



Roth IRA Advisor E-News

ACCUMULATE WEALTH AND REDUCE TAXES

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2001 Year-End Tax Planning Strategies

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This newsletter highlights critical changes in the new tax laws, suggests appropriate strategies, and reviews our tried and true year-end recommendations.

We believe tax planning should be an ongoing strategic process of implementing the best strategies suited for each taxpayer—not a desperate end game. That said, we offer these year-end strategies as reminders and recommendations in preparation for the upcoming tax season.

We start with ideas that are either new or particularly relevant this year, and we conclude with some of our oldies, but goodies. For an in depth analysis of The Economic Growth and Tax Relief Reconciliation Act including the extensive estate planning changes, please see The Economic Growth and Tax Relief Reconciliation Act of 2001 Summary on our web site at <http://rothira-advisor.com/economicgrowth.htm>.

Retirement Savings and Pension Reform

Retirement savings incentives and pension plan reform make up a significant part of the new tax bill. The new law increases contribution limits for IRAs, both traditional and Roth IRAs, 401(k)s, 403(b)s and other qualified retirement plans beginning in 2002. If you are at least 50 years old beginning in 2002, you will have the opportunity to make “catch up” contributions to your retirement plan. These “catch up” contributions provide an opportunity for individuals who are creeping closer to retirement to increase contributions to their retirement accounts. Now is the time employees should review and adjust their retirement plan deferral percentages to take advantage of the new increase limits for 2002.

Employees who haven't contributed the maximum in 2001 to their 401(k) plans should do so, if feasible, before December 31. Many employer plans allow participants to make catch up contributions late in the year. If you find yourself in a better financial position as the year-end approaches, consider increasing your contributions to the maximum amount allowed. If your employer matches any portion of your contributions, you're an instant winner. Also, you have the chance to trim 2001 income taxes by hundreds or thousands of dollars. If you're on the “adjusted gross income” phase out bubble, this strategy may help some middle-income earners qualify for additional tax breaks. Among them are the child tax credit, Hope and Lifetime learning credits and being eligible for either a Roth or traditional deductible IRA.

If you are in distribution mode, please take advantage of the lowered minimum required distri-

bution rules effectively lowering the tax burden for many IRA owners. Please see our article, *MRDefenses*, on our web site, originally published in *Financial Planning* magazine, *March 2001* for a complete analysis of the new rules and optimal estate planning for IRA owners based on the new rules (<http://rothira-advisor.com/mrdefenses.htm>).

One-Person 401(k) Plan

Another by-product of *The Economic Growth and Tax Relief Reconciliation Act of 2001* is the introduction of a feasible one-person 401(k) plan. Using a combination of new laws that go into effect January 1, 2002, this plan will allow for unusually large contributions to a tax sheltered retirement plan. Small business owners have been waiting for a plan that would allow them to set more money aside for retirement, with tax-favored treatment. The biggest potential benefit is realized by one-person businesses earning between \$50,000 and \$160,000. An unincorporated business owner earning \$100,000 will be able to shelter roughly \$28,000 in 2002. Another nice change is the ability to borrow money from the plan, a feature that is not offered by certain other retirement plans.

New: Tax Credit for IRA Contributions and Elective Deferrals

Effective in 2002, low-income taxpayers are allowed a new tax credit for a portion of their contribution to IRAs (including Roth's) and other elective deferral retirement plans. You may be eligible for a tax credit up to 50% of a \$2,000 contribution to these plans. This is in addition to any tax deduction you are eligible to receive. The credit is available for any individual, other than a full-time student, who has turned 18 as of the close of the tax year and who is not claimed as a dependent by any other taxpayer. There are certain other conditions that must be met to qualify for the full credit. If your non-dependent child qualifies, making a \$2,000 gift so they can make a Roth IRA contribution is a great move. In effect, you contribute \$2,000 to their tax-free retirement plan and the government makes a matching \$1,000 gift in the form of a tax credit.

Lower Tax Rates

With the four top income tax rates falling by another half-point in 2002, the popular recommended strategy of accelerating deductions this year and deferring income into next year can be advantageous. In recent years many individuals have used this strategy to defer taxes and take advantage of the time value of money concept. Add to the equation real tax savings because of lower tax rates, and this strategy makes even better sense. Before you jump head-first into this strategy, please be aware that Alternative Minimum Tax (AMT) rules can totally offset the benefits. In general, you compute your tax liability using both regular tax rates and the AMT tax rates and pay the higher of the two. The more deductions you take such as state taxes, real estate taxes, etc. when computing your regular tax liability, the increased chance you will fall into the AMT tax trap. Unfortunately there is no quick and easy formula to see if you are subject to alternative minimum taxes. If you think you might be vulnerable, consult with your tax advisor.

