ISSUE 19
DECEMBER 1, 2005

Elder Client PLANNER

Spidell Publishing Inc.

TAX, LEGAL & FINANCIAL SOLUTIONS FOR YOUR RETIRED CLIENTS

Happy holidays: Give the gift of a tax deduction

GIFTING: Taxpayers can combine their end-of-year holiday gifts with gifts intended to reduce the size of the estate.

By Lynn Freer, EA
ECP Publisher

Finding that gift for someone who has everything can be frustrating. And, many expensive gifts stay in a box in the closet waiting to be sold at a garage sale or regifted. Here are some unique ways to make your loved ones happy, plus get some tax benefits.

Some families take the amount that would be spent on a gift and give it to the favorite charities of other family members. One client of mine gave $50 gifts to disparate charitable organizations: an animal shelter, a Catholic church in a rural town, and an organization helping Muslim women in Afghanistan. What the gifts had in common was that the donations were made to organizations that supported the causes of his three sisters.

The result was three happy siblings and $150 in charitable contribution deductions for him. And, his sisters did not receive another vase!

Useful, deductible gifts

Successful self-employed people are often more concerned with office functionality than with beautifying the office to make it a more pleasant work environment or more attractive to clients. So, the self-employed individual's spouse might consider buying a big flat-screen monitor, or perhaps a Persian rug, or those longed-for hardwood floors for the office. Any of these might be far more appealing to the self-employed spouse than another cashmere sweater. And, unlike the cashmere sweater, these gift ideas are tax-deductible.

Education gifts

We have always advocated the use of the IRC §529 plan to secure funds for a child or grandchild's education (see "IRC §529 college savings plans offer the risk-free gift of education" in the November 2005 issue of the **Elder Client Planner**). But another option might be establishing a Coverdell education savings account under IRC §530.

The 2005 maximum contribution to a

See **Gifts**, *page 2*

Title affects the course of an entire estate plan

LEGAL: Different ways of holding title can affect a property's inherited basis or whether it goes through probate when the holder dies.

By Renée Rodda, J.D.
ECP Associate Editor

There are numerous ways to hold title to assets, and the manner in which title is held can affect:

- How much of the property is included in the decedent's estate;
- The basis at which the beneficiary inherits the property;
- Whether the property can be willed to a person other than the joint owner; and
- Whether the asset will be included in the gross estate subject to probate.

Here are the most common ways to hold title to property and what results each option will create when the property holder dies.

Property held in individual's name only

Property that is held in the decedent's name alone:

- Will be included in the decedent's estate;
- Is passed via a will; and
- Is subject to probate.

The basis of the decedent's interest acquired by the beneficiary is the fair market value of that portion of the interest at the decedent's date of death.

See **Title**, *page 3*

In this Issue

E-mail us:
ecplanner@spidell.com

Rental, *continued from page 4*

will have a full step-up in basis and can sell for no tax cost. (See "Title affects the course of an entire estate plan" on page 1.)

See Example 12-6.

EXAMPLE 12-6: Ralph and Jean decide to keep their rental property. Jean dies when the FMV is $700,000. Ralph can now sell the property for $700,000. His basis is stepped up to $700,000. After expenses of sale, Ralph has a tax loss of $49,000.

Hiring a property manager

The worst part about hiring a property manager is finding and choosing a good one. Plus, handing over management of the property severs the personal attachment to the property. This is a psychological barrier the client will have to overcome.

Suggest your client interview potential professional managers. They can find referrals through property owners' associations or local chambers of commerce. Be sure that the manager has the appropriate licenses as locally required. Also suggest that an individual or company whose sole job is managing property may cost a little more than a realtor who manages on the side, but the results will be better.

Here are the benefits of using a property manager:

- Property managers find and qualify renters.
- Property managers collect rent and have access to efficient legal services to deal with delinquent renters.
- Property managers provide accounting, which the client can then bring to you.
- Owner does not get late-night phone calls when tenants' plumbing leaks.
- Owner does not have to do repairs.

All this doesn't come for free.

The manager will charge generally 10% of the rental income. The manager will also contract with repair and maintenance workers. The owner will be billed at the rate charged by the worker, possibly with a surcharge. The owner will generally not have a say in choosing the repair and maintenance people, nor will the owner be involved in selecting tenants.

Remind your client, however, that the loss of control means loss of stress, which is what they are paying for. Remind them also that the cost of the property manager is deductible. So, if the cost is $1,200 per year, the client is really only paying $840 if the client is in the 30% federal and state bracket.

Gifting to child

If the taxpayer has a child who will be the eventual heir, the client could gift a small portion of the property to the child and share the rental income in exchange for the child managing the property. The client could form an LLC, FLP, a partnership, or joint ownership with the child. We'll discuss different ways to structure this type of arrangement, as well as exchanging for a tenants-in-common interest, in next month's issue. §

Start the tick-tock of the five-year clock by contributing to a Roth

TAX: Consider starting a Roth account with contributions or rollovers.

BY Richard B. Malamud, CPA, J.D., LL.M.
ECP Guest Contributor

Individuals who qualify should open and make a contribution or a rollover from a traditional IRA to a Roth for 2005 even if it does not seem to be the best current tax planning. The reason to make the contribution or the rollover is to start the clock running on the tax-free nature of the distribution. Contributions made for 2005 are treated as if they were made on January 1, 2005 (Treas. Regs. §1.408A-6, A-2).

