INCOME AND ESTATE TAX PLANNING

by Irving J. Sloan

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Under the Tax Reform Act of 1976
& the Revenue Act of 1978

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INTRODUCTION

To suggest that the average American lavishes more attention on his car than he does on his family would probably be met by righteous indignation. Yet, consider the suggestion for a moment. The cars we drive become virtually endowed with a personality. We wash them, polish them and service them frequently. We pay large premiums to protect them against theft, damage and collision. And after three years or so, when we go to trade them in, we find that for all the care and attention, the car has been a rapidly deteriorating investment. At best, it is worth a down payment on a new vehicle, and the cycle of monthly payments, tender solicitude and deterioration of the asset begins anew.

This is not to suggest that we all give up our automobiles and become a nation of walkers and bicycle riders. The point is simply that if we were to pay as much attention to the financial planning of our lives as we do to our cars, we would substantially minimize the element of personal tragedy that is visited upon so many families when the breadwinner departs. For, too many people provide for their families on an instinctive, rather than a reasoned and planned basis. They tend to feel that some savings, a bit of insurance, perhaps a dabble here or there in the stock market constitute adequate provision for loved ones in the event of death. Too often, they fail to analyze and resolve the basic problems, i.e.

How far will social security take my family? What happens to my wife after the children are grown, and she is no longer entitled to social security benefits?

How will the family keep the house after I'm gone? What will they use to pay up the mortgage?

Those bonds that were purchased ten years ago – are they really worth at maturity what I thought they would be? What can I buy with those dollars at maturity? What kinds of investments should I be making to protect the value of my dollar?

How much life insurance ought I have? And what kind should it be? Am I simply paying for "x" thousand dollars of life insurance – which I may or may not need – or have I worked it into a plan for providing a consistent income to the family based on its changing needs?

Will the company pension plan really enable me to take life easy some day? What else ought I be doing in order to insure financial security for the later years?

There are no pat answers to these questions. They will vary for each individual, depending on his objectives and circumstances. The man in business, for example, who has capitalized his assets, may have a going concern to pass on to the family. Or, it may be the kind of business which he alone can run, and becomes simply a liquidation headache at his death. The professional man, with good income, but only his personal services to offer, may have to find another approach to capitalizing his assets, if he hopes, after he is gone, to sustain his family at anything resembling his present standard of living. For the trade or industrial worker, social security plus the fringe benefits provided by his union contract may provide the hard core of his security plan. At any level, however, the need for taking stock of one's resources and for intelligent planning and deployment of those resources is of the essence.

The Rule of Three—Protection, Savings, Investment

Most Americans assume family responsibility at an early age. It is perhaps unfortunate that, although we have built a tremendous credit economy in this country, we have still not found a way to have all the things we may want out of life at age 25, and not begin paying for them until age 40. For most, the first ten years of married life are a constant struggle — to found a home, bring children into the world, meet the everyday needs of food and clothing and make some small deposit in that pot of gold which lies at the end of our own individual rainbow.

It is in the incorrect assessment of that rainbow that so many of us make irreparable mistakes. For some, they see a short road to glory — a boom-or-bust stock that costs pennies today and will yield hundreds of dollars tomorrow. But how often, even in these days of high prosperity, is bust rather than boom the destiny of such stocks.

Certainly more praiseworthy is the cautious and conservative saver, content with putting a few dollars away each month, earning perhaps 5% or 6 1/2%. It would be difficult to challenge either his intentions or his good faith. Yet, one might ask the question whether such a program, in and of itself, will create the financial security which is the objective. For, in the event of the breadwinner's early death, the small savings, in the absence of anything else, may be of little help to the family. And we know inflation has done what inflation has done to dollar values to realize that the end result of a too-conservative savings program may be disappointing.

Well, what then is the answer? Investment in stocks may be wrong! Saving money in a bank may be wrong! How is it possible to hedge against both inflation and deflation and emerge with a program that will insure growth of the assets, rather than their deterioration. The answer is neither simple nor the same for each person. But a first step is understanding that our objective is not so much *savings*, as it is *security*. And there are many parallel roads to security, each of which enables us to satisfy a different objective.

