AKO ESTATE PLANNING & TAX ADVISOR

Volume 1 Number 2 www.andersonkill.com Summer 2002

Final IRS Regulations Make an IRA an Even More Valuable Tax Shelter

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An Individual Retirement Account ("IRA") is one of the most accessible and widely used tax shelters available to an individual taxpayer. For example, an individual whose employer does not have a qualified pension or profit sharing plan may make a tax-deductible contribution to an IRA of up to $3,000 in 2002 (or $3,500 if the individual is at least age 50). In addition, some individuals who are covered under their employer's qualified plan may also be able to make tax-deductible contributions to an IRA. But perhaps the most valuable feature of an IRA is that it can receive an eligible rollover distribution from a qualified plan and, in doing so, postpone taxation on that distribution. This is a very significant benefit, particularly for those retiring from their jobs. Most profit sharing and 401(k) plans offer only a lump sum payment option. A retiree who receives a large lump sum payment from his or her profit sharing or 401(k) plan can rollover this payment into an IRA and defer the tax on this sum, thereby increasing its after-tax benefit to him or her in the future. As a result of the 2001 tax legislation even after-tax contributions can be rolled over into an IRA. The key point here is to defer distributions from an IRA as long as possible since funds in an IRA are not generally taxed until they are paid out to the IRA account holder or his or her beneficiaries.

However, the law requires that minimum amounts (a "required minimum distribution") must begin to be distributed to an IRA account holder no later than April 1st following the year he or her attains 70½ (the "required beginning date"). Failure to do so may result in a penalty tax of 50% being imposed on the amount of the required minimum distribution. On April 16, 2002, the IRS issued final regulations that make it much easier for an IRA account holder to defer the balance in his or her IRA account for longer periods. Now, required minimum distributions are generally calculated during the lifetime of the IRA account holder based on a uniform life expectancy table (the "Uniform Lifetime Table") that assumes a distribution period equal to the joint lives of the IRA account holder and a hypothetical designated beneficiary who is ten years younger than the IRA account holder. It will be no longer necessary to name a "designated beneficiary" by the required beginning date. In addition, the Uniform Lifetime Table, as well as the other life expectancy tables contained in the final regulations, are based on more current, longer life expectancies and, thus, the minimum required distributions are spread over a longer period.

Under the final regulations it is now easier to combine estate tax and income tax planning. For example, the IRA account holder might wish to designate a trust created under his or her will as beneficiary of the IRA. This trust could provide for annual payments from the IRA to the surviving spouse for his or her life at least equal to the minimum required distributions. Any balance at the surviving spouse's death would be payable to the IRA account holder's children. Since it is now clear

who's who

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Helpful Tips. *A working spouse may be able to make a tax-deductible contribution to an IRA established for the benefit of the non-working spouse of up to $3,000 in 2002 (or $3,500 if the non-working spouse is at least age 50). The couple must file a joint return in order to take advantage of this provision. However, the deduction is phased out if the working spouse is covered by a qualified plan and the couple's adjusted gross income exceeds $150,000.*

In addition, an IRA can be established for a child who has compensation from services (for example, income from after-school jobs). The parent can make contributions to this IRA of up to $3,000 (or the amount of child's compensation if less). The contribution would be deductible on the child's tax return. Contributions to this IRA plus accumulated investment income could be withdrawn to pay college tuition and related expenses in the future without being subject to an early withdrawal penalty of 10% generally imposed on IRA withdrawals prior to age 59½.

under the final regulations that a testamentary trust can be a designated beneficiary the minimum required distributions (based on the surviving spouse's life expectancy) can be paid from the IRA to the trust and then to the surviving spouse during his or her lifetime. If structured properly, any balance in the IRA at the time of the surviving spouse's death would pass to the children free of estate tax and could be paid to them over the remaining life expectancy of the surviving spouse at the time of his or her death.

In conclusion, the longer one can keep funds in an IRA the greater the after-tax benefit will be to the IRA account holder and his beneficiaries, since funds in an IRA are generally not taxed until they are distributed. The final regulations make it easier for required minimum distributions to be spread over longer periods of time. However, careful planning is still required in order to take full advantage of these rules.

Congress Gives an "Apple" to Primary and Secondary School Teachers

In passing the Job Creation and Worker Assistance Act of 2002, Congress gave an apple in the form of a small tax benefit to teachers (or instructors, counselors, aids or principals) who work at least 900 hours per year at schools that provide elementary or secondary education. These individuals will be able to deduct up to $250 per year of unreimbursed expenses for books and certain other items that they use in the classroom. This deduction is available even if the teacher doesn't itemize his or her deductions on Schedule A of Form 1040. There are certain restrictions on the availability of this deduction, and it will be available only for tax years 2002 and 2003, but every little bit helps!

Good News For Employers and Employees: IRS Gives Ok to Automatic Enrollment in Cafeteria Plans

A cafeteria plan is a plan under which an employee can elect to receive taxable wages or certain tax-free benefits such as group health insurance coverage. The employee agrees to forego a portion of his or her compensation, and that portion is then used to pay the employee's health insurance. The foregone compensation is not taxed. On May 20, 2002 the IRS issued Rev. Rul. 2002-27, which permits cafeteria plans to establish an automatic enrollment process whereby an employee's taxable wages are reduced each year to pay the employee's share of group health insurance coverage unless the employee makes an affirmative election to receive his or her full salary. This will permit employers to reduce administrative costs while protecting some employees from inadvertently failing to provide themselves with health insurance coverage on a reduced tax basis. This ruling is consistent with an earlier ruling that approved an automatic enrollment process for 401(k) plans. ■

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