Contributions

Although a taxpayer may receive tax-free distributions of contributions, Roth earnings are always taxable if distributed "within the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth." Earnings are taxable during the five-year period even if:

- The distribution occurs after the taxpayer reaches age 59½ or is disabled;
- The distribution is used by a first-time homebuyer (up to $10,000); or
- If distributed to the deceased taxpayer's heirs or estate.[1]

Thus, in order to be tax free, taxpayers should start the five-year Roth period running by making a contribution more then five years from the time they may want to take a distribution.

See Example 12-7.

The rules

Distributions that are not qualified may be subject to income tax and an additional 10% early distribution penalty may apply (IRC §72(t); Treas. Regs. §1.408A-6).

To be qualified, the distributions must

See **Roth**, *page 6*

EXAMPLE 12-7: Ricky and Randy are 53-year-old twins who work for the Bad Dirt Co. Neither of them has ever opened a Roth. In 2005, Ricky does nothing and Randy opens a Roth and puts $1,000 into the account. Five years later, when they are 58, Ricky puts $10,000 and Randy puts $9,000 into the Roth. Two years later, if they distribute $14,000 from their accounts (they invested it well), Ricky owes tax on $4,000 and Randy receives it all tax free, since he met the five-year holding period and he was over 59 ½.

The lesson is clear. By contributing even a small amount for 2005, the taxpayer's five-year required period begins running on January 1, 2005, and therefore, tax-free distributions can be made beginning in 2010, if one of the other tests is met, such as being at least 59½.

Roth, *continued from page 5*

meet a five-year test. The five-year test for tax purposes begins on the first day of the taxable year for which the first contribution is made (IRC §408A(d)(2)(B)). For penalty purposes, each conversion must take into account a new five-year test.

See Example 12-8.

The IRS prescribes ordering rules for distributions as follows (IRC §408A(d)(4)):

1. Regular contributions.
2. Roth conversions of traditional IRAs.
3. Roth conversion of nondeductible IRAs.
4. Earnings on all Roth accounts.

EXAMPLE 12-8: John opens a Roth account and makes a conversion contribution of $20,000 in February 2005, then makes a regular contribution of $3,000 for the 2004 tax year on April 15, 2005. The five-year period for the regular contribution (and, therefore, for the Roth account) begins on January 1, 2004. The five-year period for the conversion begins on January 1, 2005.

Income fluctuation

Starting a Roth now will also benefit the high-income taxpayer who in the future has a low-income year in which a Roth may be better than a deductible contribution because of the lower tax bracket. That could happen if, mid-year, the individual retires, is fired, laid off, or becomes disabled.

Middle age (50+)

Most conservative investors who are age 50 or older are excellent candidates for making a small early contribution to a Roth to get the five years started, especially if they have surplus cash that is earning money-market or short-term interest. If they make an initial contribution now, at age 56 or 57 they can make additional contributions and invest the money in short-term investments, such as six-month, one-year or two-year Treasury obligations.

Upon reaching age 59½ they can take distributions of the funds, tax-free, even though it had only been invested for a year or two, because they had opened the Roth at least five years earlier. For a taxpayer in the 35% federal tax bracket, getting Treasury interest tax-free results in a taxable equivalent rate of 6.15% to 9.23% on Treasury interest rates of 4% and 6%. On similar savings accounts, the benefit would be 6.785% and 10.177% in a state such as California. Not a bad rate to lock in for a year or two. §

[1] Distributions prior to five years that meet one of the above listed requirements will be subject to income tax, but the 10% early distribution penalty will not apply.

Use the retirement credit to cut the cost of retirement savings

TAX: With your help, clients in a lower tax bracket can use the credit.

By Lynn Freer, EA
ECP Publisher

IRC §25B provides a nonrefundable tax credit for contributions made by an eligible taxpayer to a qualified plan. Congress enacted the law with the idea of encouraging young people to begin saving for retirement early, however the credit can be especially useful for people in retirement or semi-retirement who don't yet need to draw upon their retirement savings.

The maximum annual contribution eligible for the credit is $2,000. An eligible taxpayer must be:

- Age 18 or over; and
- Not a full-time student or claimed as a dependent on another's return.

See the accompanying chart for AGI limits.

The credit is available for elective contributions to any of these plans:

- IRC §401(k) plan
- IRC §403(b) annuity or eligible deferred-compensation arrangement of a state or local government (IRC §457 plan)
- SIMPLE
- SEP
- Traditional IRA

See **Retirement tax credit**, *page 7*

Adjusted Gross Income

Joint return		Head of a household		All other cases		Applicable
Over	Not over	Over	Not over	Over	Not over	Percentage
	$30,000		$22,500		$15,000	50
30,000	32,500	22,500	24,375	15,000	16,250	20
32,500	50,000	24,375	37,500	16,250	25,000	10
50,000		37,500		25,000		0

EXAMPLE 12-9: Jim is age 62, single, and self employed. In 2004 he earns $20,000 from self employment plus interest of $3,000. He also received $8,000 in Social Security and contributed $6,000 to his SIMPLE. If he had not made contribution to his SIMPLE, a portion of his Social Security would be taxable and he would have federal income taxes of $1,731. By making the SIMPLE contribution, he derives three benefits:

- He gets a deduction for the contribution.
- The contribution reduces his AGI for purposes of computing the taxability of his Social Security.
- With his AGI reduced to $15,587 he gets a retirement credit of $400 (20% of the lesser of his $6,000 the maximum contribution allowable of $2,000).

His income tax is reduced to $386 after the credit (he must pay $2,286 in self-employment taxes regardless of whether he makes the SIMPLE contribution). Overall his taxes are reduced by 22% of the amount of his SIMPLE contribution — quite a trick for a taxpayer barely in the 15% bracket.