

## What the Economic Growth and Tax Relief Reconciliation Act of 2001 May Mean to You

Congress and the Administration have passed new legislation, which represents the largest tax cut in recent years. The Economic Growth and Tax Relief Reconciliation Act of 2001 provides taxpayers the ability to contribute more money into tax-deferred retirement accounts, save for higher education on a tax-free basis, and reduce the income tax rates for many individuals. In addition, the reduction of estate taxes, with the potential for estate tax repeal, has also been enacted.

Many of the new law provisions are phased in and do not take full effect for several years. However, this law also contains sunset language, which states that these new provisions do not apply for tax years after December 31, 2010. This means that without further congressional action, the current law will be reinstated after the December 31, 2010 date. Thus, the provisions included in this law will have to be addressed again in later years, presumably under a different Congress and President.

### Key Provisions and Opportunities

The Economic Growth and Tax Relief Reconciliation Act of 2001 provides tax reduction and opportunities in four key areas:

- Retirement Planning
- Education Funding
- Estate Tax Planning
- Income Taxation

This issue of *Solutions for Investors* provides a summary of select provisions of the new tax law. It is just one in a series that will be focusing on the new Act.

### Retirement Planning

The changes in the new law provide additional opportunities for you to save for your retirement. You will now have the ability to make larger annual contributions to your IRA and your qualified plan(s) available through your employer. The new law also expands the amounts eligible to be rolled over from a qualified plan into an IRA or other qualified plan. If you are eligible to make a rollover from your qualified plan, you will also be able to rollover your after-tax contributions. If you have a Section 457(b) retirement plan and are eligible to make a rollover, you will now be able to roll over these assets into an IRA or other qualified plan.

***Increase in contribution amounts to IRAs.*** Beginning in 2002, contribution limits will increase incrementally for traditional IRAs and Roth IRAs. IRA contribution limits for both traditional and Roth IRAs will rise from the current \$2,000 to \$3,000 in 2002 until it reaches an annual maximum of \$5,000 in 2008.

If you are age 50 or older, a “catch-up” provision is also available for extra contributions to a traditional IRA and Roth IRA. This “catch-up” is in addition to the general increases in contribution limits and provides that you may contribute an additional \$500 per year to your IRA in 2002 through 2006. This additional contribution will increase to \$1,000 beginning in 2006 and thereafter. You may make this additional contribution, even if you did not make contributions to your IRA in previous years and even if you contributed the maximum amount in previous years.

***Increase in contribution amounts to qualified plans.*** Contribution limits will increase for 401(k) plans,

403(b) plans, defined contribution plans, defined benefit plans, SIMPLE plans, and SEPs, beginning in 2002. The changes are as follows:

- 401(k) and 403(b) salary deferral limits will rise to \$11,000 in 2002 and increase \$1,000 each year thereafter until reaching \$15,000 in 2006.
- Defined contribution plan limits will be increased to 100% of compensation up to \$40,000.
- Defined benefit plan maximum annual benefit will rise to \$160,000.
- SIMPLE plan elective deferral limits will increase to \$7,000 in 2002, and increase \$1,000 per year thereafter until it reaches \$10,000 in 2005.
- SEP maximum contribution limit will increase to \$40,000.

If you are a participant in a qualified plan and are age 50 or older, a “catch-up” provision is also available for extra contributions to a qualified plan in addition to the general increases in contribution limits. Under the “catch-up” provision, participants age 50 and older in qualified plans may contribute an additional \$1,000 per year to your qualified plan, beginning in 2002. This additional contribution will continue to increase until it reaches the limit of \$5,000 in 2006. You may make this additional contribution as long as you are a current participant in a qualified plan. This “catch-up” provision is available even if you did not participate in a qualified plan in previous years and even if you contributed the maximum amount in previous years.

Similarly, a “catch-up” is also available for SIMPLE plans if you are a current participant age 50 or older. An additional \$500 per year may be contributed until the limit of \$2,500 is reached in 2006.

***New rollover options from a qualified plan.*** Generally, if you have separated from the service of your employer, you are eligible to make a rollover from your 401(k) or other qualified plan into an IRA or other qualified plan. Beginning in 2002, your ability to make this rollover has been expanded to include after-tax contributions made to your qualified plan. Your after-tax contributions, in addition to your pre-tax contributions, may be rolled over into an IRA or into another employer plan.

