



Roth IRA Advisor

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ACCUMULATE WEALTH AND REDUCE TAXES

Roth IRA Advisor Newsletter Edition 21:
**The Economic Growth and Tax Relief
Reconciliation Act of 2001 Summary**
by James Lange, Esq., CPA

James Lange, CPA, Esq.
James Lange Law Offices
Pittsburgh, PA

Introduction

President Bush is about to sign a massive piece of legislation with a far-reaching impact on the economy and individual taxpayers. The Act, known as *The Economic Growth and Tax Relief Reconciliation Act of 2001*, provides taxpayers with the largest tax reduction in 20 years.

The following article summarizes what I consider some of the more important provisions of the Act, i.e., those that will have an impact on the greatest number of taxpayers and, by extension, many readers of this article. As commentators and practitioners become better acquainted with the new provisions and changes, more implications will surface. We will continue to discover ways for our clients to benefit from all the new legal methods for enhancing wealth and reducing taxes.

Only as time progresses will the full effect of the Act be felt. Many of the important provisions will be phased-in, and many will have extended effective dates. One fascinating feature of the Act is that on December 31, 2010, all the provisions of the Act disappear. This reminds me of Cinderella. On midnight, December 31, 2010, the fine dress, the horses and carriage (all the tax benefits of the Act) revert back to rags, mice and a pumpkin (the law as it stands without the tax Act). The Prince, however, will enjoy a tax cut of \$53,120 while Cinderella will get a \$347 break. This assumes the Prince will enjoy the average reduction of the 1.3 million of the highest income group and that Cinderella will receive the average of the lowest income group of 78 million. (Source: Citizens for Tax Justice).

Overview

This article concentrates on three areas with significant changes:

- Estate tax
- Income tax
- Retirement Plan provisions

I have also suggested some “action” points to set the wheels of change in motion.

Estate Tax Changes

The most important action point centers on the increase in the uniform exemption amount. Currently set

at \$675,000, the exemption will increase substantially over the next few years. In addition, estate tax rates are being reduced. Ultimately, if you die in the year 2010, there is no estate tax. If you die in 2011, the federal estate tax will be based on current law.

The following table, taken directly from the Act, says it better than I can:

Table 1
Estate and Gift Tax Rates and Unified Credit Exemption Amount

Calendar Year	Estate and GST Tax Deathtime Transfer Exemption	Highest Estate and Gift Tax Rates
2001	\$675,000	55%
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A (taxes repealed)	top individual rate under the bill (gift tax only)

As the table shows, fewer estates will be subject to estate tax and the ones that will be subject to estate taxes, will be taxed at lower rates.

How Does This Affect You?

This is great news for wealthy taxpayers with significant (greater than \$1M) estates. For taxpayers with enormous estates, this is a great start toward heaven. For taxpayers with estates larger than \$3.5 million, all terminal illnesses and fatal accidents should be planned for the year 2010. (Please remember those pesky phase-ins and Cinderella provisions).

The Nastiest Trap of All

The Act creates an horrendous trap for taxpayers who have existing estate plans in place.

Let us assume you have the type of will or revocable trust that creates a B Trust, alternately called the Unified Exemption Equivalent Trust, the Unified Credit Shelter Trust, Bypass Trust etc. Upon the

death of the first spouse, the applicable exclusion amount is automatically paid into this trust, which will pay income to the surviving spouse for his or her life and provide the right to invade principal for health, maintenance and support. At the death of the surviving spouse, the trust is usually distributed to the children equally. This type of trust is used to exclude the proceeds of the trust from the estate of the second spouse.

Under the old law, this type of trust helped save on estate taxes, but unfortunately, under the new law, it creates a trap. Most of these trusts are structured so that:

1. the exemption equivalent (currently \$675,000, increasing to \$1,000,000 in 2002, \$1,500,000 in 2004, \$2,000,000 in 2006, and \$3,500,000 in 2009) is distributed to the trust, and then,
2. the balance of the estate (if any) is distributed to the surviving spouse.

Under both the old law and the new law, surviving spouses enjoy an unlimited marital deduction (assuming the spouse is a U.S. citizen). There was and there will continue to be no tax at the first death. If you have a trust in place, at the first death, a certain amount will go to the trust and the rest to the surviving spouse. At the second death, since the amount in the unified credit shelter trust is not included in the second estate, only the surviving spouse's own money would be taxable.

But here's the rub—fewer and fewer second estates will be subject to estate tax as the exemption increases. So, does this mean you can relax about estate planning?

