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# RETIREMENT INVESTING

SPECIALIZING IN INVESTMENT MANAGEMENT AND ASSET PROTECTION  
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## How Will the New 2001 Tax Act Benefit You?

It is likely that you will not find anything much more difficult to comprehend than the New 2001 Tax Act, also known as the Economic Growth and Tax Relief Reconciliation Act of 2001, a \$1.35 trillion tax-cut plan. It reportedly makes 441 changes and adds 14 sections to the Internal Revenue Code. Some of the changes took effect retroactively to Jan. 1, 2001, but most of the changes will hit in 2002 or later, and will be phased in over a number of years. The new law's complexity, however, is matched by its quirkiness. Let's review some of the tax changes in your future.

### Rate reductions

The backbone of the legislation is an across-the-board cut in income tax rates. The legislation lowers the tax rate on the first \$12,000 in taxable income for joint filers - \$6,000 for Single Filers and \$10,000 for Head of Household Filers to 10%, down from a rate of 15%. This rate cut was made retroactive to the beginning of 2001.

Other tax rates, except for the 15% bracket, would gradually be lowered by three percentage points in three stages. The first cut took effect July 1, 2001, the second in 2004, and the third in 2006. This means that in 2006, when the changes are fully implemented, the 39.6% rate will drop to 35%, the 36% rate will drop to 33%, the 31% rate will drop to 28%, and the 28% rate will drop to 25%.

### Marriage penalty relief

The good news is that the marriage penalty issues were addressed. The not-so-good news is that the impact will not be felt until 2005, when the provisions begin to phase in. And it will take five years of phasing in before the full relief will be fully realized. The relief comes in two forms. First, the standard deduction for married couples will be twice that of single taxpayers. Second, the 15% bracket will be enlarged for couples so that more income gets taxed at the 15% rate instead of the next higher tax bracket.

### Dependent care credit

The dependent care credit will be expanded effective in 2002. The amount of expenses eligible for the credit will be increased to \$3,000, up from \$2,400, for one qualifying dependent, and to \$6,000 for two or more qualifying dependents, up from \$4,800. The maximum credit will also be increased from 30% to 35% of qualifying expenses.

### Child tax credit

The child tax credit, which is now worth \$500 per qualifying child, will eventually double to \$1,000. The credit increased to \$600 in 2001, and will gradually rise to \$1,000 by 2010.

### Retirement savings

There were a number of changes to retirement plan contributions. Those changes include:

**Higher contribution limits for 401(k), 403(b), and 457 plans:** The maximum contribution in 2002 will amount to \$11,000. Then, that amount will rise until it reaches \$15,000 in 2006. After that, the annual limit may rise with inflation, but only in increments of \$500 per year.

**"Catch-up" contributions for older workers:** If you're age 50 or older, you will generally be able to set aside even more in a 401(k), 403(b), or 457 plan. In 2002 you will be able to contribute an extra \$1,000. And that extra amount will be phased in to \$5,000 per year in years 2006 and later.

**Higher contribution limits for SIMPLE IRA plans:** Effective in 2002, the maximum contribution to a SIMPLE IRA plan will increase to \$7,000 annually. And the maximum will continue to increase until it reaches a maximum of \$10,000 in 2005. Workers age 50 or older will also be able to make additional catch-up contributions to their SIMPLE IRA plans -- \$500 in 2002 going up to an additional contribution of \$2,500 in 2006 and later.

**Higher IRA limits:** You know that the maximum contribution to a traditional or Roth IRA was \$2,000, but did you know that this maximum contribution amount has not been increased in 20 years? Well, it finally has. In 2002 the maximum contribution is increased to \$3,000, and that amount will gradually increase to \$5,000 in 2008. And “*catch-up*” provisions are also alive and well for older employees when it comes to IRA contributions. For workers 50 or older, an extra contribution of \$500 is available in 2002, 2003, 2004, and 2005. In 2006 an extra \$1,000 “*catch-up*” contribution will be allowed for older workers.

**Retirement savings credits:** If your income is low enough, and you are willing to put some money into a retirement savings plan at work or into an IRA, Uncle Sam will give you back some money in the form of a tax credit as an incentive to help you save. It is a bit complicated, and takes effect in 2002. But basically, if your adjusted gross income is \$50,000 or less, \$25,000 or less if you are single, you will qualify for the credit. The lower your income, the higher your credit.

## Education tax breaks

There were also a number of education tax breaks, including:

**Prepaid tuition plans:** These plans will now be even more valuable. State-sponsored prepaid tuition plans become completely tax-free in 2002. The same tax-free provisions will be extended to prepaid tuition plans for private colleges and universities beginning in 2004.

**Employer-provided educational assistance:** The law allows for a \$5,250 tax break for graduate studies beginning in 2002. Currently only undergraduate courses qualify for this tax-free benefit.

**Student loan deduction:** This deduction has also become more valuable and also more available to taxpayers. First, the 60-month loan limit will be eliminated effective in 2002. The income eligibility limits will also be raised.