For the young family, for example, the rule of three has been asserted. First, protection! Then, savings! Finally, investment! Protection is a priority, because the death of a young breadwinner, leaving a wife tied down with small children, creates a situation in which continuing resources are going to be required if the youngsters are to get any sort of break in life. While it makes interesting fiction to exalt the struggling mother who works at a job all day to provide the necessities for her youngsters at home, the effect on children of such a situation is far from happy. Particularly, in the formative years, the young child requires the attentions of the mother to an extent that cannot be forthcoming from a mother who *must* go out and earn a living.

A measure of protection is provided by social security coverage. It varies with the earnings of the covered worker and depends on whether he is fully or partially covered. To an extent, the social security system operates to prevent the family of a deceased breadwinner from being a public charge. But this may not be enough.

Beyond social security, intelligent estate planning for the young family requires a certain amount of life insurance. Particularly when projected on a basis of furnishing a monthly income to the widow over a period of years, life insurance helps to supplement social security and to assure the family of something more than a subsistence existence. What kind of life insurance? How much? What is the role of group insurance purchase through employment plans? All of these factors vary with the individual situation.

Not only is protection in the early years a prime necessity, but it is also true that it can be purchased more cheaply at a young age. The purchase of life insurance of any kind at age 25, for example, is considerably less expensive than the same amount at age 35. Thus, to the degree that protection can be purchased at a young age, the family is buying security at a bargain price. Moreover, since all types of insurance, except term insurance, build cash values from year to year, the purchase of insurance also involves a savings factor.

It is the rare case, however, when all the protection required can be purchased through the first policy. Indeed, the requirements of protection themselves change as the family begins to grow and acquire and raise its standard of living. What may have been adequate for the widow at 25 would be totally inadequate for her and the family at 30. Thus, the creation of real protection is a gradual process, and one never influenced by "amounts" of insurance, but rather by what insurance can do for the family in the way of monthly income over a long number of years.

But, just as it would be foolhardy to rely solely on a savings account or stock purchase for security, so a program would be unbalanced if it was based solely on life insurance. Almost simultaneously with the development of adequate protection, the young family seeks to put away something periodically in safe savings, readily available in case of emergency. To develop a systematic savings program, a young couple looks to banks and savings and loan associations, or they may decide to embark on an annuity program looking toward a guaranteed income at retirement.

Finally, a family reaches a point, where having built adequate protection through a life insurance portfolio, and adequate savings through savings media, it becomes important to provide for growth of assets through investment. Here, we are concerned with the role of stocks as a hedge against inflation, the factors which enter into the decision to buy stocks for growth or for yield, and the methods – such as mutual funds – for achieving diversity in investments.

Then there may come a time when the family situation is such that provision for favored philanthropies is both desired and economically feasible. Philanthropic giving, tied in with estate planning can perform a real service both for the institutions involved and for the donor.

Against this background, it is the purpose of this volume to outline those areas and those considerations which every breadwinner should keep before him in measuring his financial planning against his present and future needs. These pages cannot answer your individual problems. They can serve to acquaint you with the nature of those problems so that you can utilize more effectively the many professional services at hand to help you do your particular and individualized job better.

It used to be that professional service to provide such planning was an expensive undertaking, pretty well reserved to the very wealthy who could afford a staff of lawyers, accountants, bankers and the like. But today, the family lawyer, like the family doctor, is prepared to do a periodic checkup on the state of a man's affairs – and at modest cost. The accountant can provide useful long-range advice on planning one's estate with an eye on future income and estate taxes. The trust officer can help secure stable management of the estate. And the life insurance underwriter, no longer simply a salesman, will periodically analyze the situation and needs of his clients, constantly reconstructing their insurance programs to reflect changing requirements and objectives. While the comparison may not be flattering to these professional men, it is submitted that they can be at least as useful to you as the garage mechanic who keeps your car in running condition.