Alas, no rest for the weary.

Presuming you have the type of documents that will force an amount equivalent to (or less than) the unified credit shelter amount (currently at \$675,000 and increasing quickly) into the unified credit shelter trust, this may mean that your existing documents will put most of your assets into the trust at the expense of your surviving spouse. The way most attorneys draft that trust is that the amount of the unified credit is used to fund the trust and the balance is left to the spouse. While funding the trust was critical when saving estate taxes was the issue, depending on the size of the estate and year of death, that logic may no longer apply. Your current documents may ensure that a huge amount of money goes into the B Trust and that only a small, or maybe no amount, will be left directly to your surviving spouse.

Many surviving spouses will be most unhappy to find that as a result of the increased exemption amounts, more money is going to a trust *for their benefit* and less money is going directly to them. There is a good chance that the surviving spouse would generally prefer money be in their name *directly* rather than in trust.

Furthermore, the costs and fees for maintaining the trust (including legal, financial and accounting) could end up being a burdensome and unnecessary expense for the family.

What if Retirement Assets will Fund the Trust?

If the assets that fund the trust are retirement assets (IRAs, 401(k)s, 403(b)s, etc.), then the minimum distribution for the trust would be significantly higher than the minimum distribution if the money was held outright by the surviving spouse. This accelerated minimum distribution will result in higher income taxes for the surviving spouse. To make matters worse, at the death of the surviving

spouse, there will be an enormous acceleration of income for the family, thereby depriving the family of the enormous potential from a "Stretch IRA".

(More specifically, the minimum required distribution of the trust is based on the life expectancy of the surviving spouse. If instead, the IRA is left to the surviving spouse outright, without a trust, and the surviving spouse rolls the IRA into his or her own IRA, the minimum distribution will be based on the joint life expectancy of the surviving spouse and a beneficiary who will be considered to be ten years younger than the surviving spouse.)

At the death of the surviving spouse, if the IRA were left to the trust, the children would be required to maintain distributions at the rate established when the surviving spouse was alive.

If the surviving spouse dies with the IRA in his or her name, then the children beneficiaries will be able to take minimum distributions based on their actual life expectancies, not the remainder of the actuarial life expectancy of their deceased parent.

The kicker is, that with the increased unified credit shelter amount, the trust may serve no purpose. That is, depending on the size of the estate, with the increased unified credit shelter amount, there may be no estate tax even if you leave everything outright to the surviving spouse.

Potentially, your past estate planning may hurt your surviving spouse and family. Under the new laws, many clients would be better off with simple "I love you" wills and named beneficiaries of their IRA, than with their existing documents. "I love you" wills leave everything to the spouse and, at second death, to the children equally.

Anyone with an automatic (not disclaimer-based) B Trust, Bypass Trust, etc., in his or her estate planning documents should plan on having their wills and trusts rewritten to avoid this horrendous trap.

Please note: most of my clients will not have to change their wills or trusts because we use a "disclaimer" approach. Briefly stated, most of my married clients have wills, revocable trusts or beneficiary designations of the retirement plans and IRAs that leave everything to their surviving spouse and the B trust as the secondary beneficiary. Like the doctor's motto: First do no harm. Since January, when changes were instituted in the minimum distribution schedules, I have preferred an extended version of the disclaimer approach that I called *Lange's Cascading Beneficiary Plan*. My approach, described more fully in the article, *MRDefenses: Everything You Always Wanted To Know About Estate Planning with the New Minimum Required Distribution Rules*, March 2001, **Financial Planning** ©2000 Thomson Financial Investment Marketing Group, (hereafter referred to as *MRDefenses*) is still what I would consider the ideal plan for many taxpayers, especially after the new changes. Furthermore, the flexibility of the disclaimer approach provides the perfect support for the transient nature of all the changes.

Estate Tax Repeal in 2010

Under the new law, estate taxes and generation skipping taxes are scheduled to be repealed in 2010 (but only for 2010). Some families may save hundreds of millions of dollars. However, in 2010, the gift tax is not repealed, though it is reduced. This will mean that in 2010, you can die and leave money without estate taxes but you will not be able to give all your money away, while you are liv-

ing, without gift taxes. This is not logically consistent, but neither are many of the provisions of the Act. The unified credit shelter amount refers to the unity of gift and estate taxes. It took years for Congress to tie in the gift tax to the estate tax. Now, that logically consistent precedent is destroyed.

