August 1997 Volume 2.3

# BFAS Money Line

TAXES TAXES TAXES

## Congress Changes the Rules!

The changes signed into law by President Clinton on August 5th will significantly impact almost everyone. While most of the changes will not begin until 1998, the capital gains changes are already in effect and we are already beginning to understand how this will change our lives. This expanded newsletter will cover the important aspects of the tax law changes as well as some other tidbits I have picked up. So, off we go –

### *Capital Gains*:

Most of you have probably heard about the **capital gains tax reduction to a maximum rate of 20%** (10% for those in the 15% tax bracket). May 7, 1997 is the date the new rates started. If you sold assets between then and July 28, 1997, you only had to have held them for 12 months to qualify for the new rate. After July 28, 1997 you must have held the assets for 18 months to qualify. If you heard about an 18% rate, it only applies to property purchased after December 31, 2000 and held at least 5 years. The old 28% maximum capital gains rate still

applies if you sell a collectible or do not meet the holding requirements stated above.

In a major change, **congress also removed most of the taxes on the sale of one's personal residence. Single persons can exclude up to $250,000 of gain and married couples filing jointly can exclude up to $500,000 of gain on a sale after May 6, 1997**. You must have owned and lived in the home at least two of the five previous years. You may use this exclusion as often as every two years.

***What does it mean to you?***

You should **closely monitor how long you have held all assets you are considering selling**. That is fairly easy for stocks. Those of you who trade frequently need to consider not only the trading costs but the even larger difference in taxes on short term gains.

**Mutual fund owners need to pay more attention to portfolio turnover**. A turnover rate of 100% means the funds held securities, on average, one year; 50% indicates a two year holding period. Two funds with identical total returns may have dramatically different after tax impact on you. An index fund, for example, usually has low turnover and most of that total return stays in the fund until you sell shares. On the other hand, an actively managed fund may be generating short term capital gains taxed currently at your income tax rate. Thus, tax efficiency in mutual funds is going to become more of issue.

This is not a pitch for index funds per se, just another thing to consider when you are choosing whether to use an index fund or an actively managed fund in your portfolio. There are tax efficient funds which are not index funds. You should note that **even tax efficient funds may generate short term capital gains if the market heads south and many shareholders redeem shares causing the funds to have to sell to generate cash for redemptions**.

Another consideration is **holding stocks in your taxable accounts to minimize taxes** (due to low capital gains rates) and **holding the bond portion of your portfolio in your pension accounts**.

Since variable annuity withdrawals are taxed at ordinary income tax rates, they may lose some of their allure.

The changes in taxes on home sales may have more impact

on many people. Most people have much of their net worth tied up in a house. Not many people are aware that the **old days of rolling over the gain on a home and the $125,000 exclusion for those over 55 are gone**. **If you sell a house after May 6, 1997 you will either qualify for the $250,000 or $500,000 exemption or you will pay capital gains tax on the sale!**

Although the wife in a divorce typically wants to keep the house, selling the house may help provide liquid assets for each partner to start over. The **elderly**, who typically own their home mortgage-free **can now sell their home and downsize to more appropriate living quarters without tax consequences in most cases.** This may be more attractive than a reverse mortgage.

Those who own really expensive houses with gains larger than $500,000 will have to pay capital gains taxes on the amount over $500,000. What about those who have **vacation homes**? You now have an opportunity to **move into your vacation home for two years, sell it with no taxes, then move back to your principal residence for two years and sell it tax free.** If you can find a house which appreciates rapidly, you can buy and sell homes every two years with no tax consequences!

Will this change have an impact on home prices? Hard to say. If there are large numbers of people out there who want to cash out of their home, the flood on the market could depress home prices. What about the sales of high priced homes now that people moving from DC and California do not have to roll over capital gains on their previous homes? Thus, there could be some unintended consequences in our housing markets.

### *Estate Taxes*

**Beginning in 1998 the unified estate and gift tax credit will increase slowly to reach $1 million in 2006**. The 1998 credit is $625,000, 1999 $650,000, 2000 $675,000, 2002 $700,000, 2004 $850,000, 2005 $950,000, 2006 $1 million.

In addition, **beginning in 1999 the $10,000 annual exclusion for gifts**, the $750,000 ceiling on special use valuation, the $1 million generation-skipping transfer tax exemption, and the $1 million ceiling on the value of a closely-held business eligible for special low interest rate **will be indexed annually to reflect inflation.** The increase will be in $1,000 increments so there will not be an increase each year.

