

November 2002

To our clients:

The following is a summary of important federal and Massachusetts tax developments that have occurred in the past year that may affect you, your family, your investment, and your livelihood. Please call me for more information about any of these developments and what steps you should take to benefit from favorable developments and to minimize the impact of those that are unfavorable. This information is intended to be informative but not to constitute advice as to a particular course of action,

Social Security Wage Base. The wage base increases to \$87,000 in 2003 from its present level of \$84,900. The maximum social security tax for each employee is 6.2% of \$87,000 or \$5,394.

New IRA Limits. For 2002 through 2004, the maximum deduction to an IRA is increased to \$3,000. In 2005 it will increase to \$4,000. Individuals age 50 and over in 2002 can contribute \$500 in addition to the above amounts.

New retirement plan contributions rules take effect. Effective for plan years commencing in 2002, you may now contribute up to **\$40,000** per year to a profit sharing and/or pension plan based upon a maximum compensation of \$200,000 (note that partners and sole proprietors must first determine a *W-2 equivalent* compensation). In addition, the limit on profit-sharing plans has been increased from 15% to 25% of compensation, making a pension plan now *unnecessary* to reach the maximum \$40,000. Importantly, 401(k) contributions of up to **\$11,000** are permitted. The limit on a 401(k) is **100% of compensation** up to the \$11,000. For example, if you have \$30,000 of salary, you could contribute as much as \$11,000 to a 401(k) plus 25% of the salary or \$7,500. The total of \$18,500 is nearly 62% of salary! If you have your Keogh profit-sharing plan or other plan at a brokerage (e.g., Fidelity) you may want to consider adopting a 401(k) feature before the end of the year. If your plans in maintained by a benefits firm and they have not contacted you, you should contact them. **In all cases, you should be certain to have the availability of the new limits checked by a qualified professional before attempting to implement them.**

IRS explains how to claim or elect-out of bonus first-year depreciation. For most equipment and furniture as well as certain leasehold improvements acquired between September 11 2001 and September 11 2004, **you are entitled to an additional 30% first year "bonus" depreciation**, after any section 179 deduction is claimed. You are then entitled to the regular depreciation deduction on the remaining basis of the property. *This is highly advantageous, particularly for qualifying leasehold improvements, which are generally depreciable over 39 years.*

The new IRS guidance makes it clear that the additional first-year depreciation deduction automatically applies to qualifying assets, unless the taxpayer elects not to use it. An election *not* to use the bonus depreciation allowance may be a good idea if a business has about-to-expire net operating losses, or anticipates being in a higher tax bracket in future years. The IRS also reiterated that the additional first-year depreciation allowance applies for both regular tax and alternative minimum tax (AMT) purposes, and generally is determined without any pro-ration based on the length of the tax year in which the qualifying property is placed in service.

Taxpayers given more time to get quick refunds from new 5-year NOL carryback. Before the Job Creation and Worker Assistance Act of 2002 (JCWAA) was enacted, an NOL (net operating loss) generally could be carried back two years and carried forward 20 years. The JCWAA increased the two year carryback period to five years for NOLs arising in tax years ending in 2001 or 2002. It also allowed a taxpayer to irrevocably elect to forgo the five-year carryback period and instead carry the NOL back 2 years and forward 20 years. The IRS announced that it is giving some taxpayers more time to elect the new 5-year net operating loss (NOL) carryback, claim a quick refund as a result of it, and make and undo NOL elections that otherwise would have been barred. The extended deadline for taking action is October 31, 2002.

Final regs liberalize required minimum distribution (RMD) rules. You must begin withdrawing minimum annual distributions from your qualified retirement plan accounts and traditional IRAs no later than April 1 following the year you attain age 70 1/2. If you are not a 5% company owner and continue working, the start date for mandatory distributions from your employer sponsored qualified retirement plan account is deferred until April 1 following the year you retire. In 2001, the IRS issued proposed regulations overhauling and simplifying the rules for determining these minimum annual amounts, which are called required minimum distributions, or RMDs. Now, the IRS has issued final regulations liberalizing the RMD rules even further. The most important changes are as follows:

The life expectancy tables used to determine RMDs have been revised to reflect current mortality experience. The net result is that RMDs may be spread over a longer period than under the 2001 proposed regulations.

Liberalized rules apply where the owner of a qualified plan account or IRA dies on or after the date when distributions must begin. Post-death RMDs are distributed over the longer of the IRA owner's remaining life expectancy or the remaining life expectancy of the eldest designated beneficiary. This helps where the IRA owner was younger than the eldest designated beneficiary. By contrast, the rules issued in 2001 required post-death RMDs to be distributed over the beneficiary's life expectancy even if the IRA owner was younger than the beneficiary.