For example, let us assume you have a \$10,000,000 estate. It is year 2010 and there is no estate tax. If you die, you can pass all your money to your family without federal estate taxes. A legitimate fear in that situation is that if you survive past year 2010 but die soon after, there will be a significant estate tax. A way to defend against that possibility is to give away a large part of your money in 2010. However, under the new Act, even though you could die with the money and your heirs would suffer no taxes, your beneficiaries will suffer a tax if you live and give them the money in the year 2010. In year 2011, unless there is subsequent legislation, the current law will prevail. What a mess!

Not the Last Dance

This Act is clearly not the final word on tax reform. Something should happen to soften the impact of the Cinderella provisions. In addition, it is easy to picture Republicans wanting to give further breaks to businesses, reduce alternative minimum taxes, reduce capital gains rates, etc. The Democrats will likely resist these changes and attempt to restore the estate tax for large estates. This country had an estate tax long before it had an income tax and England has had an estate tax since 1066, courtesy of William the Conqueror. Effectively repealing the tax in just ten years is truly a radical change and it is possible that the pendulum will swing, deficits will return, and estate taxes on the rich may become politically more feasible than income and social security taxes on the lower and middle class.

It is important to understand that this Act does not institute any huge immediate changes, but rather gradual, ever increasingly important changes as time progresses—as the charts demonstrate. Some experts believe that these changes, as they are written, will never become a reality. They believe that future administrations will make subsequent modifications, perhaps returning to a tax structure that is closer to present law.

Start Thinking about Things Differently

In a fundamental shift, estate-planning will be less motivated by avoiding transfer tax and more motivated by reducing income tax. For an in-depth discussion of estate planning with a goal of reducing future income taxes, particularly regarding the “stretch” IRA, please read my article, *MRDefenses*.

Furthermore, clients are going to have to ask themselves some harder questions. With the direction toward a massive reduction in estate taxes, the taxpayer will need to explore more specifically how they want their estate distributed. This will be tough for a lot of clients. Many of my clients don't really know what they want and previously they were willing to let tax avoidance dictate the terms of their wills and trusts.

For example, the primary motivation of the old “B Trust” was to save estate taxes at the second death. If the expanded exemption amount will be higher than the projected total estate, clients will have the freedom, as well as the burden and responsibility, to determine where they want their funds

to go after they die.

Most married clients with traditional families know they want to provide for their surviving spouses and children and sometimes grandchildren. The question will become, assuming there are no federal estate taxes at the first or second death, do you want to leave everything to your surviving spouse? Perhaps it would be beneficial to leave some of the money to your children on a first death, not to save estate taxes but because it may be the best use of the money for the family. As shown in the article, *MRDefenses*, there is certainly income tax motivation to leaving IRAs and retirement plans to younger beneficiaries.

Alternately, clients could use the approach that I have been advocating where the surviving spouse, presumably with expert advice, makes all the critical distribution decisions after the death of the first spouse. In order to use this strategy, however, the options have to be in place; spelled out in wills, revocable trusts, and IRA and retirement plan beneficiary designations while both spouses are still alive.

Loss of Step Up in Basis

Starting the year 2010, the step up in basis rules will be repealed. (Please see my article, *Capital Gains Reduction with Gallenstein*, *Pennsylvania Bar News*, December 19, 1994, for a more thorough discussion).

However, there is an amount that will be permitted a step up in basis. In the year 2010, decedent's estates are allowed a \$1.3 million step up in basis and an additional \$3 million step up in basis if you left certain qualifying property to your spouse. This provision will partially offset the benefits from the elimination of the estate tax in 2010. Obviously, greater attention will need to be placed on the long-term plans for uses of appreciated investments.

Return to Jointly Held Assets

Another action point that the new estate tax laws suggest is a return to old fashioned jointly held assets between husband and wife. For years I have been preaching the wisdom of separate assets in order for each spouse to have their own money to fund their own unified credit shelter trust. If that becomes unnecessary because the entire estate is less than the new exemption (or in 2010, all estates), then the added legal protection of owning assets as joint tenants between husband and wife could outweigh the tax benefits of separate ownership. Simply stated, many states protect jointly held assets between husband and wife against the claims of one of the joint tenants.

What of the Next Generation?

There are also significant changes to the State death tax credit and the generation skipping tax provisions. Taxpayers who have existing generation skipping tax provisions or who have made GST an important part of their planning should review their documents to take advantage of the new changes.

Clients may have to do some soul searching to answer the question, "How do I want my money distributed when I die?"

