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When this contract is executed by husband and wife, you direct me to represent your common interests rather than what might be better for one or the other spouse. You direct me to share information and recommendations with both spouses and to accept direction from either spouse.

Federal and California laws prohibit Enrolled Agents from sharing certain communications with the tax authorities without your permission.

This "privilege" is limited. It applies to tax planning but it probably does not apply to other aspects of financial planning. It applies when an Enrolled Agent represents your interests before the tax authorities but it does not apply to the information used to prepare your tax returns.

An Enrolled Agent cannot invoke your privilege in a criminal tax proceeding or in a proceeding which does not involve the tax authorities.

It is easy to do something which vacates the privilege. There is probably no privilege, for example, if you include someone else in our discussions.

We agree that

- You will consult with an attorney before you share information with me if you have concerns that your actions might be construed as fraudulent or criminal or that privilege might be needed for some other reason.
- Asserting privilege is a serious matter. It invariably raises suspicions and may stimulate the authorities' interest in your affairs. Since I am obligated to assert your privilege in the absence of instructions, you will identify in writing those communications which are to be privileged.
- You will reimburse me for costs that I incur in defending your privilege, including fees for my own attorney, and to pay for my time at my highest professional rate.

Voluntary Authorization to Release Information. Privacy concerns may make it difficult to obtain information directly from your financial institutions or when dealing with the tax authorities. I am considering including with my engagement letter an authorization to release information so that I would have something to FAX to the other party without the delay of getting you involved. The release would be optional. What do you think of this idea?

Federal Tax Legislation. The excellent explanation by the House Rules Committee is posted at www.lingane.com/tax/hr1836_explanation.pdf for your convenience. The report describes existing law, the changes proposed by the House and Senate and the changes agreed to by the Conference Committee and eventually by the Congress. This report is probably the basis on which our representatives decided their final votes and it will weigh heavily in any court determination of legislative intent.

Since many provisions have been widely reported, I will limit my comments to those changes affecting my customers.

Caveats. Many provisions take effect years from now. I expect that Mr. Bush will frustrate attempts to scale back this legislation so long as he remains in

office. But we could have a new president in four years and I would therefore not rely on provisions effective after 2004.

Some provisions require changes to pension documents or state law. For example, you won't be able to contribute more until your employer or financial institution revises your pension plan and your increased contribution will be taxed by California until the legislature passes conforming legislation.

I'd be surprised if an employer or financial institution did not revise the plan documents but I'm less sure about California. Conformity bills are introduced routinely but last year's legislation was not successful. Since the California legislature is scrambling to find money because of the energy situation, I'm inclined to think that California will NOT adopt those parts of the federal legislation which reduce revenues until the state's financial situation clarifies.

Tax Refunds. The Treasury will begin writing refund checks in late July. The checks will go to everyone who paid federal income taxes last year. If you did not pay tax last year, you will get a credit on next Spring's tax return. If you get a check but don't owe any tax next Spring, you get to keep the check¹.

To insure that you get your check, file a change of address with the Postal Service if you have moved in the last year.

529 Plan Distributions Become Tax Free as of January 2002. The analysis in my January 2001 newsletter² concluded that a 529 plan provides the donor more control but that the after-tax financial benefits were at best marginal compared to setting the money aside in a "uniform gift to minor" (UGMA) account. Now that distributions from 529 plans are tax free when used for education, 529 plans offer both control and financial advantages.

WARNING: the rules could change before you begin withdrawing the money.

The Estate Tax Exemption rises to \$1 million effective January 2002. It rises to \$1.5 million in 2004 and is scheduled to increase further in later years.

Almost certainly, your estate planning documents have been written to automatically handle changes in the exemption amount. However, if there are references to "\$600,000" rather than to "the amount that can be transferred free of federal tax", call your attorney.

Under current law, unpaid income tax on appreciated assets is forgiven at death. This "step-up in basis" is unchanged for the immediate future. If the estate tax is repealed, heirs will receive assets at the decedent's "carryover basis." This will not be a big deal for most of us since \$1.3 - 4.3 million of a decedent's assets will continue to be stepped-up and the decedent's executor can maximize the tax advantages by choosing low basis assets for the step-up.

