

# Financial Planning

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## Happy Endings

*This year, new laws provide potential payoffs, as well as pitfalls, for December tax planning.*

By Donald Jay Korn

November 1, 2006- Defer income. Accelerate expenses. Sell losers. Year-end tax planning used to be relatively straightforward. A decade of legislative changes, including two major new laws in 2006, makes maneuvering in December trickier than before. Along with increased obstacles, though, there are some unprecedented opportunities.

### CHARITABLE STRATEGIES

**For older clients.** "We've already sent a letter to our clients saying that if they've reached age 70½, they should consider utilizing their IRAs to make charitable gifts," says Roger Lusby, a partner at Frazier & Deeter, an accounting firm in Atlanta. "That's a result of the Pension Protection Act of 2006."

Under this new law, donors in that age group can make charitable distributions from their IRAs in 2006 and 2007, up to \$100,000 per year. No taxable income will be recognized and no income tax deduction can be claimed for these donations.

"Previously, if you withdrew funds from an IRA in order to make a charitable contribution, the withdrawal had to be reported as ordinary income and was subject to tax at regular income tax rates," Lusby says. "Once the charitable contribution was made, you would be entitled to a tax deduction." That tax benefit was available only for those who itemized, however; even then, the write-off might be reduced by income limitations and phase-out rules.

The new rule covers taxpayers who must take required minimum distributions (RMDs) from their IRAs. "If you make a qualified charitable distribution from your IRA in an amount at least equal to your RMD, you are considered to have satisfied the RMD rules for that year," Lusby says.

Thus, clients fulfill their RMD obligation without picking up taxable income. This strategy effectively lowers adjusted gross income, Lusby points out, which may help other areas of a client's tax return, such as increasing deductions for medical expenses and for passive losses.

In order to merit this tax break, contributions must be made directly from the IRA trustee to a charity (donor-advised funds won't qualify), without a stop in the IRA owner's bank account. In addition, all such charitable gifts must be documented; the IRA owner will need a letter of acknowledgment.

**For younger clients.** Younger donors can't use this charitable IRA rollover, but they can use a proven tactic for year-end philanthropy: Instead of cash, they can donate appreciated securities that have been held more than one year. This strategy provides a 100% deduction for giving away assets that might be worth only 90 cents or 95 cents on the dollar, after tax.

### GIFT-TAX EXCLUSIONS

The annual gift-tax exclusion (now \$12,000 per recipient) has been an estate-tax reduction tool, but it can also help in income tax planning. If John Jones gives appreciated stock to his daughter Ashley, she can sell it and owe tax in her lower tax bracket. The gift-tax exclusion can reduce or eliminate the tax consequences of John's gift.

But the Tax Increase Prevention and Reconciliation Act (TIPRA), which was signed into law this year, changed the rules? "Retroactive to January 1 of this year, the kiddie tax' now applies to children under age 18 instead of under age 14," says Blanche Lark Christerson, managing director of Deutsche Bank Private Wealth Management in New York. "That means that if children aged 14 through 17 have unearned income in excess of \$1,700 in 2006, it will be taxed at their parents' top rate."

Because taxpayers were not expecting these changes, they may not be paying enough estimated 2006 income tax, Christerson says. Clients in these situations should look at their probable 2006 income tax liability and make sure they have paid enough estimated tax to avoid interest and penalties.

On the positive side, TIPRA also extended the 0% tax on long-term capital gains through 2010 for low-bracket taxpayers. In those years, children 18 and older will be able to have taxable income north of \$30,000 and owe no tax on realized gains.

"If you think you might be selling appreciated securities in 2008 to 2010, perhaps to pay college bills, give some of those assets to your children in 2006," says Tom Ochenschlager, vice president of taxation for the American Institute of Certified Public Accountants in Washington. A married couple can give \$24,000 worth of securities without gift-tax consequences, assuming no other gifts are made.

For example, Alan and Betty Parker can give \$24,000 worth of small-cap funds to their daughter Deirdre, 17, and \$24,000 of international funds to their son Noah, 16, at year-end 2006. Similar gifts can be made in subsequent years.

In 2008, 2009 and 2010, Deirdre and Noah can sell the securities. "Any capital gains on the shares will not be subject to federal income tax, as long as the children stay within the 15% bracket, Ochenschlager explains. By then, single taxpayers should be able to report \$32,000 or more in taxable income without moving up to a higher tax rate.

## RETIREMENT PLANNING

**Non-spousal beneficiary IRA rollover rules.** Other year-end issues arising from this year's legislation involve retirement accounts. "We're delaying post-death distributions from employer retirement plans until next year to take advantage of the Pension Protection Act's non-spousal beneficiary IRA rollover rules," says Michael Kitces, director of financial planning at Pinnacle Advisory Group in Columbia, Md.

