



THE LAW FIRM OF  
BOVE & LANGA, P.C.

**FIRM NEWSLETTER OCTOBER 2002**

FIRM DEVELOPMENTS

The firm is pleased and proud to announce that Alexander A. Bove, Jr. has been invited to speak at the 37<sup>th</sup> Annual Heckerling Institute on Estate Planning which is sponsored by the University of Miami's School of Law, and takes place January 6<sup>th</sup> through 10<sup>th</sup>, 2003, in Miami. The Institute is regarded throughout the country as the premiere estate planning and tax program. While a unique honor, Alexander's speaking engagement is only one of many that the firm's attorneys engage in throughout the year. As a courtesy to our clients and friends, we would be happy to speak on the topics of our expertise to any professional group or other organizations of which you may be a member or with which you may be associated. Feel free to contact our administrator, Katherine Levin, for more details and possible topics of interest.

NEW DEVELOPMENTS

Estate Tax Sunset Provision Upheld: As reported in past up-dates, on May 26, 2001, Congress adopted The Economic Growth and Tax Relief Reconciliation Act of 2001 which increased and froze the Gift Tax exemption at \$1 million in 2002, while increasing the Estate Tax exemption to \$1 million in 2002 and 2003, \$1.5 million in 2004 and 2005, \$2 million in 2006-2008, and \$3.5 million in 2009, with similar changes made to the Generation-Skipping Transfer tax. The Estate Tax is scheduled to be fully repealed in 2010; however, all three transfer taxes re-surface in 2011 and revert to 2001 levels unless Congress makes the Act permanent. In June of 2002, the House passed the "Permanent Death Tax Repeal Act of 2001," which would have made the repeal permanent, but this Act was defeated in the Senate. Statements made by members of Congress after the defeat reflect a sentiment to freeze the exemption at a higher amount than the current \$1 million, but not to provide a total repeal.

In addition to Congressional action, Massachusetts, like other states, has passed legislation to enact its own Estate Tax (effective for decedents dying on or after January 1, 2003) which will be equivalent to the "sponge tax" which Massachusetts would have received under the federal code in effect on December 31, 2000. Unfortunately, there is confusion as to whether Massachusetts will adhere to the increasing federal Estate Tax exemption or whether it will revert to the \$675,000 exemption available on December 31, 2000. We have been in contact with the Massachusetts Department of Revenue and the State Legislature and they plan to clarify the issue.

Annual Exclusion Gifting: As of January 1, 2002, the annual exclusion for making tax-free gifts increased from \$10,000 to \$11,000 per donee per year. Although this does not seem like a large increase, when making leveraged gifts of family limited partnership interests, limited liability company interests, split interests and the like, you can accomplish transfers of greater value using the annual exclusion. So please don't forget to contact us to assist with your 2002 annual exclusion gifting before the year-end rush. If you are one of our many clients making annual exclusion gifts of family business or similar interests, you should be aware of a recent case that could potentially disqualify your gifts for the annual exclusion. The IRS successfully argued that

the gifts of partnership interests were not “present interest” gifts, which is one of the requirements for qualifying for tax-free treatment. The reason the gifts were determined to instead be gifts of “future interests” was that there was no current benefit to the beneficiaries and the financial reports for the partnership clearly indicated that no benefit was anticipated for a significant number of years. This is an extreme set of circumstances of which the IRS was able to take advantage. It is rare for a partnership to show absolutely no benefit to the partners and that no benefit is expected in the immediate future. So our advice is to not panic. It is unlikely to affect most of you so long as you are honoring the formalities of the entity. If, for example, your child is a 20% partner, pay her 20% of all distributions made. However, if you have any concerns based on the benefit flowing to your beneficiaries, we do recommend that you contact us to discuss your situation in more detail. If we determine that your gifts are vulnerable to attack, we can offset this vulnerability with changes to your operating agreement that hinder the IRS’ arguments.

Massachusetts Increases Capital Gains Tax – Retroactive to May 1, 2002: The Massachusetts legislature has eliminated the preferential capital gains tax and replaced it with a capital gains tax rate equal to the regular income tax rate in effect for the year, which for 2002 is 5.3%. The legislature enacted the law on July 25, 2002, but made it retroactive for all transactions which took place on or after May 1, 2002. All capital gain transactions which occurred between January 1, 2002 and April 30, 2002, will still be taxed at the prior preferential capital gains rates.

Property Settlement Agreements: This appears to be a time when courts seem to be attacking the true and tested asset protection vehicles, such as the spendthrift trust which has withstood centuries of creditor attacks until only recently in Massachusetts, when a judge allowed the assets in a properly designed spendthrift trust to be considered in determining property settlement and alimony in a divorce. Recently, however, we have seen another asset protection vehicle – the prenuptial agreement – hold its ground. In mid-2002 a Massachusetts court upheld the provisions of a prenuptial agreement despite the tremendous disparity in wealth that resulted between the former spouses. The court was careful in upholding the agreement, finding that there was full disclosure of each party’s assets prior to signing the agreement and that each party had independent legal representation in the negotiation of the agreement, among other factors. It is important to note that although there was a significant change in one spouse’s way of life after the divorce, that spouse is still living comfortably and well-above her means prior to the marriage.

