In Brief

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Tax Act of 2001

Part 3*

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This is the third and final article summarizing particular provisions of the Tax Relief and Reconciliation Act of 2001 ("2001 Tax Relief Act"). In this article, we will focus on two of the more important changes remaining: contributions to and withdrawals from Individual Retirement Accounts (IRAs), and the transferred "basis" of property for the purpose of computing income tax consequences of transfers of property upon the death of the property owner.

IRA Contributions and Distributions

The 2001 Tax Relief Act increased the allowable annual contributions to an IRA for most persons made during their lifetime. Also changed in 2001 were the federal regulations pertaining to beneficiary designations and "minimum distributions," although these changes came about prior to the 2001 Tax Relief Act. Most of these changes were favorable to taxpayers from an income tax perspective, and were meant to encourage greater private retirement savings.

The 2001 Tax Relief Act allows additional "catch-up" contributions for persons over age 55. For IRAs, the maximum tax-deductible annual contribution will be steadily increased to a maximum annual contribution of $5,000.00 beginning in 2008. The maximum contribution is $3,000.00 this year (2003), and will be $4,000.00 in the years 2005 through 2007. Employment plans such as 401(k), 403(b), or 457 plans will also enjoy increased limits for income-deferred contributions. Currently at $12,000.00 per year, the contribution limits for these plans will steadily increase to $15,000.00 beginning in 2006, and then will be increased thereafter to adjust for inflation in $500.00 increments per year. For persons age 50 and older, there is an additional benefit. These individuals are entitled to contribute $500.00 per year to an IRA, or $2,000.00 per year to a qualified employment retirement plan, as "catch-up" contributions, in addition to the contributions above. These catch-up contributions increase each year until 2006, when the increase will peak at $1,000.00 and $5,000.00 respectively. Contribution limits for defined benefit plans (pensions, etc.) and Roth IRAs were also increased under the 2001 Tax Relief Act.

Changes to the 2001 tax regulations altered the minimum distribution rules (MDR) for qualified retirement plans, as well as altered the rules pertaining to beneficiary designations. Most qualified retirement plans grow tax-free until the plan owner or a beneficiary designated under the plan (after the owner's death) begins to take distributions. With the exception of a Roth IRA, distributions from qualified retirement plans are taxed as income at the owner or beneficiary's normal income tax rate. For owners or beneficiaries who do not need the additional income from one or more available retirement plans at retirement age, they may wish to have the retirement account continue to grow tax-free, and also avoid the additional income taxes generated from distributions. These individuals may want to keep distributions at minimum, or to delay them entirely for the greatest amount of time possible. However, if an owner/beneficiary fails to begin taking distributions by the required beginning date (RBD) or take at least the required minimum distribution (RMD), the rules provide stiff penalties of 50 percent. Some of the new 2001 beneficiary designation and minimum distribution rules can be used by these individuals to spread out distribution from retirement plans over the greatest amount of time, thereby maximizing the tax-deferred growth of the plan and minimizing the income tax. In fact, changes to the beneficiary designation rules even allow for a beneficiary to be named after the death of the plan owner, providing flexibility to name younger beneficiaries for a longer distribution period. These rules are too numerous and complicated to merely summarize in an article such as this, but participants in any qualified retirement plan should consult with their estate planning attorney or consultant to determine the best distribution and/or beneficiary designation to take full advantage of the 2001 changes to the rules.

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The Basics of "Basis"

One of the most significant, but least publicized, changes to the Federal Tax Code under the 2001 Tax Relief Act was the treatment of the tax "basis" of assets transferred upon the death of the asset owner. "Basis" is a term used to describe the investment that a person has in assets he or she owns, for purposes of determining the capital gains that may be owed if an asset is sold. As examples, if you purchase a home for $100,000.00, your "basis" in that home is $100,000.00. If you add a room to the home that costs you $5,000.00, your new basis in the home is $105,000.00. If you sell the home years later for $125,000.00, your capital gain is $20,000.00. If you give someone an asset as a gift during your lifetime, that person gets a "carry-over basis", which means that the basis for that asset remain the same for the gift recipient as it was for the donor. The old Federal Tax Code (in effect through December 31, 2009) allowed a "stepped-up basis" for assets transferred to another upon death. As an example, if an uncle has real estate for which he originally paid $5,000.00, and he leaves that real estate to a niece under his Will, and that real estate is worth $500,000.00 at the time of his death, the basis of that real estate in the hands of the niece is "stepped-up" to $500,000.00 upon the uncle's death, and the niece would pay no capital gains tax if she immediately sold the property for market value.

The 2001 Tax Relief Act modified the application of stepped-up basis upon death. Under the 2001 Tax Relief Act, beginning January 1, 2010, a decedent's estate can receive a maximum $1.3 million of stepped-up basis on non-cash assets; anything over $1.3 million must be specifically reported and will receive only a "carry-over" basis (as with gifts). For decedents' estates that have non-cash assets in excess of $1.3 million, the appointed personal representative of the estate will have to choose which excess assets receive the stepped-up basis, and which do not. A personal representative of an estate must be able to trace the actual basis of all non-cash assets in the estate and accurately report the basis; failure to accurately report this information may lead to penalties for the personal representative and/or the estate under the 2001 Tax Relief Act. The specifics of the new basis provisions of the 2001 Tax Relief Act are beyond the scope of this article. However, in anticipation of these new provisions, it is advised that all persons with estates that have non-cash assets in excess of $1 million begin documenting the tax basis of these assets. Your estate planning attorney or other professional can assist you in putting this information together now in a form that may be very useful to your appointed personal representative in the future.

Conclusion

The 2001 Tax Relief Act was passed by Congress and signed by President Bush at a time when the federal government was projecting continuing federal budget surpluses far into the future. Terrorist attacks, falling investment markets, and, now, war have resulted in a new forecast of possible federal budget deficits. As stated in Part 1 of this series of articles, many of the provisions of the 2001 Tax Relief Act were scheduled for automatic repeal on December 31, 2010, unless specifically extended by congress and the president before that date. As the economy becomes more uncertain, it becomes more likely that the tax savings provisions of 2001 Tax Relief Act will not survive December 31, 2010, or that the act will be repealed or significantly amended long before that date. For those with estates of over $1 million, it is important that your estate plan has the flexibility to withstand any and all changes to the Federal Tax Code that lie ahead. Your estate planning attorney or professional can assist you in reviewing your current estate plan, and/or creating a new estate plan that provides that flexibility.

** Read Parts 1 and 2 of Tax Act of 2001 online at www.ferguslaw.com*

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