Under current law, a non-spouse beneficiary of an employer-sponsored retirement account often has to take the inherited money from the plan and pay all the income tax within one year. Those rules change in 2007, when beneficiaries will be able to roll plan proceeds into an inherited IRA—so Kitces is advising clients in such situations to wait. (For more information, see "[Stretching Benefits](#)," also in this issue of *Financial Planning*.)

**Defined benefit plans.** "We're also reviewing existing small-business defined benefit (DB) plans in light of the new funding rules under the Pension Protection Act," Kitces says. Some of the law's provisions require large employers to provide more funding for their DB pension plans. Some smaller companies and professional practices also have DB plans, which may permit older principals to load up on tax-deferred contributions.

"The new funding rules affect all DB plans," Kitces explains. "The implications are a little different for large companies (where the rules could change funding liabilities by millions of dollars) versus small companies (where the rules may allow larger contributions that the small-business owner wants to make), but the changes apply across the board. For the current year, additional contributions are optional but not mandatory."

**Other retirement plans.** For other types of retirement plans, familiar deadlines still apply. Clients must establish Keogh plans for self-employment income before year-end if they plan to make a deductible contribution. They can delay the actual contribution until the due date of their 2006 tax return, including an extension to October 15.

Rather than Keogh plans, some self-employed clients might prefer so-called solo 401(k) plans, which may permit larger tax-deductible contributions, depending on the amount of self-employment income involved. If so, the same year-end rules apply. "Plan participants should file a form (albeit with themselves) stating their planned deferral amount by the end of the year, for documentation purposes, although the actual funding for this year can occur in 2007," Kitces says. Again, clients can make contributions until next year's filing deadline, including an extension.

**Roth IRAs.** Clients can defer the deadlines for creating as well as for contributing to traditional IRAs and Roth IRAs for 2006 until April 16 of next year. But, clients who are interested in converting a traditional IRA to a Roth IRA should withdraw funds from the traditional IRA by the end of the year.

"The advantage to a 2006 conversion is that it starts the Roth IRA clock at Jan. 1, 2006, even if the conversion is at year-end," says Ed Slott, a CPA in Rockville Centre, N.Y., who publishes *Ed Slott's IRA Advisor* newsletter. "As long as your client is at least 59½ years old, he or she can take tax-free withdrawals from a Roth IRA after five years, which means after Jan. 1, 2011. This technique gives the client one of those five years right away."

A Roth IRA conversion will be valid only if the client's income this year is no more than \$100,000. "Even if clients are unsure about the income, they should go ahead and convert anyway. If they're over the limit or if they change their minds for any reason, they have until Oct. 15, 2007, to reverse the conversion with no penalty."

Roth IRAs were joined by Roth 401(k)s this year, adding yet another tax-planning twist. "Higher-paid people can have Roth 401(k)s as long as their employers add that option," says Elfrena Foord of Foord, Van Bruggen, Ebersole & Pajak, an investment advisory and wealth coaching firm in Sacramento. "There aren't income limits."

Roth 401(k)s make the most sense for those who assume tax rates will be higher in the future, according to Foord, because participants pay tax today, in return for eventual tax-free distributions. "Clients who want a Roth 401(k) should make sure not to make contributions to a traditional 401(k)," she says. "You can't switch money from one plan to the other after a contribution has been made."

Year-end retirement planning may also be necessary for clients who reach 70½ during 2006. For such clients, the first required distribution is due by April 1, 2007. The next required withdrawal is due by Dec. 31, 2007, and each succeeding Dec. 31.

"Taking two distributions in 2007 might push someone into a higher tax bracket," says Sidney Kess, an attorney in New York. "Such individuals might be better off taking the first RMD by year-end 2006, if that will hold down their tax bracket next year."

Natalie Choate, an attorney with Bingham McCutchen, a law firm in Boston, notes that careful planning is necessary to decide whether to take that first RMD this year. For example, this year, someone with high medical expenses might qualify for a medical deduction; taking an RMD in 2006 would push up this year's income and reduce (or even eliminate) that medical deduction. Thus, taking two distributions in 2007 could be the better choice.

On the other hand, a client who has kept money in a former employer's 401(k) plan might want to take a distribution by year-end 2006, in order to take advantage of the charitable IRA rollover described above. According to Choate, author of *Life and Death Planning for Retirement Benefits*, individuals cannot roll over money from a 401(k) to an IRA until they have taken the required 401(k) distribution, which will be included in income that year.

"After taking the 2006 RMD from the 401(k), a client can roll the balance of his or her 401(k) account to an IRA in 2006. The client can then transfer up to \$100,000 from the IRA directly to qualifying charities in both 2006 and 2007. The 2007 qualified charitable distribution will also count toward his or her 2007 minimum required distribution from the IRA."

As planners might notice, year-end 2006 planning may easily spill over into planning for 2007 and future years. Consider using the promise of tax savings to coax clients to interrupt their holiday revels for a farsighted strategy session.

*Senior Editor Donald Jay Korn has been writing about investments and tax and estate planning for Financial Planning since 1985.*

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