Qualifying Taxpayers Should Plan to Convert a Portion of their Traditional IRA to a Roth IRA

The benefits of converting a traditional IRA to a Roth IRA are discussed at length in our peer-

reviewed article, *Roth IRAs: Accumulating Tax Free Wealth Conversion*, in the recommended reading section of our web site at <http://rothira-advisor.com/roth.htm>. The conversion must be completed before year-end and many brokerage houses recommend getting the Roth IRA conversion form to their offices well before year-end to qualify for a year 2001 conversion.

Current law dictates that tax rates will be lower in the upcoming years. But waiting to convert to a Roth IRA until rates are lower is risky. Yes, the converted amounts would be taxed at a lower rate but considering the current market conditions, your IRA account value may be at its lowest point. A 3% recovery in your account value between now and 2005 would offset the 2% tax rate reduction savings that is in effect for tax years 2004-2005.

Consider Recharacterizing your Roth IRA

Assume that earlier in the year 2001, you converted a traditional IRA for \$100,000 to a Roth IRA. Since the time of the conversion, the stock value has plummeted to \$70,000. With this scenario, you are stuck paying income tax on \$100,000 for a Roth IRA currently worth \$70,000. Consider "unconverting" which would put you in a position similar to where you would have been if you had not made the conversion in the first place. That is, you would have a traditional IRA with a value of \$70,000 and no resulting tax liability from the conversion. In prior years, you were allowed to make subsequent reconversions of the same \$70,000 to a Roth IRA in the same year, but that is now forbidden.

Nonetheless, you may unconvert or recharacterize your Roth IRA and then, when you are ready, make a Roth IRA conversion using different IRA funds—even within the same tax year.

For example:

Assume that at the beginning of 2001, you held Loser Inc.1 and Loser Inc.2 in your traditional IRA, and each was valued at \$100,000. You converted Loser Inc.1 to a Roth IRA. Then, following the conversion, both Loser Inc.1 and Loser Inc.2 each dropped in value to \$70,000. Consider unconvverting or recharacterizing Loser Inc.1 and making a new Roth IRA conversion of Loser Inc.2. That way you will still have a Roth IRA of \$70,000, but you will only have to pay income tax on \$70,000 rather than paying tax on \$100,000, which is what you will be responsible for if you do not recharacterize and make a new conversion.

A more complete discussion of Roth IRA converting and unconvverting is found in a separate article on our web site, *Finessing Market Uncertainties: Roth IRA Conversion Strategies* (http://rothira-advisor.com/rothira_uncertainty.htm).

Capital Gains and Losses

New this year: Special reduced capital gains rates apply to qualified five-year capital gains, effective for taxable years beginning in 2001 and thereafter. Under these rules, capital gains for assets that are held more than five years will be taxed at a rate of 18 percent or eight percent depending on your income tax rate (versus the old rates of 20 percent for higher income taxpayers or ten percent for taxpayers in the 15% income tax bracket). The

18 percent rate only applies to assets for which the *holding period* begins *after* December 31, 2000, while the eight percent rate applies *regardless* of when the holding period began. Therefore, if you are in the 15% tax bracket, the eight percent rate could apply beginning in 2001. However, for individuals in a higher tax bracket, the 18 % rate for realized long-term capital gains on property held for five years will not apply until after January 1, 2006. Currently the 20% maximum rate still applies.

Transfer Appreciated Stock to Children 14 Years Old or Older

Consider transferring stock to your child. For example, assume you are in a 28% tax bracket and are planning to sell some appreciated long-term held stock (at least five years) to pay for your child's education. Your child is in a 15% tax bracket. Consider making a gift and transferring the stock to your child who subsequently sells the stock. You have effectively shifted long-term capital gains from a 20% taxation rate to your child's long-term capital gains tax rate of eight percent.

Offset Capital Gains with Capital Losses

Capitalize on losses. With the S&P 500 and Nasdaq down in 2001, you may be sitting on some valuable tax losses. What makes investment losses easier to digest is that you can use them to save income taxes. If you don't have any gains, or if your losses exceed your profits, you can deduct up to \$3,000 of losses against ordinary income. That adds up to a \$915 tax savings for an individual who is in a 30.5% tax bracket. In addition, the \$3,000 loss reduces your adjusted gross income and that may help some middle-income earners qualify for additional tax breaks such as the child tax credit, Hope and Lifetime learning credits and become eligible for either a Roth or traditional IRA.