A designated beneficiary of a qualified plan account or IRA is someone who was (a) named as a beneficiary as of the account owner's date of death, and (b) remains a beneficiary on Sept. 30 of the year following the year of the account owner's death. Under the 2001 rules, the designated beneficiary was determined as of the end of the year following the year of the IRA owner's death. This change means that there's slightly less time to do post-mortem tax planning to aid beneficiaries of the qualified plan account or IRA.

Divorce transfers of nonstatutory stock options and nonqualified deferred compensation not taxed until exercised or payout. The IRS has concluded that a person who transfers nonstatutory stock options and nonqualified deferred compensation to his former spouse in a divorce isn't taxed on the transfer. Rather, the former spouse is taxed on exercise of the options, and on the deferred compensation when it is paid or made available to the former spouse. A stock option is "nonstatutory" if it is not specifically provide for in the tax code or doesn't meet numerous qualification requirements. A deferred compensation plan is "non-qualified" if it doesn't meet the detailed rules in the tax code for qualified retirement plans. At the same time, the IRS issued proposed rules on the FICA, FUTA and income tax withholding consequences of the transfers. In general, the employee spouse would be hit with the FICA/FUTA burden, but income tax withholding on the exercise of nonqualified stock options would apply to the former spouse.

IRS explains how to claim deduction for part of the cost of a hybrid auto. A taxpayer may claim an above-the-line deduction for the cost of a qualified clean-fuel (e.g. electricity or natural gas) vehicle. The deduction is taken for the year in which the taxpayer places the vehicle in service (for personal or business use). Through 2003, the deduction is as much as \$2,000 for qualifying autos (higher dollar amounts apply to buses, and trucks and vans with a gross vehicle weight rating greater then 10,000 pounds). For hybrid vehicles (those propelled by clean-burning fuel and other fuel), only the incremental cost of allowing clean-burning fuel to be used qualifies for the deduction. The IRS recently explained that buyers may rely on a manufacturer's certification of this incremental cost for autos propelled by both a gasoline internal combustion engine and an electric motor that is recharged as the vehicle operates. Once certification is established, the IRS says that the deduction would apply not only to tax returns for tax year 2002, but also for the previous two years for which such hybrid autos were available. The IRS advises taxpayers to file an amended return in order to claim the deduction for a previous year.

Increased Massachusetts Taxes

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I. Provisions Affecting the Personal Income Tax

A. Tax Rates (Part A, Part B, and Part C Income)

Part A Income. Part A gross income consists of **interest** (except interest from Massachusetts banks), **dividends**, **gains from the sale or exchange of capital assets held for one year or less [short-term capital gains]**, long-term gains from collectibles, and pre-1996 gains reported on the installment method. *The tax rate on Part A taxable income consisting of short-term capital gains and long-term gains on collectibles is 12%. The tax rate on Part A taxable income consisting of interest and dividends is the rate provided for Part B taxable income (5.3% for 2002).*

Part B Income. *Part B gross income consists of all income, including wage income, that is*

*neither Part A nor Part C income. For tax years beginning on or after January 1, 2002, the tax rate on Part B taxable income remains at 5.3%. **The scheduled tax rate reduction to 5.0% in 2003 has been repealed.** Depending on economic conditions, the tax rate on Part B taxable income may decrease for future tax years.*

Part C Income; Tax rate for transactions completed *on or after May 1, 2002*. In place of the existing six categories of gain based on six defined holding periods and taxed at six different rates (ranging from 5% down to 0%), the Act defines Part C gross income as gains from the sale or exchange of capital assets (except collectibles) held for more than one year. *Effective for tax years beginning on or after January 1, 2002, the Act changes the multiple tax rates for Part C taxable income to the single rate provided for Part B taxable income (5.3% for 2002), but only for transactions completed on or after May 1, 2000.*

Part C Income; *Tax rates for transactions completed before May 1, 2002*. The Act provides that, to the maximum extent possible, all transactions that are completed prior to May 1, 2002, *shall be aggregated and taxed under the procedures and rates in place prior to the changes in law set forth in the Act, and that all transactions completed on or after May 1, 2002 shall be aggregated and taxed under the procedures and rates established by such changes in law.*

C. Personal Exemption Amounts

The personal exemption amounts are *reduced*, effective January 1, 2002, as follows: for a single person or a married person filing a separate return, from \$4,400 to \$3,300; for a head of household, from \$6,800 to \$5,100; for a husband and wife filing a joint return, from \$8,800 to \$6,600. Depending on economic conditions, these exemption amounts may increase for future tax years.

D. Conformity with Federal Law for Workplace Retirement Plans

Recently, the U.S. Congress made numerous changes to the Internal Revenue Code (“Code”) provisions relating to qualified plans and other tax-favored retirement plans. For tax years beginning after December 31, 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) increases the federal income tax contribution limits for elective deferrals, provides catch-up contributions for those age 50 or older, increases portability between plans and accounts by expanding the rollover provisions, and makes several other changes related to retirement plans and accounts. Before the Act, the reference to the 1998 Code prevented the adoption by Massachusetts of many of the EGTRRA provisions pertaining to retirement plans.

