



FINANCIAL SERVICES
FOR THE GREATER GOOD®

The 2001 Tax Act Approaches Sunset

“Changing Tax Laws” – the phrase is starting to sound redundant... you should plan accordingly.

By Douglas Rothermich, J.D.

When passed into law, the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) had a 10-year lifetime, and created a series of tax law changes to be implemented over that period. All of its provisions, however, are statutorily designed to “sunset” or lapse, as if never enacted, in 2011. In view of the uncertainty surrounding future tax laws, this may be a good time for reassessing your planning.

EGTRRA included several provisions that created planning opportunities by significantly changing the income and estate tax regimes. It also created additional incentives for increasing your retirement account(s) contributions and planning for your family’s education expenses.

Today, the likelihood that EGTRRA will “sunset” without further action from Congress seems remote. Congress, in fact, has been debating further modifications to these rules since shortly after passage of the 2001 legislation. The changing tax rules within the provisions of EGTRRA, coupled with Congress’ regular tinkering with tax laws, makes unclear the direction tax laws will take long-term, or how they may or may not apply in your situation. All of this, of course, makes planning quite difficult.

Income Tax Planning

The income tax rate changes under EGTRRA have positively affected most taxpayers, although in varying degrees. There was an immediate drop for a portion of the lowest bracket to a new 10% rate. All other brackets have now been lowered — the 28%, 31%, 36%, and 39.6% rate brackets previously in place are now 25%, 28%, 33%, and 35%, respectively.

Accompanying this gradual reduction in income tax rates, higher income taxpayers have seen some easing on the limitations for itemized deductions and personal exemptions. Overall, the combination of lower tax rates with increased itemized deductions and personal exemption amounts have generally reduced income taxes. However, the other side of this

is that millions of Americans are now begrudgingly acquainted with the alternative minimum tax (AMT).

Originally designed to prevent high-income taxpayers from dodging income taxes through exclusions, deductions, and credits, application of the AMT hasn't been adequately updated to keep pace with rising levels of income and lower net tax rates. As a result, many taxpayers' income tax savings generated by EGTRRA have been at least partially offset by the higher amounts subjected to the AMT. This is particularly true for taxpayers in states with high state income or property taxes.

The Joint Committee on Taxation originally projected a doubling of the number of taxpayers expected to be subject to the AMT by 2010, increasing from 17.5 million before EGTRRA to 35.5 million after EGTRRA. These estimates continue to hold up, as millions of taxpayers in high tax states are experiencing the AMT bite. New Jersey, New York, Connecticut, Washington, D.C., and California lead the list for the highest percentage of taxpayers now subject to the AMT.

Retirement Planning

EGTRRA also dramatically increased amounts you can set aside in tax-deferred retirement accounts. In the past six years, the pretax amount you may contribute to your 401(k), 403(b), or 457(b) plan increased from \$10,500 to \$15,500 per year. (From 2007 onward, this higher annual contribution limit will be indexed for inflation.) Overall annual dollar contribution limits (including employer contributions) have increased to the lesser of \$40,000 (for 2007, it's up to \$45,000 with indexing for inflation) or 100% of your compensation. And, for those age 50 or older, EGTRRA created a catch-up provision that allows you to save an additional \$5,000 above the annual dollar contribution limit.

For taxpayers who believe their personal income tax rates in retirement may be higher than today's tax rates, EGTRRA created greater savings opportunities with the new Roth 401(k) or 403(b) retirement accounts. With a Roth account, your contributions are not tax deductible — the full amount of the contribution is subject to income tax in the year made. However, all distributions to you or to your beneficiaries will be income tax free if all Roth requirements are met. Generally, a Roth account may make sense if you expect income tax rates to be higher in the future.

For more information on Roth accounts, see the TIAA-CREF Institute publication *The Expanding Roth Retirement Account* at www.tiaa-crefinstitute.org/research/trends/tr030106.html, or ask your TIAA-CREF advisor for a copy of company publications on the topic.

Estate Tax Planning

At the federal level: For many individuals, EGTRRA is providing temporary relief from the estate tax, but that relief could be fleeting, making it very difficult to understand today how you should plan your affairs. In the past five years, the amount of assets exempt from estate tax by using your unified credit has increased steadily from \$675,000 to \$2 million for 2007 and 2008. In 2009, this amount is scheduled to increase further to \$3.5 million. Thereafter, the estate tax is scheduled for a one-year repeal in 2010. However, following EGTRRA's 2010 sunset, the estate tax will automatically return to the pre-2001 level, bringing the 2011 exemption amount back to \$1 million.

We've also seen that while the estate tax exemption amount has increased, the federal rate of estate tax has fallen. The old gradual rate tables (with a maximum pre-2001 rate of 55%) have now been replaced with a flat rate of 46% for amounts above the \$2 million exemption equivalent. This flat estate tax rate has dropped to 45% in 2007 but will revert back to 55% after 2010, if further changes are not made before then.