TABLE OF CONTENTS

Chapter 1

SOCIAL SECURITY AS PAID-UP SECURITY

It is doubtful that many people appreciate the importance of social security both to their retirement plans and to the welfare of their families in the event of death. The fact is, however, that social security, offering three major types of benefits—retirement benefits, death benefits and disability benefits—is one of the most comprehensive insurance plus annuity bargains a person can find.

The Social Security Act was signed into law on August 14, 1935. It was the direct result of the widespread unemployment and poverty growing out of the deepest depression this country ever experienced. It was also designed to provide a permanent solution of longstanding problems of economic insecurity. For example, at the time there were only about 6 million persons, less than 15 percent of those employed, who were in jobs covered by any sort of retirement system. Today, just about every worker in the United States earns not only wages as he works, but also insurance protection against the loss of those wages.

It took a long time for most people to get effective retirement protection under social security. The retirement system features of social insurance, like any pension plan, matured slowly. This is true because those already retired when the system starts are not protected. Thus in the United States by 1950, fifteen years after the enactment of the law, only about a fourth of all people were protected by social security; even by 1960, only slightly over 70 percent had protection. But by 1977, 93 percent of the people 65 and older were eligible for social security benefits, and 95 out of 100 young children and their mothers were protected by the life insurance (survivors' insurance) features of social security. Four out of five people in the age group 21 through 64 had protection under social security against loss of income caused by severe disability. In June 1977 there were over 33 million money beneficiaries—one out of seven Americans, with the average retired beneficiary receiving about $240 a month.

Because the changes in the program in recent years—especially the across-the-board benefits increases beginning in 1968 and the changes in the way benefits are computed—have so greatly improved the Social Security program that it is worthwhile to review those changes so that the reader can have a good grasp of what this program means to him or her in terms of estate and tax planning.

From 1968 through1977, the level of benefits has been increased by about 130 percent (prices rose about 75 percent during this period, so that the real value of the benefit increased about 55 percent). More importantly, the program is now automatically kept up to date as wages and prices rise.

While keeping benefits up to date with prices for those receiving social security benefits, and thereby protecting the beneficiary's purchasing power,the automatic provisions will do even better for those still contributing for the 100-million-plus contributors, the automatic provisions guarantee increases in protection which keeps up to date with wages and thus long-run improvements in the general level of living.

With the increase in wages that can reasonably be anticipated, the benefit increases will turn out to be substantial. The benefits payable in the next few years—at the beginning of 1983, for example—will be quite high when measured by past social security standards. A wage earner 60 years old in 1978, who earns the maximum and who retires at 65, will receive benefits for himself and his wife, of $885.90 a month, or about $10,600 a year. Even when benefits are based on earnings at the Federal minumum wage, a couple whose earnings have been in the middle range, payments would be $689.30 a month, or $8,300 a year—$147.40 more a month than the benefits payable to a couple similarly situated at the beginning of 1978. As pointed out earlier, the purchasing power of these benefit amounts are kept up to date automatically with increases in the cost of living, a fact which, of course, adds greatly to their value. In addition they are tax free.

The benefit amounts given here seem high for social security, you say? You thought the purpose of social security was to prevent poverty, and the maximum amount for 1983—$10,600 a year for a couple—seems more like a payment level you would expect for a higher-paid worker under a good private pension system or a retirement system for government employees? How is it that we hear so much about social security beneficiaries living on two meals a day, unable to buy meat, and living in run-down rooming houses, if the social security benefit amounts are as high as we are indicating here?

First of all, there is a big difference between the amounts that social security will be paying for people retiring in 1983, or even for those who retired in 1978, and what is being paid to people who retired many years ago. In spite of the big benefit increases since 1968, taking into account all income, about 14 percent of retired social security beneficiaries were living below the official poverty level in 1976. Their social security benefits were as low as they were for several reasons: the beneficiaries may have worked under social security only a small part of the time since 1950, and in this case their benefits would have been based on very little coverage. If they retired many years in the past, even though they had full coverage, the wages on which their benefits were based would have been much lower than for those who have retired more recently. And people who apply for benefits before age 65 (over half the total number) get lower benefits for two reasons: One, affecting many, but not all, cases, is lower average earnings because of the failure to earn between 62 and 65; the second, affecting all cases, is the reduction in the benefit if it is taken before 65, reaching a 20 percent reduction if benefits are taken at 62. The apparently "high" benefit figure we have been using applies to the worker covered regularly by social security who postpones taking benefits until 65. Then, too, $10,600 a year is the maximum amount payable in 1983 on one wage record and is payable only to a couple.