If you are a participant in a Section 457(b) plan for state and local government employees, your ability to make

a rollover when you separate from service will be enhanced beginning in 2002. You will no longer be restricted to making a rollover into another Section 457(b) plan. Instead, the new law provides that your account balance may now be rolled over into an IRA or into another employer plan.

## **Education Funding**

The changes in the new law provide additional tax benefits for you to save for the education expenses of your children, grandchildren, relatives or any other individuals beginning in 2002. The rules for Section 529 plans will provide for tax-free distributions used for qualified higher education expenses. The Education IRA rules will afford you the opportunity to make larger annual contributions and take tax-free withdrawals for elementary and secondary school expenses.

### ***Section 529 Plans (Qualified State Tuition Programs)***

The new law has enhanced your ability to save for the costs of higher education. Distributions from a Section 529 plan will be tax-free if used for qualified higher education expenses, beginning in 2002. This is a significant change from the current law which provides that funds in a Section 529 plan grow tax-deferred and upon withdrawal (for qualified higher education) the earnings were taxed at the beneficiary’s tax rate.

The ability to save for higher education on a tax-free basis increases the power of saving for higher education for children of all ages. Consult with your tax advisor and your Financial Advisor to determine if a Section 529 plan is a more effective way to save for higher education than using an UGMA/UTMA account (Uniform Gifts to Minors Act/Uniform Transfers to Minors Act).

If you have already established a Section 529 account and wish to make a rollover to another Section 529 plan, you may make a rollover under the new law without changing the beneficiary on the account. However, you may make a rollover of that account only once in a twelve-month period. This new rollover rule, effective beginning 2002, gives you the ability to switch Section 529 plans if you wish to take advantage of different investment options and/or a higher overall account limit amount through a different Section 529 plan. You should also consider the effect of any state tax deduction available for contributions to a Section 529 plan.

If you desire, you will also be able to make contributions in the same year to both an Education IRA and a Section 529 plan.

**Education IRAs**

The annual limit on contributions to Education IRAs will increase from \$500 to \$2,000, beginning in 2002. This enhances your ability to save for the costs of higher education, since distributions from an Education IRA are tax-free if used for qualified higher education expenses. However, the amount of your contributions will phase out if your adjusted gross income (AGI) exceeds a certain amount. For married individuals filing jointly, this phase-out range will be increased to \$190,000-\$220,000 of AGI. The phase-out range for single individuals will remain at \$95,000-\$110,000 of AGI.

Under the new law, tax-free distributions for higher education have been expanded to include primary and secondary school expenses, for both public and private school, beginning in 2002. This is in addition to your ability to take tax-free distributions for post-secondary education such as vocational school, college, and graduate school.

If you desire, you will also be able to make contributions in the same year to both an Education IRA and a Section 529 plan.

**Other education-related provisions**

*Employer-provided education assistance.* The new law excludes from income employer-provided graduate education assistance (up to \$5,250 annually), and extends the exclusion to both undergraduate and graduate education.

*Student loan deduction.* Deductibility of student loans is increased by increasing the income phase-out thresholds. In 2002, the threshold for singles will be \$50,000-\$65,000 and for married couples filing jointly will be \$100,000-\$130,000. The deduction is “above-the-line” so it may be claimed even if you do not itemized your deductions

*Deductions for higher education expenses.* A new deduction will be allowed for qualified higher education expenses in the years 2002 through 2005. In 2002 and 2003, married couples filing jointly with adjusted gross income that does not exceed \$130,000 (\$65,000 for singles) could claim a maximum deduction of \$3,000. The deduction is “above-the-line” so it may be claimed

even if you do not itemize your deductions. This deduction does not apply to contributions to either an Education IRA or a Section 529 plan.

**Estate Planning**

The changes in the new law provide additional opportunities for you to review and evaluate your current estate plan, or to begin your estate tax planning if you have not already done so. With the increase in the unified estate and gift tax credit amount, additional gifting strategies for estate planning purposes may be available. Consult with your tax advisor on how you can take advantage of these changes.