¹ For more information, see http://www.irs.gov/ind_info/apinfo/index.html.

² See <http://www.lingane.com/tax/newsletr/jan01.pdf>.

Implications for a Marital Deduction Trust. The usual estate plan of a married California couple is to fund a "by-pass trust" at the first death to the amount that is free of estate tax and to leave everything else to the surviving spouse. The by-pass trust is also known as a B trust or as an exemption trust.

The estate plan often directs "everything else" to a marital deduction trust rather than leaving these assets outright to the surviving spouse. A trust is useful if the surviving spouse wants or would benefit from professional management or if the surviving spouse is not a US citizen³.

A difficulty with a marital trust, in the view of some spouses, is that the surviving spouse has the right to whatever they want, whenever they want, for whatever purpose they want and to appoint whatever is left to whomever they choose. Indeed, it is exactly this unfettered ownership that qualifies the assets for the marital deduction.

A Qualified Terminal Interest Property Trust (QTIP) Trust is a special form of the marital trust. Some restrictions can be placed on the surviving spouse without disqualifying the assets for the marital deduction. For example, the surviving spouse might be allowed withdrawals for any purpose but might not be allowed to change the remainder beneficiaries⁴.

A final reason for a marital trust has been to save generation skipping transfer (GST) tax on bequests to younger beneficiaries. Up to now, the million dollar lifetime exemption from GST tax has exceeded the estate tax exemption and this extra exemption was wasted without a marital deduction trust. The GST incentive for a marital trust disappears next year when the estate tax and GST exemption amounts are equalized.

Implications for the By-Pass Trust. This trust is designed to support the surviving spouse and to shield assets from estate tax at the second death. As commonly formulated, the surviving spouse receives the interest and dividends and can ask for additional money if he or she needs it. The surviving spouse is not entitled to extra money simply because he or she wants it.

There are extra costs for accounting and tax preparation and, possibly, trustee and financial management fees. There is no step-up in basis for trust assets at the death of the surviving spouse and no \$250,000 exemption on the sale of a personal residence owned by the by-pass trust⁵.

³ A trust structure is essential if assets left to a non citizen spouse are to be eligible for the unlimited marital deduction. The trustee of a qualified domestic trust or "QDOT" pledges to pay estate tax on all principal distributions (income distributions are free of estate tax) during the lifetime of or upon the death of the non citizen surviving spouse. The trustee must be a US citizen.

⁴ This limitation can be attractive when there are children from more than one marriage.

⁵ The new legislation modifies the Section 121 home sale rules to allow the executor to claim the exclusion if the decedent met the ownership and use tests and to allow an heir to combine the decedent's ownership and use with their own. However, an heir living in a residence owned by a by-pass trust cannot claim the exclusion because they do not own the property at the time of the sale.

Despite these disadvantages, the potential estate tax savings are so large that most California couples include a by-pass trust in their estate plan.

The increased exemption amounts could mean that a by-pass trust no longer saves you estate tax. For example, assume that a couple's net worth is \$1.5 million. If one spouse were to die today without a by-pass trust and the surviving spouse were to die soon after, the estate tax liability would be hundreds of thousands of dollars. Whereas, if the second death occurs in 2004, there would be no estate tax even without a by-pass trust.

My suggestion is to review whether you still need a by-pass trust in your plan.

Funding the By-Pass Trust. My suggestion is to review whether your executor will be able to fund the by-pass trust to the full, increased exemption amounts. Funding a million dollar by-pass trust should be straightforward if you own two million dollars of securities as community property but it may be impossible if the securities are in joint tenancy. If your principal assets are a large IRA and a pricey residence, your attorney may need to prepare a special beneficiary designation and/or a non pro rata agreement under Probate Code 100 if you are to use these assets to fund a by-pass trust⁶.

Implications for Gifting. The ten thousand dollar annual exclusion from gift tax is unchanged. "Crummey powers"⁷ are eliminated. The amount you can give away during your lifetime without paying a gift tax is capped at a million dollars. The gift tax continues at a lower rate after repeal of the estate tax.

