PRICEWATERHOUSECOOPERS'

Guide to the New Tax Rules

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This book is dedicated to the many partners and professionals of PricewaterhouseCoopers LLP who have spent a significant portion of their careers working with clients in developing strategies designed to help build, preserve and maximize wealth.

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YEAR-ROUND TAX PLANNING STRATEGIES

INTRODUCTION

To life's two proverbial certainties—death and taxes—we can safely add a third related one: tax *changes.* Year-in and year-out, the Internal Revenue Code presents a moving target. Congress, while keeping up a steady stream of complaints about the tax code's complexity and impenetrability, just can't seem to leave it alone. Whether there's a major overhaul or relatively minor tinkering, there is always something new to worry about or to profit from. Sometimes fairness or simplification is the goal; other times it's a break just for a small group of taxpayers; occasionally it's across-the-board relief. Right now, we have it all. The Economic Growth and Tax Relief Reconciliation Act of 2001 gave us the deepest tax cut since President Reagan's two decades ago. It created a new lower rate bracket at the bottom and slashed rates further up the line to the top bracket. That law also phases out the estate tax, reduces the marriage penalty, gives greater tax incentives to education savings, and allows larger deductions for contributions to retirement accounts of all kinds. It even helps some people temporarily avoid the dreaded alternative minimum tax.

These changes don't hit all at one time. Instead, they are phased in on varying timetables for this entire decade. Some are in effect for only a few years; others don't start until years in the future. If there was any doubt before, tax change is now a given and taxpayers have to cope with it. As if to prove that, Congress has already passed more new tax laws since the massive 2001 Act, mainly to give some tax relief to businesses and, hopefully, to stimulate the sluggish economy. The IRS constantly puts its own interpretation on things with a steady stream of new regulations and rulings, which sometimes upset years of careful tax planning, as happened this year when it changed the rules for taxation of many split-dollar life insurance arrangements.

Rest assured, there's plenty more change to come. Some of the recent changes likely will be made permanent, and some could be repealed or delayed. But whatever happens, every year each one of us must deal with the tax law as it then exists and try to make the most of it. We also have to look ahead to plan our future tax strategies based on what we know in the present. That vision is a bit unsettling, because all of the changes made by the 2001 Act are scheduled to vanish after 2010, unless Congress acts to prevent that. The law contains its own demise: Its sunset provision ends all the changes and leaves us with the Tax Code as it was before the massive 2001 Act.

In effect, this guarantees a decade of dynamic change in everyone's financial and tax life. The shifting tax milieu and its implications reach into every aspect of our personal finances, from deciding where to live to the education of our children to our investment strategies and retirement planning.

What can we do? We can learn and adapt and cope. As complex as it is, the basics of the Tax Code can be understood. Moreover, we owe it to ourselves and to our families to make the effort.

This book will give you the tools you need to begin to sort things out and put them straight. It identifies the four major areas of the tax code that are most affected in this decade of shifting tax sands:

individual income-tax rate reductions, increased child credits, marriage penalty relief, and estate tax relief. It also shows how to qualify for tax assistance for education-related costs, and how to maximize the expanded tax breaks for company-sponsored and individual retirement plans. The largest share of the current and coming tax reduction—fully 65 percent—comes from lower marginal income-tax rates for individuals. Child-related items account for 13 percent of the cuts, and phasing out the estate tax takes another 10 percent. The remaining 12 percent comes from reducing the marriage penalty, pension and IRA reform, education incentives, and relief from the AMT.

This book spells out the most important features of all these changes as well as the impact of those that occurred in 2002. And it clearly sets forth the opportunities they offer to seize new tax-saving advantages and strategies now and in the coming years.

Who We Are

We are personal financial services professionals at PricewaterhouseCoopers, one of the leading worldwide organizations of tax advisers, accountants and auditors. The firm operates in 150 countries and territories, advising large and small businesses, individuals, governments, and not for profit organizations. Over 300 personal financial services professionals in the United States provide high net worth individuals with comprehensive financial planning services including estate and gift tax planning, income tax consulting and preparation, compensation and stock option planning, investment advisory services, retirement planning and charitable giving strategies.

How to Use This Book

Chapter by chapter, we clarify the vital sections of the new tax laws, with concrete examples that tell taxpayers what they need to know to build a solid base for planning and then to begin to map their own dollar-saving strategies. Remember, however, that oversimplification is dangerous. We strongly recommend that taxpayers understand at least the basic provisions of the law and the fundamentals of the tax code before planning, say, educational savings or stock option strategy—-that is why we wrote this book.

Here's what lies ahead:

- Chapter 1 spells out the key elements of the new tax acts and other changes, explaining briefly what each major provision and change does, how it works, and its timing.
- The laws' impact on investments and stock options is the subject of Chapter 2. Timing is crucial in this area as various provisions of the law phase in and out.
- Retirement planning should be part of each taxpayer's strategy from the time he or she begins work. Chapter 3 discusses how to make planning for retirement a reality, and what changes in planning the new laws will entail.
- The tax advantages of home ownership have been received wisdom for decades. But Chapter 4 explores the subtle differences the new law will make when it comes to owning a home.
- The 2001 tax bill provides incentives for education, with extensive specific provisions affecting primary, secondary, and higher institutions. Chapter 5 covers how to maximize savings for education.
- How can you structure your estate for a time when the "death tax" is gradually phasing out, only to reappear after 10 years? Chapter 6 offers estate planning ideas.
- Chapter 7 sums up important strategies for year-end tax planning in a quick planning guide.
- When preparing your taxes, moving deductions to the previous tax year can save significant dollars, particularly if they are deductions that are going to be phased out. Chapter 8 describes those deductions that may be best to accelerate.
- Chapter 9 applies the same year-end tax saving principles to deferring income from one year to the next, when it may be taxed less under scheduled changes.