Finally, **beginning in 1998**, executors may elect special estate tax treatment for qualified "**family owned business interests**" if these interests comprise **more than 50 percent of a person's estate** and certain other requirements are met. The **total exemption including the unified credit may not exceed $1.3 million (single) or $2.6 million (couples),** thus the 1998 credit will be worth $675,000. To be eligible **all of the heirs must participate in running the business for the next 10 years**, difficult criteria to meet.

***What does it mean to you?***

It is **time to review estate plans to insure they take full advantage of these new provisions.** The rise in the unified credit to $1 million just helps make up for the impact of inflation on the original 1987 $600,000 unified credit. With the values of estates rising due to the incredible market we have experienced, more and more estates will be subject to estate taxes. Since the rate starts at 37%, planning is the only way to keep the money in the family.

### *Child Tax Credit*

**Each qualifying child under 17 years of age is eligible for a $400 tax credit in 1998, $500 starting in 1999.** There is a phase out for high income folks. It starts at $110,000 for joint filers, $75,000 for singles and $55,000 for married filing separately. The credit is reduced in $50 steps for each $1,000 over the AGIs listed above.

***What does it mean to you?***

These credits could play a role in divorce settlements. All **parents may want to revisit their W-4 federal withholding for 1998 to reflect the benefit from the child tax credit.**

## Education Incentives

The **Hope Scholarship Credit** allows taxpayers a **maximum credit of $1,500** (100% of the first $1,000 of tuition and 50% of the next $1,000 of tuition and fees) **for expenses paid for the first two years of post-secondary education at an eligible institution.** This credit **starts in 1998** for education and expenses paid in 1998 for students enrolled at least on a half-time basis for at least one academic period during the year.

The **Lifetime Learning Credit** allows taxpayers a **maximum credit equal to 20% of up to $5,000 of expenses** ($10,000 beginning in 2003) **incurred during the year for qualified tuition and fees for eligible students for post-secondary education, including any course of instruction to improve or acquire job skills**. This credit applies to expenses paid **after June 30, 1998** for education after that date.

**Both credits are only eligible for the taxpayer, spouse or dependent**. They phase out

between $80,000 - $100,000 for joint filers ($40,000 - $50,000 for single filers). You must choose one or the other (or the education IRA described below) in a tax year.

The **Education IRA** is not a retirement account. **Starting in 1998**, you **can make non-deductible contributions of up to $500 annually per beneficiary under the age of 18**. The phase out for this is $150,000 - $160,000 for joint filers and $95,000 - $110,000 for single filers. The money in this IRA grows tax deferred and can be used to pay higher education expenses (tuition, fees, books, supplies, equipment, room and board) of a designated beneficiary.

There are **no taxes on the distributions for education**. Any distributions in excess of education costs or for any other reason are taxable plus a 10% penalty. Any balance remaining at the time the beneficiary turns 30 must be distributed and taxed (including the 10% penalty). However, the balance may be rolled over tax free to another education IRA benefiting another family member.

You may also take a **deduction starting in 1998 for $1,000 of qualified education loans**. This increases $500 yearly to $2,500 in 2001. Deductions are only allowed for the first 60 months that interest payments are required. The deduction is phased out for taxpayers with AGIs between $60,000 - $75,000 for joint filers and $40,000 - $55,000 for single filers.

***What does it mean to you?***

The interplay of these incentives requires some thought. **An Education IRA allows about $8,500 in contributions** (in $500 yearly increments). At a 9% return this **would amount to over $18,000 in tax free assets to pay for college.** This might be a great plan for grandparents.

In addition to the Education IRA, a contribution up to $2,000 can be made to a traditional or Roth IRA in the child's name, if the child earned income.

Remember that **you may not contribute to an Education IRA and to Virginia's pre-paid state tuition program in the same year**. You must choose one or the other.

The **Hope Scholarship applies to the first two years of school** while the **Lifetime Learning Credit applies to juniors, seniors, graduate students and working adults.**

Obviously, the education tax incentives require a re-evaluation of how best to save for college. Lower capital gains tax, expanded IRA opportunity, qualified savings plan loans, the "kiddie tax", tuition savings plans, student loans and excluded scholarships all figure into the mix.

## IRAs

Plain-vanilla IRAs are gone. We have more liberal rules for regular IRAs as well as new backloaded IRAs.

