

1998

## Individual Tax Planning

James V. Duty

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*Forty-Fourth*  
**WILLIAM & MARY TAX CONFERENCE**

# **INDIVIDUAL TAX PLANNING**

*James V. Duty*

**1998 William and Mary Tax Conference  
Presentation Outline**

- I. The Roth IRA, a new savings vehicle as of January 1, 1998, presents a unique opportunity for a taxpayer to receive tax-free income
  - A. To receive tax free treatment, distributions from a Roth IRA must be “qualified distributions.”
    - 1. After age 59 1/2, §408A(d)(2)(A)(i);
    - 2. On account of death or disability, §408A(d)(2)(A)(ii) and (iii),
    - 3. In a qualified first-time homebuyer distribution, subject to a \$10,000 lifetime limit. The distribution must be used to acquire a principal residence of the taxpayer, a spouse, child, grandchild, or ancestor. A first-time homebuyer, generally, is a taxpayer who has not owned a principal residence for two years. §408A(d)(2)(A)(iv) and §72(t)(2)(F).
    - 4. No qualified distribution can be made until the taxpayer has had a Roth IRA for five years. §408(A)(d)(2)(B).
  - B. Contribution Rules
    - 1. No deduction up front. §408A(c)(1).
    - 2. Contributions are limited to \$2,000 per year per person. §408(c)(2).
    - 3. Can be made even after age 70 1/2. §408A(c)(4).
    - 4. The \$2,000 limit is reduced for taxpayers with AGI above \$150,000 (\$95,000 if single) and eliminated if AGI is above \$160,000 (\$110,000 for singles). §408A(c)(3).
    - 5. The regular IRA rules will apply except where expressly changed. (§408A(a)), so that for instance earned income is required, except in the case of spousal IRAs.
    - 6. The \$2,000 contribution limit is reduced for amounts contributed to a regular IRA. §408A(c)(2)(B).
  - C. Conversion Rules
    - 1. A regular IRA owned by a taxpayer with AGI of no more than \$100,000 (who is not married filing separately) can be converted into a Roth IRA. (§408A(c)(3)(B)).
    - 2. AGI for this purpose does not include income from conversion. §408A(c)(3)(C)(i).
    - 3. For years after 2004, AGI for this purpose also does not include minimum required distributions from qualified plans or IRAs. §408A(c)(3)(C)(i)(II).
    - 4. The value of the IRA being converted in excess of basis (if any) is included in the income. §408A(d)(3)(A)(i).

5. If conversion occurs during 1998, the taxpayer can take converted IRA amount into income ratably over four years. §408A(d)(3)(A)(iii).
6. The taxpayer may elect to waive the four year spread on 1998 conversions and include the entire conversion in 1998 income. §408A(d)(3)(A)(iii).
7. The 10 percent early distributions tax does not apply to the conversion. §408A(d)(3)(A)(ii).
8. A taxpayer may undo a Roth conversion. §1.408A-5.

D. Conversion Analysis - For many people Roth conversion should be attractive. Acceleration of the tax at conversion is generally outweighed by the benefit of future tax exemption. See Example below and detailed calculations in Exhibit I.

Example 1: Roth IRA vs. Taxable Minimum Distribution Analysis - Joe Smith, retired at age 64, has \$3.6 million in a fully deductible IRA. He is in the maximum income tax bracket and because of a generous pension, does not need the IRA for current cash flow. He considers his IRA a “rainy day fund” and would only take distributions in the event of an emergency, except as required to avoid minimum distribution penalties. He has \$1.4 million in liquid assets he can access without incurring income tax. He would like to compare the after tax value of a Roth conversion versus a minimum distribution strategy from his deductible IRA. Exhibit 1 shows the after tax amount that the accounts would grow to, assuming a 9.5% pretax total return and an 7.5% after tax return on those investment earnings currently taxable. This assumes the accounts are depleted only by income tax - over 4 years in the Roth conversion scenario, and each year the funds are taken in the minimum distribution scenario. As per the Multi-file Analysis report in Exhibit 1, Mr. Smith would have 13% - 53% more funds available from a Roth conversion account depending on what year he accessed the account.