Since 1940, when monthly benefits were first paid, the amount of the benefit has been related to the worker's average monthly earnings in covered employment. The amount paid in the early years were very low, averaging from $23 to $26 a month for retirement benefits from 1940 up to the Social Security Act amendments of 1950. Even as late as 1968, the average payment was still under $100 a month. By 1977, as a result of a series of liberalizing amendments and the maturing of the program (by 1977 large numbers of people had been under social security for a major part of their working lifetimes), the average benefit amounts, though still quite low, were much higher. The average retirement benefit was about $240 a month in June 1977; for a retired couple, the average was $400. And the benefit amounts are increased automatically with increases in the cost of living.

In most cases, the average monthly wage on which benefit amounts are computed is based on earnings since 1950 up to the year in which the worker reaches 62, becomes disabled, or dies, with the five years of lowest earnings dropped from the computation. The earnings used in computing benefits include only earnings up to the amount specified by law for contribution purposes in a particular year. The maximum amount on which contributions were paid was $3,000 at the beginning. It has been increased many times as wage levels have risen over the years. In 1978, the maximum amount on which people paid and which was credited toward benefits was $17,700.

This amount increased to $22,900 in 1979, $25,900 in 1980, and $29,700 in 1981, under the 1977 amendments. From then on, as in the old law, the amount is increased automatically in relation to increases in average earnings.

For persons who become 62, become disabled, or die after 1978, the earnings record will be updated—that is, indexed in accordance with increases in average covered earnings between the year the wages were earned up to the second year before the year of first elgibility for benefits. Earnings in the year before the year of first eligibility are not indexed but are included as actually earned. Any earnings (unindexed) in the year of attainment of age 62 or later can be included in place of earlier years of indexed earnings if their inclusion produces a more favorable result.The new law guarantees that, until 1984, if it is more favorable, benefits can be computed for retired workers under the old method, using the benefit table in effect in Decembér 1978. Wages earned after age 61 cannot be used for the purpose of this guarantee.

While both benefits and contributions are related to earnings, they are related somewhat differently. The contribution rate is the same for each dollar of covered earnings. In 1978, for the cash benefit program, the contribution rate is 5.05 percent each for the employee and employer. (An additional contribution of 1.0 percent is charged for Medicare hospital insurance.) The benefit amounts, however, are a substantially higher percentage of lower average earnings than they are of higher earnings. The benefit formula to be used with average indexed monthly earnings (AIME) is 90 percent of the first $180, 32 percent pf the next $905, and 15 percent of any remainder. (These dollar figures will be increased automatically in proportion to increase in average earnings under the program so that the formula will remain the same in relative terms regardless of increases in the level of earnings.) In those cases where benefit are based on actual earnings, the table in the law which governs benefit amounts in such cases is also heavily weighted toward lower earnings. This "weighting" in the benefit formula is an advantage both to the regular worker who earns low wages and to the person whose average covered earnings are low because he or she is not under the system, full time. For example, the weighting is particularly advantageous to women workers who may leave the labor market for substantial periods in order to take care of young children.

The minimum monthly benefit for the worker who retires at 65 or later was $114.30 in January 1978, and the maximum was $459.80.

As a result of the amendments of 1977, the minimum benefit will be phased out. It will be frozen at the December 1978 dollar amount (estimated to be $121) for new beneficiaries, but will continue to increase in line with the cost of living after a person becomes eligible for benefits.

There is a special minimum benefit designed for workers who have long coverage under the program but who have earned low wages. Beginning January 1979 it will be calculated by multiplying $11.50 by the number of years of coverage in excess of 10 and up to 30. Thus the most payable under this provision is $230 in 1979. Thereafter it will be tied to cost-of-living increases.