Income Tax Changes

New 10% Bracket

Under the current law, the lowest tax bracket is 15%. Under the new law, starting on July 1, 2001, the 10% bracket applies to the first \$6,000 of taxable income for singles (\$7,000 for years 2008 and after), \$10,000 for head of household, and \$12,000 for married couples filing jointly.

In lieu of having the lower 10% tax bracket for 2001 when you complete your 2001 tax return, the Act includes a rate reduction credit for 2001 to deliver the benefit of the difference between the 10% and 15% rate. This refund is based on the year 2000 tax returns filed, so it really is not a true 2001 credit. For singles, the credit is calculated \$600 times 50%, or \$300, \$500 for head of households, and \$600 for married filing jointly. It should be noted that if your year 2000 tax return did not have at least \$6,000 of taxable income for singles (\$12,000 for married couples filing jointly and \$10,000 for heads of household), then you will not receive the full refund.

The Act includes a credit for 2001 to deliver the benefit of the difference between the 10% and 15% rate. For singles, the credit is calculated \$600 times 50%, or \$300, \$500 for head of households, and \$600 for married filing jointly.

Most taxpayers who filed their 2000 tax return on time will likely receive a check before October 1, 2001 for either, \$300, \$500, or \$600 depending on their filing status. Please note that all taxpayers will benefit from this new 10% rate because of the design of the marginal tax brackets, not simply lower income taxpayers. However, many low income tax bracket taxpayers will not receive a rebate or will only receive a partial rebate.

The following table best summarizes the changes in the Regular Income Tax Rate Reductions over and above the new 10% bracket.

Table 2
Regular Income Tax Rate Reductions

Calendar Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2000				
2001	27.5%	30.5%	35.5%	39.1%
2002 – 2003	27%	30%	35%	38.6%
2004 – 2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35%

An obvious action point for most taxpayers is to accelerate expenses and defer income. In light of the decreasing tax rates, this advice becomes even more valuable.

Phase-Out of Itemized Deductions and Personal Exemptions

Under the previous law, there were limitations placed on the total deductible itemized deductions and exemptions. The law effectively raised the tax rate for high-income earners. Beginning in 2006 and

2007, the existing overall limitation on itemized deductions and personal exemptions will be reduced by one-third and by two-thirds for 2008 and 2009. For year 2010, the limitation is eliminated and the full limitations are restored in year 2011.

Goodies for Kids

The Act increases the child tax credit to \$1,000 over a ten-year period.

Table 3
Increase of the Child Tax Credit

Calendar Year	Credit Amount Per Child
2001 – 2004	\$600
2005 – 2008	\$700
2009	\$800
2010 and later	\$1,000

There are limitations on the credit, but the basic idea is that working families with kids will benefit.

There are also increased adoption tax benefits, dependent day care tax credits and tax credits for employer-provided child care facilities.

Marriage Penalty Relief

The attempted elimination of the “marriage penalty” is achieved through a combination of rate reductions, standard deduction changes, and the way the childcare credit is calculated. Changes in the standard deduction don’t help taxpayers who itemize deductions. Virtually all of these changes start slowly and are gradually phased in until 2009 when they all become fully effective. Even after fully effective, there will still be a marriage penalty, but not as large as current law.

Education

Education IRAs, something that I have never been excited about because the previous limit was only \$500, will expand to \$2,000. I am still not too excited, but there are income limits so wealthier taxpayers will not be able to take advantage of this provision. Barry Picker, CPA and IRA expert, says, no problem. Give the money to your children and have the children fund their own account. Since there is no need for income to fund an account, your child or grandchild can take advantage of this provision while you cannot. Withdrawals are tax-free to pay school expenses. In addition, the Act allows withdrawals for K-12 expenses, including tuition for private and parochial schools as well as college. This means you could gift your children money, have them make a contribution to their education IRA, and later use those same funds to pay for their private grade or high school tuition and expenses. The new limits are effective in 2002. There are also a host of other small favorable changes relating to the HOPE credit and lifetime learning credit.

A more significant change is to the private prepaid tuition programs and Section 529 savings plans (also called qualified state tuition programs). Up until now, I have preferred the 529 savings plans to the in-

state sponsored prepaid tuition plans. Now, I will take a closer look at the prepaid plans because the changes open avenues for private colleges and the terms are more favorable. A good source for more information would be Joseph Hurley's web site at www.savingforcollege.com. Joe Hurley, as I have, has always favored the 529 qualified state tuition program savings plan. He sent out an e-mail stating that after the changes, he was even more excited about the 529 savings plan. The 529 savings plan will now allow tax-free benefits for the student for qualifying expenses. The old law allowed tax deferrals, but the student had to pay tax on the growth upon withdrawal. Now, as long as the funds are used for "qualified education expenses," there will be no income tax on the distributions. (But that is also something that could be changed in the future).