E. Conversion Strategies

1. Deferred Compensation
  - a. An unfunded (unsecured) agreement by an employer to pay an amount to an employee at some point in the future is not taxable until payment is made, provided the agreement is entered into before the rendition of services for which compensation is to be deferred. Rev. Rul. 60-31, 1961-C.B. 174.
  - b. IRS position on bonus deferrals is unclear.
    1. Employee elects, at any time on or before December 15 of the year preceding the year in which the bonus

would otherwise become payable ... Rev. Rul. 67-449, 67-2 C.B. 173.

2. For advance ruling purposes IRA will issue rulings if and only if all the following guidelines are met:
  - a. The election to defer compensation must be made before the beginning of the taxable year for which the compensation is payable, provided, however, that in the year in which the plan is first implemented, or the year in which a participant become eligible to participant, such election may be made within 30 days after the plan is effective or the employee becomes eligible;
  - b. The plan must define the time and method for payment of deferred compensation for each event (such as termination of employment or death);
  - c. The plan may provide for payment of benefits in the case of an unforeseeable emergency” only if this is defined in the plan as an unanticipated emergency that is caused by an event beyond the control of the participant and that would result in severe financial hardship if early withdrawal were permitted (any such withdrawal must be limited to the amount necessary to meet the emergency);
  - d. The plan must provide that participants have the status of general unsecured creditors of the employer and that the plan constitutes a mere promise by the employer to make benefit payments in the future;
  - e. If a trust is utilized, it must conform to the terms of model trust described in Rev. Proc 92-64, 1992-2 C.B. 422. and;
  - f. The plan must provide that a participant’s rights to benefit payments under the plan are not subject to alienation, pledge or garnishment by creditors of the participants or the participant’s beneficiary.

Rev. Proc. 92-65, 1992-2 C.B. 428.

2. Oil and Gas Working Interests

A passive activity does not include a working interest in any oil or gas property which the taxpayer holds directly or through an entity which

does not limit his liability with respect to such interest. §469(c)(3).

The taxpayer must not limit liability (determined on a well-by-well basis), and must share in the cost of production (not merely share in revenue or net profits). §469(c)(3)(4); 1986 TRA General Explanation.

3. Investment Income Management
    - a. Family Income Shifting
    - b. Municipal Bonds
    - c. Mutual Fund Strategies
    - d. Equities
- F. Roth IRA's are superior to regular IRA's at death, in that post death distributions will not represent income in respect of a decedent. The same options for a designated beneficiary exist for Roth IRA's as for regular IRA's.

## II. Unrealized Appreciation on Employer Securities

- A. Net unrealized appreciation (NUA) on employer securities distributed from a qualified plan is not currently taxed for income tax purposes.
1. If employer securities are distributed periodically the amount that is excluded is the NUA attributable to the employee's contributions securities. §402(e)(4)(A).
  2. NUA attributable to employer contributions can also be excluded, but only if the distribution represents a lump sum distribution. §402(e)(4)(B).
  3. Five year forward averaging on lump sum distributions is repealed for tax years beginning after 1999. §1401(a) and (c)(1).
  4. Most amounts within qualified plans are attributable to employer contributions. Employee deferrals made under a §401(k) plan and amounts paid by the employer to match employee deferrals are treated as employee contributions. Reg. §1.402(a)-(1)(d)(2). Employee contributions are only those made on after-tax basis.
  5. NUA realized in a subsequent sale or disposition will be treated as long-term, regardless of how long the plan or the employee holds the employer securities. §1.402(a)-1(b)(1)(i).
  6. The amount of NUA within a qualified plan should directly impact selection of a distribution strategy. See Examples 2 and 3 below.

Example 2: Assumptions: In the following scenario involving taxpayer W, and her husband, H, the following facts are present:

- 1) W was born June 1, 1935. Her spouse, H, was born on June 1, 1939.
- 2) H is the sole beneficiary of W's estate.

3) W has one qualified plan through her employer, Megaco, Inc. It is a profit sharing plan. The balance on January 1, 1998, is \$450,000. Net unrealized appreciation of securities is currently \$315,000, of which \$300,000 is attributable to employer contributions, and \$15,000 attributable to W's contributions. W's participation in the plan began in January 1966.

4) The regular income tax rate (combined federal and state) is 43.07%, the combined capital gain rate is 23.47%, the IRD tax rate is 43.07%, and the estate tax rate is 55%.