Determining how, or if, the changing exemption amounts and moving tax rate targets could apply to your situation has only been made more complicated by EGTRRA's sunset uncertainty. At current levels, millions of Americans who would not be subject to estate tax (under EGTRRA provisions) would again be subject to estate taxes if the sunset occurred before their deaths (because the exemption amount would revert to the \$1 million level). Again, not knowing what will happen to the EGTRRA provisions after 2010 makes planning very, very difficult.

Most commentators, including the author, don't believe Congress will allow EGTRRA to sunset. Rather, Congress will probably make permanent some form of estate tax relief. Tax provisions currently debated in Congress would set the exemption presumably somewhere between today's \$2 million level and a higher fixed level, maybe as high as \$5 million or so, according to many reports. But even with a permanent fix, seasoned tax planners know that there's nothing permanent about tax laws. A future Congress or new administration could reverse or further alter the tax rules. With or without additional changes in the near-term, it seems fairly certain that tax planning will remain a part of estate planning for individuals who've accumulated significant assets.

At the state level: Besides the uncertainty surrounding the federal estate tax laws, EGTRRA created one other murky area. Many states historically collected a state estate tax, typically tied to the amount of the federal estate tax credit for state death taxes paid. But as of 2005, EGTRRA eliminated the federal credit allowed for state-level estate tax and replaced it with a general deduction for state estate taxes paid.

The impact on various state treasuries has been dramatic. For states that imposed a tax equal to the federal credit, the state-level tax (by definition) has been reduced to zero. This means that rather than collecting an estate tax based on the previously allowed credit for state death taxes, these states now collect an estate tax of zero (because there's no

longer any federal estate tax credit available), thus producing zero estate tax revenues. At this point, about half of the states have established new state-level estate tax systems apart from the federal one, forcing current tax planners to consider both federal and state-level taxes.

The relevant point of all this is that state estate taxation has become an important but complex aspect of estate planning that is difficult to illustrate with examples, because it can vary significantly from state to state. If you are working on your estate plan and aren't sure what's happening with your state's estate taxation, please have a discussion with a capable estate planning attorney who can provide clarification.

If Congress extends the federal estate tax repeal beyond 2010, the benefits won't come without a cost. Although little publicized, EGTRRA also included a provision to alter the income tax basis step-up rules following estate tax repeal. Currently (and until 2009), at death, your income tax basis for most nonretirement plan assets (e.g., real estate or securities held outside of a retirement plan) is generally stepped up for income tax purposes to the asset's date-of-death value. This means your beneficiaries won't pay capital gains tax on the appreciation of these assets during your lifetime. Instead, they will pay capital gains taxes on the post-death appreciation of these assets. But beginning in 2010 (the same year of the scheduled estate tax repeal), only the first \$1.3 million of such assets will be stepped up for income tax purposes, along with an additional \$3 million for amounts going to a surviving spouse. Any amount exceeding \$1.3 million will have the same income tax basis for your beneficiaries as it would for you before your death.

To do appropriate long-term estate planning, in light of the additional unknowns created by EGTRRA, clearer direction is needed from Congress on the future or eventual application of the estate tax. If that direction is not forthcoming in a permanent manner, which seems unlikely at this time, regular updates to your estate tax planning will continue to be necessary to keep your financial matters in order.

Things to Consider

Based on the changes that have occurred in the past six years, how should you react?

Here are some basic considerations:

- Take advantage and defer more income to your tax-deferred retirement plans. Contribute the maximum allowed to your tax-deferred retirement accounts; and if you are 50 or older, use the catch-up provisions to increase your contributions even more.
- If you believe your personal income tax rates may be higher in retirement, consider if a Roth account is available and desirable.
- Don't assume the AMT will not affect you. Meet with your accountant to prepare future tax estimates, which must include projected AMT liability. Knowing how your income tax will be calculated will allow you to plan more appropriately.

- Don't assume that higher estate tax exemption amounts mean that you don't need to consider tax planning and life insurance coverage in your estate plan.
- If you haven't already done so, update your estate plan to reflect all EGTRRA changes and any other applicable state estate tax law changes. Coordinate all these changes with both your retirement accounts and life insurance beneficiary designations.
- Discuss with your estate planning attorney how your plan should be amended to ensure the greatest flexibility in the future, while still capturing the benefits under the current tax system, if your death should occur in the near term.

This article attempts to summarize some of the basic changes in EGTRRA and outlines the planning challenges or opportunities presented. Because this article covers a very complex topic, it should not be viewed as specific tax or legal advice. Before making any changes, you should consult with your accountant and or attorney.

About the author: *Douglas A. Rothermich, J.D., is vice president, Wealth Planning Strategies, for TIAA-CREF's Wealth Management Group. Wealth Management Group services are provided by Advice and Planning Services, a division of TIAA-CREF Individual & Institutional Services, LLC, a Registered Investment Advisor.*

© 2007 Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), 730 Third Avenue, New York, NY 10017

C38346