A second potential benefit would occur if you think the security has a chance to appreciate in the future. By buying back the stock in 31 days and avoiding the "wash-sale" loss rules, the new five-year holding period and favorable tax rate takes effect.

Method for "Netting" Realized Gains And Losses

First, take your long-term capital gains (from assets held one year or more as well as from the projected long-term capital gain distributions from mutual funds) and net them against your long-term capital losses to arrive at net long-term capital (gain or loss). Then, take your short-term capital gains and net them against your short-term capital losses to arrive at net short-term capital (gain or loss). If both are either net gains or net losses, there is no offset. If one is a gain and one is a loss, then net them together and determine which is bigger—the long-term or short-term portion. If the net is a gain, you may benefit from tax loss selling. Based on the results of this netting process and the rest of your tax situation, you may need to make adjustments to decrease your net gains.

Please keep in mind that the total net capital loss deducted in one year cannot exceed \$3,000. If the loss exceeds \$3,000, there is a loss carryforward to next year. Please be aware of the "wash-sale" loss rules if you plan to sell and repurchase a loser. You must wait 31 days to repurchase the same stock or securities substantially identical to those you sold in order to take advantage of the capital loss. However, because of the broad diversity of investment products and publicly traded companies, it is usually possible to simultaneously

sell one security or mutual fund and buy a similar one. By doing this, your long-term investment objective is not at risk since being out of the market for 31 days could cause severe damage if the market increases and you are not a participant.

Deemed Sale Election

A new item in effect for the 2001 tax year is the Deemed Sale Election. This provision allows taxpayers to make an election to pay income tax on appreciated capital gains without having to actually sell the property. This will in effect start the clock as it pertains to the new five-year holding period changes mentioned in the above paragraph. I usually don't recommend paying current income taxes on the appreciated value of investments. I will say, however, there are certain instances where electing this option could make sense. For instance, using the deemed sale election on an asset that will be sold in 2002 (before the 2001 tax return has been filed) will effectively create an installment sale and allow for spreading the gain over two years.

Financing an Education for Your Children and Grandchildren

Let's start with my favorite way to finance the education of your family.

Section 529 Qualified State Tuition Plans

The 529 plans, which are distinct from the prepaid tuition plans, provide an excellent way to save for college. The real windfall for these plans will go into effect beginning in 2002. The 529 plans will now allow *tax-free* benefits on all withdrawals used for "qualifying educational expenses." The current law allowed for earnings to compound on a pre-tax basis and then the withdrawals used for qualifying expenses would be taxed at the student's rate.

529 plans also have significant estate tax advantages. Ideally, they can be considered a gift to children or grandchildren who will eventually go to college. However, if you decide for whatever reason you want to take the money back and use it for yourself, you may do so—a little like a gift with a string attached that you can yank back if and whenever you want.

Accounting headaches and filing requirements are eliminated. Set up and maintenance costs are minimal. Another strategy that we recommend under certain circumstances is to transfer your children's UGMA accounts to 529 plans.

A disadvantage of the 529 Plan is that your investment options are limited. Also, 529 plans may be inappropriate if you can afford to pay tuition directly *and* make a personal gift. Please note that the tax break for direct tuition payments to qualifying educational institutions includes private grade schools as well as colleges and universities.

For example:

You have a potential federal estate tax and are trying to reduce your estate with gifts to children or grandchildren. Your grandchild is 18 and you want to take care of his tuition and give him an additional \$10,000. If you put \$10,000 in a 529 plan, that is deemed a gift to him; however, if you pay his tuition directly, that is not deemed a gift and you can give him an additional \$10,000 without eating into your once-in-a-lifetime exclusion. Under these circum-

stances, you would be better off not establishing a 529 plan.

A more detailed discussion of 529 plans is found on my web site at <http://rothira-advisor.com/collegesaving.htm>.

Tax Planning for Education Tax Credits

The Economic Growth and Tax Relief Reconciliation Act of 2001 introduced a slew of favorable changes effective January 1, 2002. You can help yourself to a lower tax bill if you follow some of these steps below. Be sure to maximize any available education credits that you qualify for. Knowing when and when not to prepay tuition expenses could save otherwise reduced or lost college tax credits. You might want to contact your tax advisor for assistance in this area.