Giving money away is a common strategy for reducing a taxable estate. Because of the increased exemption amounts, you may find that gifting no longer provides a tax benefit. For example, a widow worth \$800,000 saves estate tax under the current rules by giving money away. But, come January, her estate is not taxable and there is no longer a tax incentive to gifting.

Increased Pension Contribution Limits. The new legislation makes it possible to stuff more money into pensions and it removes some of the differences which currently distinguish one pension from another.

Increasing the 457 elective deferral limit to that of other pension plans is a useful step towards pension simplification. However, I wonder why, as a matter of public policy, we retain a different limit for SIMPLE plans and IRAs.

⁶ See the sections "How Do We Fund the By-Pass Trust?" and "Non Pro Rata Allocation of Community Property" at www.lingane.com/tax/seminars/designtn.htm.

⁷ The annual gift tax exclusion only applies if the recipient has immediate access to the money. Gifts in trust do not usually qualify because the beneficiary does not have control over the assets. A creative individual realized that if a beneficiary were allowed a one time opportunity to withdraw gifts made to a trust on their behalf, the gift would qualify for the annual exclusion. The IRS opposed this technique but lost in *Crummey vs. Commissioner* (Ninth Circuit, 1968, 397 F.2d 82.) "Crummey powers" had become a standard feature of irrevocable trusts. The new legislation denies the exclusion to non grantor trusts.

Keith Schiller, a respected attorney and educator in Walnut Creek, told a CPE class June 22nd that he had been told by a legislative staffer that Congress had not intended to repeal Crummey. So, stay tuned.

In general, an employer must adopt the higher contributions limits before they are effective. Employers are likely to allow employees to make the increased deferrals allowed under the new law and they may increase the maximum contribution by employer and employee to \$40,000 but they are unlikely to increase their contribution own beyond 25% of compensation⁸.

In a break with tradition, those aged fifty or older are allowed to make extra elective deferrals to IRAs and to 401k, SEP and SIMPLE plans. Existing higher limits for older participants in 403b and 457 plans are enhanced.

Beginning in 2006, an employee may include contributions to section 401k and 403b plans in taxable income and receive distributions tax free. Because of the similarity to the rules for the Roth IRA, these are called "Roth contributions." Since foregoing a tax deduction effectively increases the amount contributed to the pension account, this election should be attractive to anyone trying to maximize their pension contributions.

The maximum baseline payment from a defined benefit plan increases to \$160,000 annually from \$140,000 in 2001. The actual payment depends on the age at which benefits begin - and on whether you are a retired airline pilot.

Rollovers and Required Distributions. Under current law, there are restrictions on moving money from one tax favored plan to another. One cannot roll over money from a 401k to a 403b plan, for example, nor from a 457 plan to an IRA. Rollovers are now permitted among all types of plans and from all plans to IRAs except 457 plans sponsored by tax exempt organizations.

A surviving spouse may now rollover distributions to their own plan. Previously, this option was only available with IRAs. WARNING: it is possible for a surviving spouse to accelerate minimum required distributions by rolling a younger spouse's pension into their own name.

The IRS was given authority to extend the 60 day rollover window when failure to extend the period would be "against equity or good conscience."

Managing Your Rainy Day Fund. When you are growing your portfolio, your income exceeds your expenses. Assuming adequate life and disability insurance, there is no need to keep more than a few months income in cash. Most of your portfolio can be invested in volatile assets.

Should you begin to use your investments to supplement your other income, you will want to complement a diversified stock portfolio with enough bonds to tide you over during the inevitable periods of market decline⁹. When the market is down, as now, you will supplement your other income by cashing in part of your rainy day fund. When times are good, you will sell stocks to supplement your income and to rebuild your rainy day fund.

⁸ For my reasons, and more on the revised contributions limits, see the text of my June 21st seminar "The Pension Rules are in Flux" which has been posted at www.lingane.com/tax/seminars/pension_rules.pdf.

⁹ See www.lingane.com/tax/newsletr/nov00.pdf.