In addition to the different 529 plans, the Education IRAs, and the HOPE credit, married taxpayers with an AGI of \$130,000 or less will be able to deduct \$3,000 in 2002 and 2003 for tuition and other qualifying education expenses. In 2004 and 2005, the deduction increases to \$5,000. There is no deduction after 2005. Now there will be true competition between the various Section 529 saving plans, the newly enhanced prepaid tuition plans, the Education IRAs, and direct payment of partially deductible tuition. For now, it is sufficient to know there are a lot of good choices. Given the mentality of most of my clients (and me too), if I had to choose one, I would still go with the 529 savings plan. The feature I love most about the 529 savings plan is that the person establishing the education fund can use the money for himself or herself if he or she so chooses.

The new rules and additional benefits provide for the possibility of exploiting the 529 plans in a way the IRS has perhaps not anticipated. This is a great time to be rich.

If you are wealthy and married, consider contributing up to \$100,000 (much smaller amounts will be far more common) to each of your grandchildren's 529 savings plans. (Please be sure to see if the state plan you are interested in doesn't have rules that would make this plan unfeasible.) I arrive at that figure in the following way: both grandparents may give up to five years gifts of \$10,000 per year, i.e., \$10,000 X 2 X 5. This gets a lot of money out of your estate and the money grows tax-free. If, upon your or a designated custodian's approval, the grandchild withdraws money for a qualified education use, there is no tax on the original contribution nor on the growth in the account.

Another idea, perhaps approaching an abuse of the tax laws follows: When the children or grandchildren go to college, let the money in the 529 plan sit and pay their tuition directly which is not deemed a gift. The child or grandchild can then maintain the investment for their children's education.

Remember, even if you need the money, you can make withdrawals for yourself from your children's or grandchildren's 529 savings plans. The money is subject to a 10% penalty if withdrawn for non-qualifying uses, i.e., not relating to education. If the money is invested long enough, whether you make non-qualified withdrawals or whether the beneficiaries make nonqualified withdrawals, then the 10% penalty on the earnings will pale compared to the benefits of tax-free growth.

Even forgetting the aggressive idea of using the 529 as a tax shelter over and above true education expenses, the Section 529 savings plan is still my favorite way to provide for a child's or grandchild's education—and it just got better. I will admit, that even though all the changes are favorable, it is now more complicated to choose a strategy because there are so many good options if you have a lot of money.

Alternative Minimum Tax—Beware

The alternative minimum tax has been a thorn in wealthy taxpayers' sides for years. Now it is a dagger. For many taxpayers who never heard about it or never worried about it—beware. The original idea of the alternative minimum tax was to prevent a taxpayer with a substantial income, who also had significant deductions and exemptions, from avoiding a significant tax liability.

The alternative minimum is a tax that is calculated separately from the traditional income tax. If the alternative calculation is higher than the regular tax, the taxpayer must pay the higher alternative minimum tax. The alternative minimum tax calculation gives either no weight or partial weight to a variety of deductions and exemptions. In addition, the alternative minimum tax calculation uses a different income tax rate schedule. One glaring omission is the Act did not adjust alternative minimum tax rates for inflation.

The Act includes modest and temporary relief from the alternative minimum tax. The bill increases the limit on deductions that are exempt from the alternative minimum tax by \$4,000 to \$49,000 for married and by \$2,000 to \$24,500 for singles. But even this relief is dropped in 2005.

The impact of the Act is that many more taxpayers who would have never had an alternative minimum tax problem will likely fall within the alternative minimum tax's grasp. After you get through running the numbers for the new Act, the conclusion is that taxpayers making roughly between \$70,000 and \$600,000 will have a much smaller tax break than they think. According to the *Citizens for Tax Justice*, a couple with two children and with an income of \$373,000 will receive a base tax cut of \$11,900 before alternative minimum tax but only enjoy a \$2,940 break after alternative minimum tax.

Those making over \$600,000 will not likely qualify for alternative minimum tax and will enjoy the full benefits of the Act. For residents with high state income taxes and property taxes, the alternative minimum tax will hit hard.

Pension and Individual Retirement Arrangement Provisions

For many taxpayers, the greatest benefits will be derived from the long-term impact of the Pension and Individual Retirement Arrangement Provisions Act. Coupled with the recent changes Congress enacted on January 11, 2001, (see my article, *Life Simplified and Sweetened—Sweeping Changes for IRAs and Retirement Plans*, January 2001), retirement plans, IRAs and Roth IRAs will play an increasingly important role for tax savvy investors.