New: Deduction for Qualified Higher Education Expenses. Some higher-income individuals who don't expect to receive any benefits for qualified tuition paid this year may want to delay sending payments until the new-year. Beginning in 2002, these expenses are now eligible for an above-the-line deduction. Taxpayers may claim this deduction whether or not they itemize their deductions. In 2002, taxpayers with an adjusted gross income not exceeding \$65,000 (\$130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of \$3,000 per year. These gross income limits are higher than the levels necessary for qualifying for the Hope and lifetime learning education credits.

Maximize Student Loan Interest. More college grads will be eligible to deduct student loan interest in 2002. Deductions will no longer be limited to the first 60 months that payments are required on the loan. More importantly the income eligibility limits will rise to \$65,000 for single and \$130,000 for couples. If you anticipate qualifying next year for this break, if possible, consider holding off on any remaining payments this year.

Let your Child Claim the Hope or Lifetime Learning Credits. If you're tired of losing education tax credits because of your income bracket, all is not lost. If you are eligible to claim your student child as a dependent, but choose not to, your child may be able to claim a Hope Scholarship or Lifetime Learning Credit for the qualified tuition and related expenses that you paid. This move can be a family tax saver if your income level is above the phase out range for claiming the tax credit. Of course your child must have a taxable income to claim the credit. Note that the child cannot claim the forfeited dependency exemption on his own return. This is really good when your child's dependency exemption is partially or fully phased out on the parent's return.

For example:

The parent(s) gifts appreciated stock to the child, who in turn sells the stock to pay for qualifying tuition expenses. The capital gain is reported and taxable on the child's return at a much lower tax rate. The tax savings could be as much as 12% on the long-term gain. The tax liability is now offset by the education tax credit claimed on your child's return. If you are applying for financial aid, keep in mind that the student's assets are a much bigger factor in the financial aid formula than the parents' assets. However, if you're incorporating this strategy, you probably don't qualify for financial aid assistance.

Contribute to a Coverdell Education Savings Account (formerly called Education IRAs). There are two significant changes in Education savings accounts going into effect beginning in 2002. First the contribution limit has increased from \$500 to \$2000 per designated beneficiary per year. Second, these tax-free accounts can be used to pay for elementary and high school expenses. Now parents and grandparents have a tax-free savings vehicle to meet education costs from kindergarten to graduate school. Currently 2001 contributions must be received by December 31 of this year. Beginning in 2002, taxpayers will be allowed to make contributions until April 15 of the following year. If you plan to establish a Section 529 plan, mentioned above, you cannot make an Education IRA contribution in the same year for the same named beneficiary.

There are income limitations on the Coverdell Education Savings Account. One way to avoid the income limitations is to give your children or grandchildren money and have them purchase their own Education Savings Account.

Refinance Before Year-End

Individuals who have refinanced their mortgage in recent years are now prompted to consider refinancing again due to the lowest interest rates in years. If you're planning to refinance, there is a tax advantage to due it before December 31. If you paid points to your lender in connection with your previous refinancing, you are eligible to take a full write-off of the undeducted points from your previous refinancing on your 2001 tax return. Please see our recent newsletter, *Consider Refinancing Your Mortgage*, on our web site at http://rothira-advisor.com/refinancing_mortgages.htm.

Oldies, But Goodies

Make or Increase Retirement Plan Contributions: Business owners can reduce AGI by increasing contributions to pre-existing retirement plans or establishing a new plan such as 401(k) plans, SIMPLE pension plans, SEPs, Keogh plans, or regular (deductible) IRAs. Most self-employed retirement plans allow for deductions in tax year 2001, although payment can be postponed until the extended due date for filing the return. In other words, payment of 2001 deductible retirement plan contributions can be postponed until October 15, 2002 in certain cases.

Enroll in a Cafeteria or Flexible Spending Plan: If you have not yet done so, please enroll in your employer's Cafeteria or Flexible Spending Plan for the year 2002. This strategy allows you to pay for medical, child-care and other qualified expenses with pre-tax dollars. Medical expenses are rarely fully deductible on Schedule A due to the 7.5% of AGI limitation. Medical costs paid for through your company's cafeteria plan, however, will allow you to fully deduct your medical expenses from your W-2 wages that includes social security taxes.

Make a good estimate of your projected qualified expenses for the year. If you set aside more pre-tax dollars than you will be able to claim, the unused portion is forfeited. Don't let the forfeiture risk deter you from participating, just be a little more conservative in your estimate. If you are currently enrolled in a program, review your outstanding balance, and if necessary, schedule a dentist, doctor, optometrist, chiropractor, etc. appointment before December 31st.