I like Treasury Inflation Protection Securities (TIPS) for the rainy day fund. They shift the inflation risk to the government, portfolio values fluctuate less than for comparable securities and, after figuring in inflation, they tend to return a bit more than comparable securities¹⁰. TIPS are California tax free.

Like original issue discount bonds, one must pay income tax on TIPS annual inflation increment even though the increment is not paid out until maturity. If cash flow is an issue¹¹, the TIPS can be held in a retirement account. In a down market, the proceeds from the sale of TIPS are either used to fund mandatory distributions or to buy stock. If you buy stock, you would raise cash by selling the same stocks in a non retirement account.

The tradeoff is that California taxes TIPS if held in a retirement account.

Treasury securities usually return between three and four percent above inflation¹². Current yields are at the bottom of this range¹³ and thus this is not the best time to lock in an interest rate for the long term.

I especially discourage the purchase of bond funds. Since the prices of bonds and bond funds move inversely with yields, returns can be spectacular when interest rates are declining. The current high returns of bond funds are a warning that returns will be disappointing when interest rates eventually rise.

California's energy crisis has a silver lining for bond investors. California will sell \$13 billion of long term municipal bonds in the August time frame. August is a poor time of the year to sell bonds, the issue is huge and California's credit rating is not as robust as previously. Therefore, yields will be attractive, perhaps 5.5% free of taxes¹⁴ or about the same as taxable Treasury bonds. Contact your broker for more information.

The Stock Market. The broad US stock market rebounded in April and May and recovered most of the February and March losses. For the year ending June 1, 2001, my "baseline" portfolio is down 4%. The winners have been REITS and smaller stocks; the losers have been international offerings.

The pundits are saying that the market has bottomed; I wonder.

The Frank Russell Company will be updating its index of smaller US companies on June 30th. Last summer's changes produced large capital gain

¹⁰ See www.lingane.com/tax/tips.pdf.

¹¹ An investor in the highest federal income tax bracket receives only \$6,000 a year after income taxes on a million dollar TIPS portfolio, based on current 3.2% yields and 3.3% inflation.

¹² "The Bond Book" by Annette Thau, Irwin, 1992, p. 38.

¹³ The annualized yield on Fidelity's Spartan US Money Market is 4.1%; yield on the ten year Treasury bond is 5.5% or about 2.2% more than current inflation; yield on ten year TIPS is 3.3% plus inflation.

¹⁴ "California Will Pay Steep Price for Energy Issue," *The Wall Street Journal*, May 17, 2001, p. C1. Try out the free 30-day subscription to www.wsj.com.

distributions in indexed mutual funds. This summer's changes are likely to trigger more taxable distributions.

As discussed in my January 2001 newsletter¹⁵, an index mutual fund must sell the old stocks and buy the new whenever the composition of the underlying index changes. In contrast, the custodian of an "exchange traded fund" or ETF adjusts to changes in the index by distributing the old shares in kind. Since the custodian makes few sales, there are few gains to distribute.

For example, Vanguard's Small Cap Index Fund, which tracks the Russell 2000® index, distributed 15% of the value of the fund last year. Barclay's iShares Russell 2000, an exchange traded fund, distributed only 0.2%.

If you own a Russell 2000® mutual fund in a IRA or pension account, capital gain distributions do not trigger taxable income. If you own the fund in a taxable account and wish to avoid the capital gain distribution, consider selling before the distribution (usually in December - check with the fund.) If the sale provides a capital loss, the loss will offset gains in other accounts and up to \$3,000 of other income. If you wish to keep the money invested in smaller stocks, reinvest the proceeds in an ETF tracking the Russell 2000® index.

The Feds Get Tough. Beginning in October, 15% of monthly Social Security checks in excess of \$750 will be withheld to pay delinquent VA mortgage loans and small-business, disaster and student loans. Payments to people with disabilities and Supplemental Security Income (SSI) are not affected.

A Reminder. Estimated tax payments are due June 15th.

I hope that these periodic communications are useful to you. If something sparks your interest, please call.

Sincerely,

Peter James Lingane

¹⁵ See <http://www.lingane.com/tax/newsletr/jan01.pdf>.