The new provisions:

- Allow increased contributions to traditional and Roth IRAs.
- Allow substantial increases in voluntary contributions to many employer's retirement plans.
- Provide catch-up provisions for taxpayers who are 50 and beyond.
- Create a new Roth 401(k).
- Provide breaks for small business owners regarding retirement plans.
- Provide credit for low-income taxpayers who contribute to retirement plans.

Increased IRAs and Roth IRAs

The Act provides for an increase in both traditional and Roth IRAs.

Table 4
Deductible IRAs

<i>For taxable years beginning in:</i>	<i>The deductible amount is:</i>
2001.....	\$2,000
2002 through 2004.....	\$3,000
2005 through 2007.....	\$4,000
2008 and thereafter.....	\$5,000

Substantial Increases in Allowable Contributions to 401(k), 403(b) and Other Retirement Plans

The present law allows employees to contribute 15% or \$10,500 (whichever is lower) to their 401(k) plan or 403(b) plan. Under the new law, employees will be able to contribute even more to their retirement plan, moving more assets into the tax deferred environment. This significant switch will have enormous implications for long-term retirement and estate planning.

Table 5
Increase in Employee's Retirement Contribution

<i>For taxable years beginning in calendar year:</i>	<i>The applicable dollar amount is:</i>
2001.....	\$10,500
2002.....	\$11,000
2003.....	\$12,500
2004.....	\$13,000
2005.....	\$14,000
2006 and thereafter.....	\$15,000

Catch-Up Provisions for Individuals 50 and Older

The Act will allow taxpayers, 50 or over, to make additional deductible contributions to retirement plans, IRA plans, employer sponsored plans, and SIMPLE plans.

Table 6
IRA Catch-Up Contributions for 50 or Older

<i>For taxable years beginning in:</i>	<i>The deductible amount is:</i>
2002 through 2005.....	\$ 500
2006 and thereafter.....	\$1,000

The greater “catch-up” provisions are in the later years for employer-sponsored plans. In those plans, the employee, assuming he meets the income qualification, will be able to increase their contribution according to the following table.

Table 7
Increase of Employee Contribution for Taxpayers 50 and Older

<i>For taxable years beginning in:</i>	<i>The applicable dollar amount is:</i>
2002.....	\$1,000
2003	\$2,000
2004.....	\$3,000
2005.....	\$4,000
2006 and thereafter.....	\$5,000

Creation of a Roth 401(k) and 403(b)

Starting in 2006, current participants in 401(k) and 403(b) plans will be able to make contributions to a retirement plan through work, which will have practically all of the tax characteristics of a Roth IRA. Participants will not receive an income tax deduction for the contribution, but the amount contributed will grow income tax free, quite similar to a Roth IRA. Another interesting feature of the Roth 401(k) is that employees who have been making nondeductible contributions to their retirement plan can now substitute a Roth 401(k) plan for the nondeductible portion.

Once the provision takes effect, employees will face a significant choice: Do I continue contributing to the traditional tax-deferred environment? Or, do I move to the Roth environment?

When calculating the amount of the contribution to the plan it is also important to factor in the percentage of the employees contribution that is matched by the employer (if your employer sponsors this type of plan).

Another interesting feature of the Roth 401(k) is that employees who have been making nondeductible contributions to their retirement plan can now substitute a Roth 401(k) plan for the nondeductible portion.

Example: Professor Smart has a base salary of \$180,000 at the University of Pittsburgh. The University has a policy of contributing 150% of the employees' contribution up to 8% of salary. Therefore, in the past, Professor Smart contributed the full 8% of salary for \$14,400. Only \$10,500 was deductible. However, since it was prudent, Professor Smart contributed the additional \$3,900. The University contributed \$21,600. Assuming he makes the same salary in 2006, there are two significant changes. If he wanted to, Professor Smart could contribute the \$14,400 and obtain the full tax deduction instead of \$10,500. Alternately, he could do what I will generally recommend which is to contribute the full \$14,400 into a Roth 403(b). He could also split his share of the contribution in any proportion between the deductible account and the Roth 403(b) account. In either case, the University will contribute \$21,600 which will be deposited in his regular 403(b).