Calculate Medical Expenses: If this year's out-of-pocket medical expenses are larger than

usual and your company doesn't offer a flexible spending account, it makes sense to compute if you're eligible to write-off your medical expenses. The total medical expenses must exceed 7.5% of your adjusted gross income to qualify. Because very few people normally beat the 7.5% test, be sure to pay as much as you can before the year-end in a year that you qualify for medical itemized deduction.

Take Advantage of Pre-Tax Parking Breaks: If your employer offers pre-tax dollars to be used for parking, mass transit or van pools, take advantage of the tax savings. Many individuals are not afforded the luxury of being able to deduct personal parking costs.

Make a Roth IRA Contribution: If you qualify, making an annual \$2,000 Roth IRA contribution both for you and your spouse will help you accumulate tax-free wealth. ***You have until April 15, 2002 to fund a 2001 Roth IRA.***

Make your Non-Cash Charitable Deductions before December 31: The IRS allows a deduction for the lower of cost or fair market value for your non-cash contributions. Please remember to ask for a receipt. You must provide a schedule if your non-cash contributions exceed \$500.

Donate Stock Instead of Cash to your Favorite Charity: If you hold appreciated publicly traded stock for more than one-year, you can donate the stock and get a charitable deduction for the full market value of the stock *and* avoid paying any capital gains tax. You must give the stock directly to the charity. The opposite is true for stocks that have gone down in value. Never donate stocks that have declined in value, but rather sell the stock at a loss and donate the cash to charity.

Avoid Doubling Up on First Year Minimum Distributions: It's possible to receive two minimum distributions in the year after you reach age 70 1/2. This may push you into a higher tax bracket, or even worse, cause some of your social security benefits to become taxable. Analyze your situation to see what strategy benefits you the most. Please see details in our Minimum Distribution Calculator on our web site at <http://rothira-advisor.com/calculator/>, by entering 1930 or 1931 in the year of birth column.

Self-Employed Individuals Should Consider Employing their Child(ren): Employing your child (age permitting) offers great tax-saving opportunities. Assuming your child has no unearned income, the parent could pay the child wages up to \$4,550 in 2001, and the child would not have to pay any federal income taxes. If the parents' marginal income tax bracket were 27.5%, the wage deduction would generate \$1,263 in federal income tax savings. Furthermore, when you employ a child under 18-years-old, neither the employer nor the employee is subject to social security tax on the child's wages. The wages your child earns will qualify as earned income for the purpose of establishing a Roth IRA. A Roth IRA will provide your child with an exceptional opportunity to accumulate money with tax-free growth.

I am not suggesting a sham employment. I have read of parents employing their infant children for modeling and paying them wages. That is a little aggressive for my blood. Paying an 11-year-old for computer consulting may well be a legitimate expense. If you have sufficient support for the minor having their own business, the child could establish a SIMPLE plans as well as a Roth IRA.

Self-Employed Individuals with No Employees Should Consider Employing Their

Spouse: A self-employed individual may be able to deduct all of their health insurance premiums and medical expenses by setting up a medical reimbursement plan with his/her spouse as the only employee of his/her business. Your spouse must become a bona fide employee of your business. Theoretically, that means your spouse will be working under your control.

Good luck.

Beware of the Option Trap: The market decline could be especially painful if you exercised incentive stock options in 2001. Exercising an ISO can trigger the dreaded Alternative Minimum Tax on the spread between the strike price and the fair market value the day you exercise. Consult your tax advisor in these instances for your best options.

Last, But Not Least

High-income taxpayers should consider investing in tax-exempt investments.

Middle- or low-income taxpayers should consider selling tax-exempt investments and aim for greater appreciation or income.

Be sure that you meet the requirements for excluding gain on the sale of your principal residence. The exclusion amounts are up to \$250,000 for single filers and \$500,000 for married taxpayers filing jointly.

Conclusion

We hope this year-end planning letter has been helpful. These strategies are aimed at reducing both your short-term and long-term tax burden. Please take a moment to review your personal game plan to be sure you are not missing any opportunities.

If you are in need of tax planning and/or income tax preparation, the CPA side of our business stands prepared to help you. Client satisfaction was at an all time high last tax season. This year, we happily report that all eleven members of our tax staff are returning, and we expect an even better year.

We wish you and your family a happy, healthy and profitable holiday season and New Year!

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