**College tax deductions:** This is a new deduction for college expenses that could be claimed in lieu of the Hope Credit or Lifetime Learning Credit. Because of the higher income limits on this deduction, it will be more helpful for higher-income taxpayers who can not make use of the Lifetime or Hope credits. In 2002, single taxpayers with adjusted gross incomes up to \$65,000, and

\$130,000 for joint filers, will be entitled to a maximum deduction of \$3,000 per year. And these deductions will rise in future years, but will lapse after 2005.

## Estate tax repeal

The New 2001 Tax Act will abolish the estate tax in 2010. In the meantime, the estate tax exemption in 2001 was \$675,000, but will gradually increase to \$3.5 million in 2009. Additionally, the top estate tax rate will drop from 55% to 50%, and will gradually decline to 45%.

## Legislative magic

Here's a kicker: Virtually all of the tax cuts in this legislation are scheduled to expire after 2010. And some provisions will expire much sooner than 2010. For example, provisions increasing the exemption from the alternative minimum tax for certain tax credits will extend only until 2004. And who knows what might happen to the tax law between now and 2010. So many of these provisions may never take full effect; and they may be revised or eliminated before they are fully phased in.

## Quirks in the 2001 Tax Act

### Phase in... and in... and in...

We are all accustomed to seeing new tax laws that take a while to implement. We are also accustomed to seeing changes taking place, or being phased in, over a few years. But the new law imposes phase-in times that stretch over quite a few years --10 years in some cases. This is unprecedented.

So we now have a tax law that will have different effects on different people over longer periods of time. You might just think that you can put your finances on autopilot and bask in the glow of the phase-in period. But it will not be that easy. You will have to be proactive in your planning in order to take maximum advantage of this extraordinary phase-in period.

### Now you see it, now you don't

In order to make the bill fit within certain budget constraints, many of the tax provisions will have a “*sunset provision*” in 2011 unless Congress, either the current Congress or some future Congress, takes action to

make the legislation permanent. So it is very possible that virtually all of the tax benefits will disappear in 2011. The Congress in place in 2010 could institute one of the largest tax increases in the history of the United States simply by doing nothing. This assumes, obviously, that nothing has been done by any prior Congress to make the new tax cuts permanent. So enjoy the cuts while you can. They may not be around after the year 2010.

## **AMT: A Miserable Tax**

While the New 2001 Tax Act made some minor modifications to the dreaded Alternative Minimum Tax (AMT), some AMT increases are on the horizon. Beginning in 2004, many tax credits that we all use to reduce our taxes will not be allowed for AMT purposes. So it is possible that, unless this issue is addressed by Congress, many taxpayers will actually have a tax increase buried in the tax bill. While you might not know beans about the AMT, *if* AMT relief is no longer applied to many of our most popular credits, such as the child tax credit, the dependent care credit, or education credits, you might receive a very nasty surprise!

## **The estate tax loop**

The estate tax will be repealed completely in 2010. However, this repeal will last for only one year. As previously discussed, the estate tax repeal provisions will have a "sunset provision" in 2011, which will put the estate tax back into place as it existed before. So while the estate tax "exemption" will rise to \$3.5 million in 2009, and estate taxes will be repealed completely in 2010, it is quite possible that in 2011 that the estate tax "exemption" will fall back to the \$675,000 level as it was in 2001 when the law is automatically repealed. So you can rest assured that the matter of estate taxes will be revisited by some future Congress as it has been in the past. The estate tax has been repealed and brought back four times in the last 100 years. But who knows what the political landscape will look like when Congress does decide to revisit this hot-button issue?

Sound complicated? Well, you haven't seen anything yet! Once estate taxes are fully repealed in 2010, a modified carryover basis rule immediately goes into effect. At that time, death becomes an income tax problem as opposed to an estate tax problem. The basis of assets received from a decedent will carry over from the decedent, rather than be stepped up to fair market value at the date-of-death as is now the law. There are some exceptions and

legislative additions to basis of certain property. But the rules are really extremely complicated. Again, it's not something that you will have to worry about immediately. But just understand that, unless some future Congress makes some changes, beneficiaries of people that die in 2010 will have completely separate rules regarding carryover basis than the rest of us.

## **More Information**

We have only touched on the highlights. There are other provisions that we have not even discussed. It is still not clear how many of the provisions will be handled administratively. It is also not clear how many of the laws and rules will interact with laws and rules currently on the books. But it will certainly be interesting. If we have not done so, it is time to sit down and do some Tax Planning prior to the end of the year. Give me a call and we will schedule an appointment. We are here to help.

## **On September 11<sup>th</sup>**

September 11, 2002, is soon approaching. On that day, please wear red, white and blue to show your support for those who lost their lives on 9/11/2001, to honor the heroes who worked to save them, and for the families left behind. At noon your time on September 11, 2002, no matter where you are or what you are doing, stop, put your hand on your heart, say the Pledge of Allegiance, and say a prayer for our nation.

If all of us would do this together in every time zone around the world, we will have a powerful chain of prayer surrounding us. Please keep this message going to your friends and family. By September 11, 2002, hopefully enough people will do this and we will all join together in unity.

## **God Bless the USA!**

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