In previous articles, I have compared the benefits of a traditional IRA (which for our purposes is treated as a deductible 401(k) or 403 (b)) to a Roth IRA. The winner: the Roth IRA. Please see

Jim's article, *IRAs After the TRA 97 – What Hath Congress Roth?*, May 1998, *The Tax Adviser* ©1998 by The American Institute of Certified Public Accountants.

The New York Times nicely summarized a combination of some of the above tables.

Table 8 Saving for Retirement

Congress will let Americans save more in tax-favored accounts as part of the new tax-cut bill.

Maximum Any Individual Under 50 Can Save/Maximum Those 50 And Older Can Save

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Individual Retirement Accounts	\$ 3,000 3,500	\$ 3,000 3,500	\$ 3,000 3,500	\$ 4,000 4,500	\$ 4,000 5,000	\$ 4,000 5,000	\$ 5,000* 6,000
Simple Plans**	\$ 7,000 7,500	\$ 8,000 9,000	\$ 9,000 10,500	\$10,000 12,500	\$10,000* 12,500	\$10,000* 12,500	\$10,000* 12,500
401(k), 403(b) and 457 Plans***	\$11,000 12,000	\$12,000 14,000	\$13,000 16,000	\$14,000 18,000	\$15,000 20,000	\$15,000* 20,000	\$15,000* 20,000
Roth 401(k)	N/A	N/A	N/A	N/A	\$15,000 20,000	\$15,000* 20,000	\$15,000* 20,000

*Plus inflation adjustment in \$500 increments.

**Simple plans are for enterprises with 100 or fewer workers.

***403(b) plans are for nonprofits; 457 plans are for governments. In the last three years before retirement, workers in 457 plans can save double the limit for those under 50.

Note: The maximum that an employer can contribute annually will rise to \$40,000 next year, a 14 percent increase, and will be adjusted for inflation thereafter.

Changes in the Minimum Distribution Rules

Before the Act, the IRS made a tremendous change governing the minimum required distributions of traditional IRAs, 401(k)s and 403(b)s, both during the life and at the death of the IRA owner. The previous changes, supplemented by the current legislation, will have an enormous impact on retirement and estate planning for married retirees who are older than 70½ and who have significant retirement assets in their retirement plans. The earlier IRS changes allow IRAs to be “stretched” further by reducing minimum required distributions. This attribute becomes even more valuable as contributions to IRAs and Roth IRAs grow. Please see my article, *MRDefenses*, for a complete discussion of the recent IRS changes.

Unfortunately, the Act calls for the IRS to adjust their life expectancy tables. If I were the IRS, I

would tell Congress to go pound salt. On January 11, 2001, the IRS, on their own, unilaterally simplified the minimum required distribution rules. In a bold step, they made massive changes to the life expectancy tables. In a rare display of intelligence and effective execution, they significantly improved, simplified, and set in motion an effective method for enforcement of the IRA distribution rules. They did a great job. It seems most everyone, who understands what they did, is happy. Just leave it alone.

That is one of my gripes with the constant changes. Clients and practitioners should have a set of tax laws on which they can, with some degree of certainty, rely and plan. Instead, we are getting massive wholesale changes that are likely to be constantly changed by both the present and future administrations. The Cinderella doctrine alone makes effective planning impossible (unless you use Lange's Cascading Beneficiary Plan or a similar plan relying on disclaimers).

Prepare to Shift Contributions to the Roth 401(k)

Starting in the year 2006, the new law allows a choice between a Roth 401(k) and a traditional contribution to a retirement plan. This will be especially welcome for taxpayers who liked the idea of a Roth IRA but up to now, their income has been too high to qualify for a Roth IRA contribution or conversion. Based on analysis previously published in Jim's article, *IRAs After the TRA 97 – What Hath Congress Roth?*, May 1998, *The Tax Adviser* ©1998 by The American Institute of Certified Public Accountants, in most cases, the Roth type retirement plans will be more beneficial than the traditional plans.

So How Should Employees Maximize their Retirement Savings?

Subject to some exceptions, my preferences for accumulating wealth are:

1. Participate in any employer-matching program to the fullest extent.
2. Put money in the Roth IRA environment.
3. Put money in the traditional IRA or 401(k) environment.

If you are 50 or over, take advantage of the new "catch-up" provisions that allow you to make additional contributions to IRAs and retirement plans at work.

Fun for Small Business Pension Plans

There are a variety of different retirement plans including pension plans, profit-sharing plans, defined benefit plans, "top heavy" plans, SIMPLE plans, and others. Many of these plans are changed in a way that will allow participants to contribute more money and employers to put more money away for themselves.