- Year-end planning for business owners incorporates all of the personal strategies previously discussed, but doesn't end there. There are many additional considerations that can generate tax savings for business owners and for their companies that can be found in Chapter 10.
- Chapter 11 explains basic tax concepts as they have evolved in the tax code and puts the 2001 changes into context.

Interspersed through each chapter are a number of special features. The bulk of the text consists of individual "observations"—brief, clear explanations of specific features of the new law and how they will be applied. There are also occasional passages labeled "caution," warning of a possible blunder taxpayers might make based on a misinterpretation of the law. In addition, each chapter contains an "idea checklist," offering readers a quick summary of concepts to be used for taking advantage of the new law and its changes.

Let's Get Started

It is human, and normal, to be intimidated by the subject of taxes. For most of us, our dealings with the Internal Revenue Service won't end with a royal tap on the shoulder, but we can benefit greatly if we take the initiative and make the effort to overcome such fears. When it comes to taxes, forewarned is forearmed. An investment of time and effort in forming a strategy for the coming years will pay off, year after year.

Recent Tax Laws Affect Tax Planning for This Decade

Chapter 1

THE 2001 AND 2002 TAX ACTS

The Internal Revenue Code is a work in progress, if ever there was one. Congress never leaves it alone for long. But every couple of decades there are changes that cause people to rethink everything. Their old tax planning strategies no longer work. One of those quantum leaps took place last year and is beginning to be felt now.

"Across-the-board tax relief does not happen often in Washington, DC," President George W. Bush said as he was signing his $1.35 trillion tax cut bill into law last year. "In fact, since World War II, it has happened only twice: President Kennedy's tax cut in the sixties and President Reagan's tax cuts in the 1980s. And now it's happening for the third time, and it's about time."

The president's tax cut was large, but the Economic Growth and Tax Relief Reconciliation Act of 2001 is more than a tax cut. It is a huge and complex changing-of-the-rules of the game—rules that phase in over the entire decade of the 2000s. For well-informed savvy people, this ever-changing scenario offers tax-saving opportunities to plan for year after year. There is an opportunity to take advantage of each provision as it phases in (or phases out), adjusting investments and compensation strategies, and accelerating (moving into an earlier year) or deferring (delaying to the following year) income and deductions to keep the greatest possible share of income for themselves and their families.

These tax cuts are powerful enough to affect the economic lives of many taxpayers. They surely alter the way people invest their money, save for their children's education and their own retirement, write their wills, and structure their estates. Professional advisors are sorting out the mind-boggling array of interconnected changes, and taxpayers are gradually becoming aware of the fundamental importance of them.

The first step, however, must be to understand the changes and how they work. This book aims to make that large task as painless as possible. In this chapter, we begin by discussing and explaining the decade-long tax cuts in each of four main areas:

1. **Rate reductions, tax credits, and deductions.** All taxpayers who are not subject to the AMT benefit from a new 10 percent bracket, which was carved out of the old 15 percent bracket. For married couples, the 10 percent tax rate applies to the first \$12,000 of taxable income and will save them as much as \$600 a year. In higher brackets, tax rates will fall in stages over the next five years. The top rate which had been 39.6 percent, paid by the top 1 percent of taxpayers, will fall to 35 percent; the 36 percent rate to 33 percent; the 31 percent rate to 28 percent; and the 28 percent rate to 25 percent. The child credit rises in increments to \$1,000, and the credit for child care expenses also increases. Limits on personal exemptions and itemized deductions, which were formerly imposed in stages as income rose, will be phased out by 2010. There is limited relief from the Alternative Minimum Tax (AMT), although the relief only lasts through 2004 unless Congress takes further action. Married people who pay more tax than they would as singles will get some relief from the hated marriage penalty, beginning in 2005.
2. **Education reforms.** In 2002, the maximum (nondeductible) contribution that can be made to an educational Individual

Retirement Account (IRA), now called a Coverdell Education Savings Account, quadrupled to $2,000. Income from these accounts can be withdrawn tax-free to pay for school expenses, including tuition for private and parochial schools and expenses for state-approved homeschooling, as well as for college. The so-called Section 529 plan, for parents saving for tuition and expenses at colleges and universities, has expanded to include plans of private institutions. Deductibility of interest on student loans has also been expanded, and there now is a short-lived deduction for up to $4,000 in college tuition for couples earning less than $130,000.

3. **Retirement plan changes.** There also are vastly improved incentives for retirement savings. The Roth IRA, which is funded with after-tax dollars and offers tax-free withdrawal of gains, will be extended to some high-income families who did not previously qualify, and the limits on contributions have been raised. Limits on annual funding for conventional IRAs are being phased up from $2,000 in 2001 to $5,000 in 2008, and permitted employee contributions to 401(k) and equivalent plans will increase year by year to a maximum of $15,000 in 2006. Workers who are age 50 or older are now allowed to make larger contributions, and there are special tax credits to help low-income taxpayers save for retirement.
4. **Estate tax changes.** Reforms of the so-called death tax have created considerable estate planning complexities for the wealthiest 2 percent of taxpayers—those who may owe taxes on their accumulated wealth when they die. The amount exempt from being taxed has increased to $1 million, and will keep rising. The top rate has dropped and will continue to fall until the estate tax phases out entirely in 2010. On the other hand, unless Congress intervenes, the estate tax will come back in 2011, just as it would have been if it hadn't been changed at all! And even if the revival of the estate tax is later repealed, new rules will require heirs to pay tax on some of the capital gains from their inherited wealth—a complication that never had to be dealt with before.