5) The rate of return (current yield and appreciation) "inside" the plan is 10.0% and "outside" the plan (i.e. investments subject to current tax) is 8.5% after tax.

In 1998, W is presented with three distribution scenarios: (1) a lump sum distribution, (2) minimum distributions, (3) substantially equal periodic distributions. Minimum distributions are calculated on a joint life expectancy, with a recalculated life expectancy for W and fixed life expectancy for H.

As per Exhibit 2, the results of the three scenarios (after imposition of all relevant taxes) are summarized below:

*Scenario 1:* Lump Sum Distribution - this distribution method provides the best result for all years.

*Scenario 2:* Minimum Distributions - this distribution strategy provides the second best results for all years.

*Scenario 3 - Substantially Equal Payments* - this distribution method provides the worst results for all years.

Example 3: Same assumptions as Example 2, except the plan balance is \$2,000,000 instead of \$450,000. Therefore, less of the plan on a percentage basis is made up of net unrealized appreciation. As per Exhibit 3, the results of the three scenarios are summarized below:

*Scenario 1:* Lump Sum Distribution - this strategy provides the best results for 14 years (1998 - 2011), the second best results for 5 years (2012-2016), and the worst results thereafter.

*Scenario 2:* Minimum Distributions - this strategy provides the worst results for one year (1998), the second best results for 13 years (1999-2011), and the best results thereafter.

*Scenario 3:* Substantially Equal Payments - this strategy is second best for one year (1998), the worst for 18 years (1999-2016), and the second best thereafter.

### III. Education Incentives

A. Accumulation

1. Education IRA's

- a. Education IRAs can be established for any person under age 18 up to the maximum annual allowable contribution of \$500 per beneficiary per year). §530(b)(1)(A)(ii) and (iii). No deduction will be allowed for the contributions.
- b. Distributions from the IRA that are used to pay qualifying educational expenses will be excluded from the beneficiary's income and will not be subject to any penalties. §530(d)(2).
- c. Qualifying educational expenses include tuition, fees, books, supplies, and equipment for post secondary education. In addition, as long as the student is enrolled in a qualifying program and is carrying at least a one-half of the normal load, then room and board up to certain limits is a qualifying expense. §§530(b)(2) and 529(e)(5).
- d. To qualify for the income exclusion, no one can claim an educational tax credit for the student for the year of distribution from the IRA. §530(d)(2)(D).
- e. Education IRA contributions can not be made for any year in which anyone is making a contribution to a qualified state tuition program on behalf of the same person. §530(d)(2)(D).
- f. Individuals can make Education IRA contributions as long as the taxpayer's Adjusted Gross Income (AGI) is less than \$150,000 for married couples and \$ 95,000 for single taxpayers. Married taxpayers with AGI between \$150,000 and \$160,000 and Single taxpayers with AGI between \$ 95,000 and \$110,000 can make Education IRA contributions but the allowable amount is phased out depending on the AGI. §530(c)(1).
- g. Education IRAs must be distributed no later than the year in which the beneficiary reaches age 30. §530(b)(1)(E).
- h. If distributions are made which do not qualify as education expenses, then the earnings on the account are taxable to the beneficiary and a 10% penalty is due. §§530(d)(1) and (4).
- i. Prior to obtaining age 30, the balance in the account can be transferred to an education IRA for a qualifying family member. §530(d)(5).

2. Virginia Prepaid Tuition Plan §529

- a. Primary benefit is protection against inflation in college tuition costs.

- b. Primary concern is that maximum benefit is obtained only if child or sibling attends Virginia public college. The benefits vary if child does not attend a Virginia public college depending on specific circumstances. Value of benefits in excess of cost of plan is includible in student's federal taxable income in the year utilized; however, the student or a qualified taxpayer may be able to benefit from one of the special educational tax credit provisions as payments from these plans qualify for the credits. Value of benefits is now exempt from Virginia income tax, and purchase is deductible within limits.
- c. Covers the tuition and mandatory fees for undergraduate enrollment. Currently the plan does not include room and board, but it may be expanded in the future to cover these expenses. The plan can be used for graduate school, but it will not cover costs in excess of the undergraduate costs.
- d. Beneficiary can be changed to a younger sibling of the original beneficiary.
- e. Due to uncertainty of child's attendance at a Virginia public college, it may be advisable not to purchase contracts for 100% of anticipated college needs. As contracts can be transferred to younger siblings, it generally is recommended that contracts be purchased for the older siblings first.
- f. From investment perspective, depending on time horizon, this may be an appropriate method to fund a specific need.