For example, sole proprietors have access to a SIMPLE plan that currently allows a contribution of \$6,500, even if Schedule C income is only \$6,500. Now, the SIMPLE plans will boast higher deductible contributions. The increase in the deduction is as follows:

Table 9
Expansion of SIMPLE

<i>“For taxable years beginning in calendar year:</i>	<i>The applicable dollar amount is:</i>
2002.....	\$7,000
2003.....	\$8,000
2004.....	\$9,000
2005 and thereafter.....	\$10,000

Retirement Savings for the Lower Income Taxpayers

This provision will cause the cynics to chuckle while shaking their heads in disgust.

If your adjusted income is low enough and you meet other eligibility requirements, you will receive a tax credit of up to 50% for your contribution to an IRA or other eligible retirement plan. (Students and dependents are excluded.) For example, if you are a single mother with an adjusted gross income of \$22,500 or less and you contributed \$2,000 to an IRA, you would get an income tax credit of \$1,000. This credit is in addition to any deduction you may be eligible for. However, in general, I would prefer the contribution be to a Roth IRA rather than a traditional IRA or retirement plan.

That seems like a nice break for low-income taxpayers until you think about it for a minute. What single mother with an adjusted gross income of \$22,500 or less can afford to make a \$2,000 IRA contribution, even if their true after-credit cost would be \$1,000?

As a practical matter, I intend to take advantage of this provision by telling my wealthy clients to give money to their children (or grandchildren) and have the children use the money to make an IRA contribution.

Example: Your single daughter (not a dependent or full-time student) earns \$15,000. You give her \$2,000 to contribute to her IRA. She makes the Roth IRA contribution and also gets a \$1,000 tax credit. That is really a leveraged gift where you are providing \$2,000 for her retirement plan with tax-free growth and also providing her with \$1,000 to spend or save now for a total cost to you of \$2,000.

The more you make, the lower the percentage of your credit. Please see Table 10.

Table 10
Credit for Retirement Plan Contribution

<i>Adjusted Gross Income</i>						
<i>Joint Return</i>		<i>Head of a household</i>		<i>All other cases</i>		<i>Applicable percentage</i>
<i>Over</i>	<i>Not over</i>	<i>Over</i>	<i>Not over</i>	<i>Over</i>	<i>Not over</i>	
\$0	\$30,000	\$0	\$22,500	\$0	\$15,000	50
30,000	32,500	22,500	24,375	15,000	16,250	20
32,500	50,000	24,375	37,500	16,250	25,000	10
50,000		37,500		25,000		0

The new rules will also allow participants to put more money in other retirement plans including: Section 457 plans, defined benefit plans, pension and profit sharing plans, top-heavy plans, SIMPLE plans, SEP plans and others. The plans will also be more portable and have greater rollover possibilities between plans.

On a Final Note—A Word of Caution

Within the next few weeks a lot more information will be available. I will make changes to this article, as I deem appropriate. Each time you access the article from the Internet, you will receive the latest updated version.

This article is really just the start of what promises to be a complex, yet extremely fruitful examination of the Act and ways you and your family can benefit by taking advantage of the provisions.

Sources for Additional Information

There is a reasonable summary of the estate changes and income tax changes in the following .pdf files at a House web site, <http://www.house.gov/jct/x-50-01.pdf>. A more thorough, but awkwardly presented, source of information is now available as a 186-page file, <http://waysandmeans.house.gov/fullcomm/107congress/hr1836/legtext.pdf>. There is also a 258-page file, <http://waysandmeans.house.gov/fullcomm/107congress/hr1836/statemgrs.pdf> (5/26/01, updated 5/29/01).

Best Thing You Can Do for Yourself

Attend a seminar that concentrates on retirement assets but incorporates the most recent changes.

If you *are not* a financial professional and live in the Pittsburgh area, attend one of my seminars in Oakland on June 13th or in Squirrel Hill on June 28th. Call 412-521-2732 to reserve your seat.

If you *are* a financial professional and live in or near Pittsburgh, PA; Detroit, MI; Indianapolis, IN; Charleston, WV or Morgantown, WV, please call 412-521-2732 for details on how to register for an upcoming continuing education seminar.

If you are interested in having me examine your own retirement and estate plan, please call 412-521-2732 to schedule a free initial consultation regardless of where you live.

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<http://www.rothira-advisor.com>
Law Offices of James Lange
2200 Murray Avenue
Pittsburgh, PA 15217
412 521-2732 - 800-387-1129
412-521-2285 FAX
admin@rothira-advisor.com