Dependent's and survivors benefits are related to the amount computed for a worker, an amount referred to in the law as the primary insurance amount (PIA). Thus a wife's or husband's benefits is equal to one-half of the PIA; a widow or the widower who begins to receive benefits at 65 or later gets a benefit equal to the PIA (if he or she takes benefits earlier, or if the wage earner took retirement benefits earlier, the payment will be less). The life insurance benefit for the surviving child of an uninsured worker is three-fourths of the PIA, and the benefit payable to dependents and survivors are similarly related to the retired workers benefits. Total amounts payable on a single wage records are subject to maximums that range from 150 percent to 188 percent of the PIA, depending on how much the PIA is.

A worker may choose to begin to receive retirement benefits as early as age 62, but the benefits are reduced if taken before 65. This so-called "actuarial" reduction takes account of the longer period over which the benefit produces the same total payment as the higher rate payable at 65 over a shorter period of time.

Although calculated as of age 62, the benefit is kept up to date with the PIA from then on, whether the worker retires or not.

Who Is Eligible for Social Security Benefits and Under What Eligibility Conditions?

Workers and their dependents and survivors are eligible for benefits only if worker has been under the program for a minimum amount of time. To be "fully insured," the worker is required to have been under the program about one-fourth of the time from age 21 (or 1950, whichever is later) until he or she reaches retirement age, becomes disabled, or dies. Thus, for retirement benefits, a worker now young needs the maximum required of anyone—10 years (technically, 40 quarters of coverage) out of approximately a 40-year working lifetime. But for older workers, the requirement is on a sliding scale related to age. For example, workers who become 62 in 1977 needed 27 quarters; and so on, until the maximum 40 quarters is reached for those who become 62 in 1991 and later years. Most survivors benefits are payable on the basis of a less stringent rule. For example, benefits to surviving children are payable on the death of a wage earner if he or she either meets the above test or has 6 quarters of coverage out of the 13-quarter period ending with the quarter of death.

On the other hand, to be eligible for disability benefits, workers over age 30, in addition to being fully insured as defined for retirement benefits, must have been covered under the program for 5 years out of the 10 (20 quarters out of 40) just preceding the onset of disability.) There is a less stringent requirement for workers who become disabled at or before age 30—graduated from 6 to 20 quarters—because they would have less opportunity to be employed for a full five years.)

Prior to 1978 a quarter of coverage was ordinarily defined as a calender quarter (January, February, and March as one quarter; April, May and June another, and so on) in which the worker was paid covered wages of at least $50, but beginning in 1978—because social security reports are now made annually—the number of quarters credited depends on total earnings in a year. One quarter is given for each $250 paid in 1978. Thereafter the amount is adjusted annually to increases in wages.

In accord with the objective of partially replacing earnings that have been lost, benefits are not paid before age 72 (70 beginning in 1982) to the worker or his or her dependents if he or she continues to earn substantial amounts. The rule in 1978 is that an individual 65 or over earning $4000 or less in a year receives full social security benefits, but above this amount social security benefits are reduced $1 for each $2 earned. However, regardless of the amount of annual earnings, a worker 65 or over gets benefits in the year of retirement for any month in which his or her earnings did not exceed $333.33 and in which he or she did not perform "substantial services" in self-employment. The exempt amount will be increased for those 65 and over to $4,500 in 1979, $5,000 in 1980, $5,500 in 1981 and $6,000 in 1982. After that point the exempt amount will be increased automatically to keep pace with increases in the general level of earnings. For beneficiaries below 65 the exempt amount is less liberal ($3,240 in 1978) but is also kept up to date automatically with increases in the general level of earnings and in other respects operates in the same way as for those 65 and over.

Benefits of dependents and survivors who have earnings of their own are also reduced under the same rules. This earnings test, however, does not apply to those receiving disability benefits. To be eligible for disability benefits one must be unable to engage in "any substantial gainful activity." Thus,. in the case of disability, earnings above the amount defined as substantial gainful activity do not reduce benefit payments but stop them altogether.

Needless to say, there are gaps in the protection program which social security still leaves open. It is primarily the job of life insurance to close the gaps.