Deduction for Educator Expenses: Good news for teachers, instructors, counselors, principals, and aides in a K-12 school! The Job Creation and Worker Assistance Act of 2002 established an adjustment to income of up to \$250 for eligible educators who incur qualified expenses during 2002 and 2003. Qualified expenses are unreimbursed expenses for supplies and equipment used in the classroom. For more details look to the Internal Revenue Service’s Publication 3991.

## PLANNING OPPORTUNITIES

Asset Protection Planning: Asset protection seems to be something all clients ask for these days, whether they need it or not. Since everyone is afraid of being sued and “losing everything,” there has grown a successful market in pedaling asset protection packages of various sorts offered through advertisements, lectures, and the like, by asset protection “specialists,” many of whom seem to have more assertiveness than competence in the field. Competent asset protection planning begins with a careful assessment of whether and to what extent a client actually needs such protection, followed by the development of a particular plan that suits the individual client’s needs. Such a plan may range from a simple homestead declaration or tenancy by the entirety for the family home, to one or more limited liability companies, to offshore trusts. It is definitely not the “one size fits all” approach, so be very leery of ready made package plans that promise to protect you against all attacks and offer a set of steak knives if you buy now. Just take the steak knives.

Split Purchase of a Home: One of the more effective estate tax savings options is the split purchase of a personal residence. This plan is based on the ability to legally separate the ownership of property into the right to occupy for a period of time or for life (a life estate) and the right to the property after the right of occupancy terminates (the remainder). It is therefore possible for one person, typically a parent, to purchase the right to occupy property for life, and another person, typically a child, to purchase the remainder. Under certain IRS tables, it is possible to value each interest separately. Since the parent’s life estate terminates on her death, none of the property is includible in her estate for estate tax purposes, even though she may have paid a substantial sum for the life estate. This planning tactic must follow exact requirements to be successful, and it may only be used on a new purchase of a principal or a secondary residence. Further, the child must use his own separate funds to purchase the remainder, not funds gifted him by the parent.

Life Insurance: Life insurance is a serious trap for the unwary. It is possible to receive life insurance proceeds on the death of a loved one completely estate tax free – regardless of the amount! However, it is also possible for every penny of life insurance proceeds to be subject to the estate tax – not only significantly reducing the net proceeds, but also *increasing the tax rate applied to the entire estate*. The rules for the inclusion of life insurance in an estate for estate tax purposes are very tricky. They are based on the Internal Revenue Code and therefore not on any form of common sense. As many of you are aware, the estate plans we prepare include instruction as to the proper way to hold life insurance policies and the proper beneficiary designations so as to comply with your intentions while avoiding the unnecessary taxation. Unfortunately, more often than not, we discover after the death of the insured that the proceeds are taxable for any number of reasons, including simple errors in the paperwork that can easily go unnoticed. Please take this opportunity to review your policies to ensure they accurately reflect the intended ownership and beneficiary as well as any instructions our office has sent you. Feel free to contact us if you have any questions or would like us to review your policies and advise you accordingly.

IRA Contributions: If you make or plan to make contributions to an IRA account, read this. For individuals, the maximum annual contribution limit for those who meet the income requirements, is \$3,000 for the taxable years 2002-2004, \$4,000 for the taxable years 2005 through 2007, and \$5,000 for 2008. For taxable years beginning in 2009, the \$5,000 amount will be indexed for inflation in increments of \$500. For individuals who have attained the age of 50 before the close

of the tax year, the maximum annual contribution limit for the taxable years beginning in 2002 through 2005 is increased by \$500. This “catch-up” amount is increased to \$1,000 for taxable years beginning in 2006 through 2010.

Tax-exempt v. Taxable Investments: Given that many investors are considering tax-exempt investments in the current economy, here is an easy formula for comparing the investment returns from tax-exempt v. taxable investments. Assume you are comparing a taxable return of 7.5% with a tax-exempt return of 5%. First, convert your tax bracket to a decimal and subtract it from one. For example, if you are in the 36% bracket, subtract 0.36 from 1.0 which equals 0.64. Second, divided the tax-free yield by this number to obtain the tax equivalent yield. Thus, 5% (tax exempt return) divided by 0.64 equals 7.8125% (taxable return).

Year-End Tax Planning Ideas: In general, you may be able to lower this years tax bill by focusing on the payment of expenses and recognition of income/loss by December 31, 2002. In order to increase your deductions for this year, consider paying estimated taxes and real estate taxes due in 2003, as well as your January 2003 mortgage payment by year-end. If possible, defer your year end bonus to next year, but make charitable contributions of appreciated stock by year end. If you are a cash basis business owner you may also consider accelerating or delaying the payment of bills. You may also be able to shift income to your children in lower brackets by making gifts of investments or employing them in your business. However, you need to consider the impact of the “Kiddie Tax” (for children under 14). If possible, you should maximize contributions to IRA plans. Finally, if you have a capital gain which you previously thought was tax-free for Massachusetts, but now find that if it occurred on or after May 1, 2002, it will be taxed by the State, you should consider recognizing a capital loss in order to offset the gain.

This up-date is provided for educational and informational purposes only and is not intended and should not be construed as legal advice.