Effective Date for Retirement Plan Conformity. Under the Act, *Massachusetts retains the reference to the 1998 Code for most income tax provisions*, but adopts the current Code for the treatment of qualified plans and certain other tax-favored retirement plans. *Effective for tax years beginning on or after January 1, 2002, the Act conforms the Massachusetts personal income tax to the following sections of the Code as amended and in effect for the taxable year (“current Code”):*

Exclusions from Gross Income. As a result of the Act, all amounts of retirement plan contributions and distributions that are excluded from federal gross income under the sections of

the current Code enumerated in the Act are excluded from Massachusetts gross income. In the case of contributions to and distributions from qualified plans, §401(k) plans, §403(b) plans, §457 plans, SEPs (simplified employee pensions), and SIMPLE IRAs (savings incentive match plans for employees), the amount excluded from Massachusetts gross income is the amount excluded from federal gross income by the current Code. *Thus, for these plans, Massachusetts conforms to federal law in the treatment of elective deferrals, catch-up contributions, and qualified rollovers of plan proceeds.*

Maximum Exclusion Amounts for Elective Deferrals. For tax year 2002 and subsequent tax years, Massachusetts follows federal law in determining the amount of the maximum exclusion for elective deferrals for the following plans and accounts.

For contributions to a SIMPLE IRA governed by IRC §408(p), the maximum exclusion from federal gross income in tax year 2002 is \$7,000, with an additional exclusion of \$500 allowed for age 50 catch-up contributions. The maximum applicable dollar amount of excludable salary deferrals will increase in subsequent tax years. Also, the additional exclusion allowed for age 50 catch-up contributions will increase in subsequent tax years.

For contributions to a §401(k), §403(b), §408(k) SEP or §457 plan, the maximum exclusion from federal gross income in tax year 2002 is \$11,000 (or other applicable amount determined by federal law), with an additional exclusion of \$1,000 allowed for age 50 catch-up contributions. The maximum applicable dollar amount of excludable salary deferrals will increase in subsequent tax years. Also, the additional exclusion allowed for age 50 catch-up contributions will increase in subsequent tax years.

Employer's Deduction. The Act adopts the current Code at § 404 where employers taxed under chapter 62 are allowed a deduction for employer contributions to qualified plans and other retirement plans. In calculating adjusted gross income, Massachusetts generally allows the deductions available under §404. However, under subparagraph (D) of that section, *the §404 deduction for contributions on behalf of Code §401(c)(1) employees (sole proprietors and partners) is specifically disallowed.*

E. Qualified Tuition Programs--Code §529

The Act adds Code §529 plans to the list of Code sections for which Massachusetts follows the current Code. *As of January 1, 2002, Massachusetts is aligned with federal treatment of qualified tuition programs, including the substantial changes made to such plans under EGTRRA.* EGTRRA amended Code § 529 to exclude earnings distributed from Qualified Tuition Programs ("QTPs") after 2001 from the beneficiary's federal gross income to the extent the distribution is used to pay for qualified higher education expenses. EGTRRA also eased rollover rules, expanded the definition of qualified distributions, and authorized educational institutions to establish and maintain QTPs.

F. Charitable Contributions

The Act disallows a deduction for charitable contributions for taxable years beginning on or after January 1, 2002. A deduction for charitable contributions may become available in future

tax years if the rate of tax on Part B income decreases to 5 percent.

Carryover. Under prior law, the charitable contributions deduction was effective for contributions paid on or after January 1, 2001. For taxable year 2001, certain taxpayers had excess charitable contribution amounts that could not be deducted in 2001, resulting in carryover amounts for 2002. Under the Act, *these amounts cannot be deducted in 2002.* However, the taxpayer is permitted to carry over, for up to five succeeding taxable years, charitable contribution deduction amounts that exceeded the amount allowable by Massachusetts in 2001. *Taxpayers will not be able to deduct these carryover amounts unless the charitable contributions deduction is restored by 2006.*

G. Withholding and Estimated Tax Issues

It is possible that estimated payments made during the first two quarters of 2002 may be insufficient, either because the taxpayer 1) sold assets after May 1, 2002 but before the legislation imposing higher rates on capital gains had been enacted; or 2) relied on a deduction for charitable contributions made during the first half of the year, before the Act repealed the charitable contribution deduction for 2002. Taxpayers with underpayments of estimated tax as a result of the amendments made to chapter 62 may avoid any addition to tax for the portion of the underpayment attributable to the changes made by the Act if the estimated tax payment due on September 15, 2002 is increased by the amount of the underpayment from the previous two quarters. Such taxpayers should file form M-2210 with their income tax return, and check the box labeled "Adjustment for 2002 Act Enhancing State Revenues." In calculating their underpayment penalty, taxpayers may subtract from the underpayment amounts in the first two quarterly installments the amounts attributable to changes made by the Act and paid by September 15, 2002.