### 3. Qualified U.S. Savings Bond

- a. An income exclusion is available for any qualified U.S. Savings bond redeemed in a year in which qualified higher educational expenses are paid.
- b. A qualified bond is any series EE U.S. Savings Bond issued after 1989 to an individual who reached age 24 before the date of issue §135(c)(1)(A) and (B).
- c. Qualified higher education expenses include only tuition and mandatory fees for the taxpayer, a spouse or a dependent. §135(c)(2).
- d. Qualified expenses must be reduced by any nontaxable educational benefits such as qualified scholarships, other educational assistance under certain chapters of title 38 of the United States Code, or payments qualifying as employer provided educational assistance. §135(d).
- e. Also, the qualified expenses must be reduced for amounts taken into account for the HOPE Scholarship or Lifetime Learning credits. §135(d)(2).

- f. Effective for post-1997 years, amounts redeemed and contributed to a qualified tuition program are eligible for the exclusion. §135(c)(2)(C).
- g. The exclusion is subject to a phaseout based upon a taxpayer's modified adjusted gross income. For 1997, the phaseout began at \$40,850 for singles and \$76,250 for joint filers. The exclusion was completely phased out at \$65,850 for singles and \$106,250 for joint filers. §135(b)(2).
- h. Taxpayers who file married filing separately are not eligible for the exclusion. §135(d)(2).

**B. Distribution Opportunities**

- 1. HOPE Scholarship Credit
  - a. The HOPE Scholarship Credit may be elected for qualified tuition and mandatory fees incurred during a taxpayer's, spouse's, or dependent's first two years of post-secondary education. §25A(b)(2)(A).
  - b. Amounts paid for room and board or books do not qualify. §25A(f)
  - c. The student must be enrolled at least part-time carrying at least one-half of the workload of a full-time student. §25A(b)(3).
  - d. The HOPE credit is nonrefundable and is available for up to 100 percent of the first \$1,000 and 50 percent of the second \$1,000 of qualified tuition and related expenses. §25A(b).
  - e. The HOPE credit is not available in any year in which the Lifetime Learning Credit or the income exclusion from an Educational IRA is utilized with respect to that student. §25A(e)(2).
  - f. The HOPE credit is phased out as modified adjusted gross income increases from \$80,000 to \$100,000 for joint filers and \$40,000 to \$50,000 for single filers. §25A(d)(2).
  - g. The HOPE credit is available for expenses paid after 1997. §25A.
- 2. Lifetime Learning Credit
  - a. The lifetime learning credit is allowed for up to 20 percent of qualified tuition and mandatory fees paid with respect to one or more students after June 30, 1998. The maximum qualified tuition and fees is \$5,000 per year through 2002 (\$10,000 per year for 2003 and years thereafter). §25A(c). The limits are based on amounts paid by the taxpayer for any number of dependent students.
  - b. In general, the lifetime learning credit follows the same limitations and incorporates the same definitions as the HOPE credit. However, unlike the HOPE Credit, the

lifetime learning credit is available for an unlimited number of years and it is available for any undergraduate, graduate or professional degree programs. Also, the credit may be claimed for any course at an eligible institution that helps an individual improve their job skills. Thus, both CPE credit and noncredit professional seminars provided by eligible institutions may qualify for the credit. Generally, an eligible institution is one which is eligible to participate in student aid programs sponsored by the Department of Education. §25A.

#### IV. Other Tax Favored Investments

##### A. Low-Income Housing Credit (“LIHC”)

1. A tax credit may be claimed by owners of residential rental property used for low-income housing. §42.
2. A percentage of the qualified basis may be claimed for 10 years as the LIHC. §42(f)(1).
3. The credit is recaptured if the qualified basis is not maintained for 15 years. §42(j).

##### B. Rehabilitation Tax Credit

1. A credit is available for 10% of qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure. §47(a)(1).
2. A credit of 20% of qualified rehabilitation expenditures is available for a certified historic structure. §47(a)(2).

##### C. Both the LIHC and Rehabilitation credits are limited to a \$25,000 deduction equivalent without regard to active or material participation requirements. §469(i)(2) and (i)(6)(B).