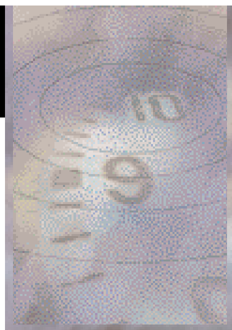

legal matters

The New Tax Bill

Pay attention: This time you're actually going to get a break or two. Here are ten tax changes that will help you keep more of your earnings.

BY JOHN ALLEVATO

In early June, President Bush signed into law the tax cut bill, generally fulfilling a campaign promise to reduce taxes. The new law, technically known as The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"), actually contains tax savings provisions for everyone.

I said everyone—and I mean it—including you. Read on.

Rather than recite what the Act says, I'm going to present some helpful ideas and information to you in a format which has become pervasive in our modern culture—the Top Ten list. Here goes.

Top Ten Things Physicians Should Know about the New Tax Act (in no particular order):

NUMBER 10—Section 529 plans.

In the March/April 2001 issue of this magazine, I introduced you to these types of plans and their benefits. In a nutshell, these plans allow you to invest money in stocks and bonds and have the investment and its gains available for your children (or grandchildren) to use to pay for college expenses. The kicker is that the income earned on the investments was taxed, albeit at the college student's lower tax rates. As much as $100,000 or more per child or grandchild can be transferred this way, though some of the nuances can be a bit complex.

How prescient that article was at the time was revealed by the changes to those plans made by the Act. Beginning in 2002, withdrawals and distributions made from Section 529 plans for payment of tuition and room and board will be tax-free. Yes, tax-free to everyone, including the beneficiary (the student) of the plan. Chalk one up for the good guys as this is truly a wonderful way to put away money for college—and all the growth and earnings are tax-free if used for educational purposes. Your financial or tax adviser can help you get on board this one.

NUMBER 9—Education IRAs.

OK, this one isn't nearly as attractive as a Section 529 plan, but it is another break to help pay for college education. Beginning in 2002, you can contribute (but the contribution is not tax-deductible) up to $2,000 per year (up from $500 per year) per beneficiary (per child) to this special type of IRA if your adjusted gross income (if filing jointly) does not exceed $190,000. Amounts of income above that result in a phase-out of the amount which can be contributed to the Education IRA, with full phase-out occurring

Continued from previous page

at $220,000 of adjusted gross income.

Amounts withdrawn from an Education IRA and used for qualified expenses of the student are tax-free at the time of withdrawal. Again, a nice break, although somewhat limited.

Oh, did I mention that qualifying expenses for these devices now include private school costs? That includes private elementary and secondary school expenses. This could be a great way to sock away money if private school education is in the cards for your beloved little ones.

NUMBER 8 —Lower Tax Rates Across the Board.

Everyone's tax rate is lowered, beginning this year. By the year 2006, the top individual tax rate will be 35 percent, compared to the current top rate of 39.6 percent.

A familiar tax axiom is that when rates are dropping, defer income and accelerate deductible expenses. That's true for these tax cuts as well. While these rate reductions may not result in a large windfall in any one year, pushing taxable income further out will result in some tax savings. Consult with your tax adviser as to how the alternative minimum tax may affect you before deferring income or accelerating deductions.

What this also means is that you should determine whether you are operating your business in the best form for tax purposes. Specifically, if you are not operating in a "flow-through" entity, see if that might make sense for you now. A flow-through entity would be an S corporation, limited liability company or partnership where income or loss "flows through" the company to the owners.

NUMBER 7 —True Rate Relief.

The top marginal tax rate is actually now over 43 percent due to the phase-out of certain deductions and exemptions under current law. For example, if your income is over a certain threshold amount, you start to lose the benefit of your itemized deductions and exemptions, effectively increasing your income tax rate. Beginning in year 2010, the top tax rate will truly be the stated rate of 35 percent—quite a reduction from the top rate now as the deduction phase-outs and exemption reductions will be eliminated. This benefit will be slow in coming, as it is gradually phased in over the next decade.

Beginning in 2002, up to $40,000 per year can be contributed to a profit sharing plan and/or money purchase plan on behalf of a participant, up from this year's limit of $35,000. Almost as significant is that a higher percentage of your qualified compensation (up to 25 percent from this year's limit of 15 percent) can be set aside, up to the maximum contribution amount.

Nevertheless, this is a significant change, and not only have tax rates been lowered, some "back door" tax increases have been eliminated.

NUMBER 6 — Less Tax Pain When You're Married.

It was true that some couples paid less federal income tax by remaining unmarried and filing as singles instead of getting married and filing jointly. Finally, the instances in which that silliness is encouraged by our tax laws will be reduced as the Act contains relief for married couples.

Not surprisingly, this relief will not be fully phased in until the year 2009, but when it is it will provide that the lowest tax bracket for married couples filing jointly will be twice that of a single person's, and the standard deduction amount for married couples filing jointly will be twice that of a single person's. While this will not fix all the inequities, progress has been made.