Starting in 1998 the old phase out limits for **deductible IRAs** ($25,000 - $35,000 for singles, $40,000 - $50,000 for married filing jointly) increase annually until they double by 2007. The **1998 AGI lower limits are $30,000 single and $50,000 married.** A non-employed spouse may still make a deducible IRA contribution of $2,000 even if the employed spouse has a pension plan (phase out starts at $150,000).

The new law also relaxes the penalty free withdrawal options. Now **you may withdraw for qualified higher-education expenses such as tuition or room or board, as well as expenses related to the first-time purchase of a home.**

The new law also **repealed the "Success Tax". This is the 15% excise tax on "excess" distributions from pension plans. The repeal is effective as of January 1, 1997.**

The **new "Roth IRA" does not allow a tax deduction.** However, it may be even more attractive than traditional IRAs. That is because your **$2,000 maximum contribution grows tax free and may be withdrawn tax free as long as the account is five years old and the withdrawal was**:

- made on or after the date the person reaches age 59 ½

- made to a beneficiary or the person's estate on or after death

- due to disability, or

- a qualifying special purpose distribution, including those made for up to $10,000 of first-time homebuyer expenses.

Limits on contributions (up to $2,000) start at $150,000 for couples and $95,000 for singles. There are **no minimum distribution requirements on Roth IRAs, unlike regular IRAs.** If you work past the age of 70 ½, you may continue to make contributions to your Roth IRA.

**Amounts currently in deductible IRA accounts may be rolled over into Roth IRAs (if your AGI is $100,000 or less).** However, the **amount rolled over is considered income.** If the transfer occurs in 1998, **income from the transfer is spread out over four years ( ¼ of the transferred amount is includable in 1998, 1999, 2000, 2001).**

Nondeductible IRAs are still around. Those whose incomes exceed the limits for the other IRAs may make nondeductible contributions up to $2,000 per year and they will be treated the same as before. You will, however be able to withdraw money penalty-free before 59 ½ if used for higher education expenses or first-time home purchase.

***What does it mean to you?***

A broader range of taxpayers with higher incomes will now be able to contribute to a deductible IRA. **Although withdrawals for education or a first home are now available without penalty, I would caution against forgoing the tax deferred/free buildup in an IRA account.** This should be the last resort, not the first.

IRAs should be used to the maximum extent possible, depending upon which you are eligible to use. One issue is whether to contribute to a Roth IRA or a deductible IRA and whether to roll deductible IRAs into Roth IRAs.

**If you assume that your tax rate in retirement will be the same as or more than current rates, contributing to or rolling over into the Roth IRA is probably the best option. If tax rates are substantially lower (28% now, 15% in retirement), using the deductible IRA may be best.** Length of compounding before withdrawals may also factor in here. **Individual situations should be reviewed before making the decision.**

If you want to roll over your regular IRA to a Roth IRA, you might want to work with your employer to reduce AGI one year to $100,000. If you had a $1 million IRA and met the AGI requirement only once, you could roll the whole amount into a Roth IRA. Something to consider.

**VIRGINIA TAXES**

# Are You a Caregiver?

Starting in 1998, Virginia law provides for a $500 tax credit to taxpayers with adjusted gross incomes between $5,000 and $50,000 who provide unreimbursed care to a physically or mentally impaired relative who required assistance with two or more activities of daily living during more than half the year.

**LIFE INSURANCE**

# Potential Financial Time Bomb!

This could affect you or someone close to you. **In the 1970's and 80's many people paid their life insurance premiums with loans taken from the same policies.** This technique was known as minimum deposit. This financial magic was possible since policy loan interest was fully deductible and dividend scales were at an all time high.

However the Tax Reform Act of 1986 did away with the magic. **The elimination of loan interest deductions and lower dividends has led to an increasing possibility that policies will lapse.** If the existing policy loan exceeds the owners cost basis in the policy, the "gain" is taxable as ordinary income in the year the policy terminates.

**Some minimum deposit policies have loans that exceed the owner's cost basis by hundreds of thousands of dollars. These owners will be taxed on a gain with no equity in the policy to pay the tax.**

A similar problem exists in cases where investors purchased **"single premium" whole life policies with the intention of "borrowing" the cash value as a means of obtaining what was promoted as "tax free" income.** Often, these policies used what was known as **"wash loans"** to accomplish the objectives. Again, changes in law and economic conditions have created a potential financial trap.

There are solutions to these problems. As a licensed insurance consultant, I can show you possible solutions to these problems.

# Prudential

**Anyone who owned a Prudential Life Insurance policy between 1982 and 1995 should contact the company.** You may be eligible for a settlement as a result of a recent legal action.

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