

The Sgroi Financial

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Planning for Today and Tomorrow

THE NEW IRAs AND MORE

In August of this year The Tax Payer Relief Act of 1997 became law. It contains some of the most meaningful changes to the rules governing IRAs since they were first introduced in 1974. They were made tax deductible in 1981. Limits on tax deductibility were instituted in 1986. This issue will attempt to summarize these changes and other related information in an understandable form.

IRA stands for individual retirement account. As the name states it is an account owned by a person, as opposed to a business or organized group, which is invested for that persons retirement needs. The investments must be of an approved type such as mutual funds, CDs and annuities but not rental properties, personal businesses, antique automobiles or such. The assets must be held by an approved institution, called a trustee, such as a mutual fund company, insurance company or bank which does the required accounting, oversight and reporting.

All retirement/pension plans, be they IRA, 401(k), 403(b), profit sharing or others are governed by volumes of tax law. These laws lay out the requirements each type must meet in order to be judged a "qualified" pension plan. These plans generally have two advantages and they are huge: monies going into the accounts are tax deductible and they grow tax deferred.

As an example, if a person were in the 33% state and federal combined tax rate and that person was contributing \$50.00 per week, the net cost to him or her would only be \$33.50 per week! The person is saving \$50.00 but because it hasn't been taxed the difference in their paycheck is only \$33.50. In other words, the money is invested "pre-tax". If the person were to make their contributions with money that had already been taxed or will be taxed, then the contributed amount is deducted from their income on their tax return and the tax is basically returned to them or not owed. Their contributions are called "tax deductible". Either way the person is not paying income tax on their contributions and that essentially translates into an immediate return on their investment of 33% or whatever their income tax rate is. (Please note that you still have to pay Social Security and Medicare taxes, FICA on these contributions. FICA stands for Federal Insurance Contribution Act. We didn't know

they were contributions either).

There are numerous types of IRAs and the most recent legislation created two more. The original IRA allows a person to donate \$2,000 per year to his or her account. If that person is not covered by another qualified retirement plan or if he or she meets certain income limits, those contributions are tax deductible just as stated in the preceding paragraphs.

A **Spousal IRA** is an IRA set up for a non-working spouse and is the subject of some significant rules changes. It used to be that a non-working spouse whose partner was covered under an employer sponsored pension plan could not make a fully deductible contribution to an IRA unless their combined income was under \$40,000. Then the most that could be contributed was \$2,250 for both people. Once the combined income reached \$50,000 none of the contributions were deductible. The new law allows contributions of \$4,000 (\$2,000 max each) and the income limits will increase from the current \$40,000-\$50,000 to \$80,000-\$100,000 by the year 2007. Furthermore, starting in 1998, if only one spouse is covered under a retirement plan they will be able to make a fully deductible IRA contribution for the uncovered spouse so long as their combined income is under \$150,000. This all represents a nice change for those where say one spouse desires only part time employment (or not to work at all) but they want to shelter more income from taxes and increase retirement savings.

A **SEP IRA**, Simplified Employee Pension IRA, is a retirement plan for small businesses and partnerships with 25 or fewer employees. With a SEP an owner may contribute to his or her own account and directly into separate accounts of their employees. The maximum allowed contribution on behalf of each employee is the lesser of 15% of the employees compensation or \$22,500. The owner's limits for themselves are 13.0435% up to \$19,565 (go figure). Contributions by the owner are voluntary, not mandatory. But if contributions are made they must be made for all eligible employees. (Continued next page).

A personal letter from Joe

Dear Friend,

Hello! I hope that all is well with you, your family and loved ones. With today's society running at such a fast pace it's nice to step back and take a look at all we do and why we do it.

This has been an extremely productive year for my firm and the recent tax law changes have us all burning the midnight oil. If you have been by the office recently you've seen our new parking area. It looks great and I want to thank all the people at Amherst Paving for the fantastic job they've done.

This issue of our newsletter is devoted almost entirely to the subject of IRAs and the new tax law changes. The laws were passed and signed in August but they are very complicated. Well intended but complicated. In fact some have called this the "The Tax Complexity Act of 1997".

Many of the new rules are quite beneficial and we are very excited. The new "Roth" IRAs look like a huge winner, especially in 1998. With a Roth IRA you may contribute up to \$2,000 per year. Your contributions are not tax deductible but your investment will grow tax free and when it comes time to use the money it will not be taxed. Furthermore, you may convert your existing IRA to a Roth IRA without penalty in 1998. You will have to pay income tax on the amount you convert but if you do it in 1998 you may spread that income over four years. This could be a once in a lifetime opportunity and we will be advising many of you, maybe most of you to take advantage of it. As is the case with all the work we do for you, each file will have to be carefully studied on an individual basis. If you have not been in recently, please schedule in at your earliest convenience. My first quarter schedule for 1998 will fill up quickly.



SIMPLE IRAs are actually almost a year old but they are wonderful programs for small business people. So many small business owners have been discouraged from establishing retirement plans because of the complexity and expense of most other type of plans. The SIMPLE will solve those problems and provide a wonderful incentive and opportunity for both employer and employee. We are fully geared up to handle these and strongly encourage you to take advantage of them.