NUMBER 5 —Sock More Away in Your Retirement Plan.

Beginning in 2002, up to $40,000 can be contributed per year to a profit sharing plan and/or money purchase plan (known as defined contribution plans and also as qualified plans) on behalf of a participant, up from this year's limit of $35,000. Almost as significant is that a higher percentage of your qualified compensation (up to 25 percent from this year's limit of 15 percent) can be set aside, up to the maximum contribution amount. The rules governing qualified plans are still as complicated (and even more so after the Act), but now more can be put aside for you and your employees' benefit and deducted for retirement savings by your medical corporation or partnership.

To accomplish this, your plan is once again going to have to be modified some time next year for this change and others made by the Act. You have been forewarned—though there is good news in here for you, too. For example, if you currently have both a money purchase pension plan and a profit sharing plan to increase the amounts you can contribute and deduct, you may be able to eliminate one of those plans next year and still qualify for the maximum contribution percentages. Check with your retirement planning adviser.

NUMBER 4 — 401(k) Plan Deduction Increases.

Continuing with the retirement planning modifications made by the Act, beginning in 2002 the maximum amount

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which can be "deferred" by an employee and contributed to a Section 401(k) retirement plan increases from $10,500 this year to $11,000, and then increases an additional $1,000 per year until the year 2006 when the sum of $15,000 can be deferred by an employee and contributed to his or her 401(k) plan. While this is positive, this amount is not in addition to the maximum $40,000 which can be contributed by an employer for an employee as noted above.

Nevertheless, with the rapid rise in 401(k) plans and provisions as part of company's retirement plans, this is a favorable development. The maximum amount will be indexed for inflation beginning in year 2006, which will provide additional modest increases as the years go by.

NUMBER 3 — Don't Forget About IRAs.

While those who participate in qualified retirement plans or Section 401(k) plans cannot make tax-deductible contributions to an IRA, the maximum tax-deductible amount for those eligible to fund IRAs will increase from $2,000 this year in increments to the maximum of $5,000 in year 2008.

If you are not eligible to make contributions to a tax-deductible IRA, consider establishing a Roth IRA. Why? While amounts contributed to tax-deductible IRAs are fully taxable upon withdrawal, amounts withdrawn from Roth IRAs are withdrawn tax-free, including any earnings on the account over the years. The downside is that no tax deductions are available for contributions to a Roth IRA, but the fact that withdrawals are tax-free make these vehicles very attractive for those qualified to contribute to them.

One more important note. If you are over 50, the Act allows you to make additional contributions to IRAs, intended as a "catch-up." Again, these rules are complex but should be investigated if you can otherwise benefit from either a tax-deductible IRA or a Roth IRA. These catch-up provisions also mean that more can be deferred and contributed to a 401(k) plan for those over 50.

NUMBER 2 — Fewer People to Get Hit by Estate Taxes.

Estate taxes, maybe the least understood but probably the most loathed taxes to come out of Washington, have been reduced beginning in 2002. The current $675,000 exemption amount of property and assets which can be given away during your lifetime or at death and not incur estate or gift taxes will rise to $1,000,000 next year, $1,500,000 in year 2004, $2,000,000 in year 2006 and $3,500,000 in year 2009. Rates will also gradually decline each year as well.

What should you do about this? Even if you have a recently drafted a will and trust, you should once again visit your estate planner if your estate is worth $1,000,000 or more (counting all your assets, including the face value of your insurance policies and amounts in retirement plans). It could be that you will want to rethink how your assets pass to your beneficiaries, as the Act changes may affect how the amounts are allocated to various trusts in your estate plan.

NUMBER 1 — The "Sunset."

For most people, the word "sunset" conjures images of breathtaking colors in the sky—peaceful images and the hopes of a new and better day tomorrow.

Sorry to rain on your parade, but leave it to Congress to totally mess up what was once a beautiful thing. As you may have discerned by the descriptions above, the Act is full of provisions that don't come into effect until later years, or are phased in slowly. What you might not know is that the whole Act will "sunset" in later years as well, meaning it will disappear into the night, unless Congress takes future action to preserve its provisions.

One of the most glaring "sunset" provisions is the repeal of the estate tax. By reviewing Number 2 above you can see that fewer and fewer estates will be subject to the estate tax. Even better, in year 2010 the entire estate tax is repealed—for one year. In year 2011, the estate tax is back. This creates a nightmare for you and your estate-planning adviser, and will probably complicate your estate plan if your estate is valued between $1 million and $6 million or so.

In any event, expect Congress to deal with this in later years, which they can do by eliminating the sunset or making changes to the provisions of the Act—all as they see fit. For now, let's enjoy the breaks contained in the Act. ■

John Allevato is a member in the Charleston, West Virginia, law firm of Spilman Thomas & Battle, PLLC, where he practices business and tax law. He routinely advises and counsels health-care entities and physicians. He is a member of American Health Lawyers Association and can be reached via e-mail at jallevato@spilmanlaw.com