***Increase in unified estate and gift tax credit amount and estate tax phase-out.***

Beginning in 2002, the unified credit effective exemption amount and rates for estate taxes will be adjusted as follows:

Calendar Year	Estate Tax Transfer Exemption Amount	Highest Estate and Gift Tax Rates
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	Scheduled repeal	Top individual rate (gift tax only)
2011*	\$1 million	55%

\*In absence of re-enactment

Furthermore, the 5% estate tax surtax is repealed; estate and gift tax rates in excess of 50% will be repealed in 2002; and the top estate and gift tax rate will drop to 49% in 2003 and continue to drop until the rate reaches 45% in 2007.

Please note that due to the “sunset” provision within the law, the repeal of estate taxes is only in effect for the year 2010. Unless at least 60 senators vote to eliminate this “sunset” provision, current estate tax laws go back into effect on January 1, 2011. Given that there will be five congressional and two presidential elections between now and then, it is uncertain as to whether estate tax repeal will ever actually take effect.

The new rules for gift tax vary from the new rules for estate taxes. A modified gift tax remains in the law, and there is a separate unified credit exclusion amount for gift tax purposes that is not the same as the one for estate tax purposes. The gift tax exclusion amount will increase to \$1 million in 2002 and will not increase beyond this amount. As a result, while the amount you may pass free of estate taxes will continue to increase, the amount you may gift tax-free during your lifetime will not increase to over \$1 million.

After the scheduled repeal of the estate tax beginning in 2010, there would no longer be an adjustment in the basis of inherited assets to fair market value on date of death (commonly referred to as a “stepped-up” basis). Instead, after repeal, the new law will provide for a basis in inherited property equal to the lesser of the (1) decedent’s adjusted basis in the property or (2) fair market value on decedent’s date of death (referred to as a “modified carry-over basis”). However, a limited basis “step-up” exception will apply to \$1.3 million of assets and a basis “step-up” for \$3 million of assets transferred to a surviving spouse. If you own low cost basis assets and/or property, this may result in significant capital gains tax when the low cost basis assets are sold, as well as a significant bookkeeping burden. As under current law, this “step-up” will not be available for certain assets, such as IRAs, qualified plans, and annuities. Due to the complexities inherent in the new tax laws, proper estate planning with your Financial Advisor is crucial.

## Income Taxation

The changes in the new law provide additional opportunities for you to save income taxes through tax rate reductions, changes to the phase-out for itemized deductions and reduction of the marriage penalty. Check with your tax and Financial Advisor on the new

laws’ effect on your fixed income portfolio and charitable planning.

## Income Tax Rate Reductions

Effective January 1, 2001, there is a new 10% bracket for the first \$12,000 of taxable income for married couples filing jointly and \$6,000 of taxable income for singles. This income was originally taxed at the 15% tax rate. As a result of this new tax bracket in 2001, if you filed a return for 2000 you may receive a check from the IRS of a maximum amount of \$300 if you are single and \$600 if you are married filing jointly.

In addition, the 28%, 31%, 36%, and 39.6% income tax rates will be reduced in each bracket. For the 2001 year, this rate reduction will be ½%. For the 2002 year the rate will be reduced by another ½%. Further tax rate reductions will occur until 2006.

### *Other income-tax-related provisions*

*Reduced phase-out of itemized deductions and personal exemptions.* The limitations on itemized deductions and personal exemptions for upper-income taxpayers will both be reduced beginning in 2006 and will be eliminated by 2010.

*Partial “marriage penalty” relief.* Relief from the marriage penalty is delayed until 2005 and will phase-in until 2009.

## For More Information

The Economic Growth and Tax Relief Reconciliation Act of 2001 provides tax reduction and opportunities for retirement planning, education funding, estate tax planning, and income taxation. The new law affords you time to contact your Prudential Securities Financial Advisor and your tax advisor and discuss how the new law may affect your portfolio, your financial planning goals, and your estate planning objectives. Review these changes with your Prudential Securities Financial Advisor and your tax advisor. Your Financial Advisor can work closely with you and your tax advisor to help you pursue your investment goals. Please remember that Prudential Securities is not a legal or tax advisor, and you should consult with your tax advisor before making any tax-related investment decisions.