It is very rare that political statements are made in this newsletter but I feel one is appropriate now. I have more confidence in our current congress than any in my professional career. The recent changes in the tax law including the lowering of capital gains taxes, lower estate taxes, child tax credits and the added accessibility of IRAs are all positive changes. I would also like to applaud the current effort to reform the IRS. It's long overdue.

Finally, do not let the recent bumpiness in the stock market scare you out of this market. Stocks never go straight up. The long term economic indicators (low inflation, low interest rates, good corporate profits, the likelihood of a balanced budget which may lower interest rates even more) are extremely bullish. The percentage of your assets targeted for long term growth should always stay invested. Use any correction to add to your positions. Market timing has never proven to work. What has proven to work is staying the course and continuously adding to your positions.

We work very hard to stay up to date and then get that information to you. I feel we have the highest quality clientele (as well as the nicest ☺) and want you to be the best informed. Thanks for your support and the tons of referrals you continuously send into our firm.☺☺☺

P.S. *The \$9,500 TSA maximum has just been increased to \$10,000/year, beginning 1/1/98. Additionally, the \$12,500 "catch up" maximum for a limited number of you has been increased to \$13,000. If you are currently at \$9,500 or \$12,500 and wish to increase to these new limits, call right away. ☺☺☺*

IRAs CONTINUED

A SEP IRA is an especially good plan for a one person operation or a partnership where the partners are the only employees or a small firm with few employees. Once a firm starts employing more, we may recommend a different type of plan, the SIMPLE IRA.

SIMPLE IRA stands for Savings Incentive Match Plan for Employees. These plans are especially good for the small, family business (100 or less employees). Each employee may contribute up to 100 % of their first \$6,000 of income. If the spouse or other family members work in the firm, this can be especially effective. 401(k) limits are usually 15% or less of compensation with complicated and extensive rules. SIMPLE IRAs have almost none of the administrative cost of a 401(k). Key points are that all contributions from the employee must be made on a salary reduction basis and cannot exceed \$6,000 annually. There is also an employer matching feature.

A matching contribution is money put into the employees account by the employer. Most qualified pension plans involve some type of matching and there are formulas for each. With SIMPLE IRA plans there are two basic methods. The one we like the most has the employer matching a maximum of 3 percent of the employees compensation provided the employee is also contributing at least that amount. For example, if an employee earned \$500 per week and contributed \$15 of that to the plan, the employer's required matching contribution would also be \$15 ($\$500 \times 3\% = \15). Should the employee decide to contribute more, and they should, the employer's contribution would remain at the legal maximum of 3%. If the employee made a smaller contribution, say 1%, then the employers *matching* contribution is only 1%. If the employee makes no contribution then the employer's matching requirement is eliminated.

The second basic formula has the employer contributing 2 percent of compensation to the account of all eligible employees regardless of whether the employee contributes or not. There are other variations that may be applicable in very isolated instances and we'll be happy to explain them on an individual basis. However, the above two formulas will cover the vast majority of plans.

The enclosed chart illustrates the growth of capital over time at various rates. It is included to help encourage people to save. If you are a business owner and would like help setting up a SIMPLE or SEP IRA, please call. We will guide you through the whole process and answer your employees' questions too. If you are an employee and think your company's plan could be improved, our services are available. These are wonderful plans that could make the difference between a financial struggle or a comfortable retirement.

As stated earlier, there are two new types of IRAs: the "Roth" IRA and the Education IRA. The **Roth IRA** is so named because Senator William Roth of Delaware was its major proponent. With a Roth IRA an individual may contribute up to \$2,000 per year. The contribution is not tax deductible. However, and this is the big news, distributions are taken tax-free. This means that all the interest, dividends and growth achieved by your investments does so tax-free. It's yours.

Roth IRAs will be available in 1998. Eligibility is phased out for singles with adjusted gross incomes of \$95,000 to \$110,000 and for married couples with adjusted gross incomes of \$150,000 to \$160,000. (Check with your accountant on adjusted gross income.) Qualified distributions can be made for such items as a relative's education at a qualified institution, the down payment of up to \$10,000 for a first time home buyer, in the case of disability or to the named beneficiary in case of death. Other distributions may begin after age 59 1/2 and after a five-year waiting period from the year the first contribution is made. Contributions may be made as long as one has an earned income and there are no required minimum distributions at age 70 1/2.

There are provisions in the new law to convert your regular IRA into a Roth IRA. This may be advisable for many of us. Ones Adjusted Gross Income must be \$100,000 or less whether you file joint or single. Any deductible contributions and all income and growth in the IRA will be taxed as income. But if done in 1998, the income can be spread over four years for tax purposes.

For example, if you had \$10,000 in an IRA and your tax rate was 28%, the taxes on the conversion would amount to \$2,800. Spread over a four-year period this amounts to \$700 per year. However the entire account then grows tax-free. Combined with a reduced capital gains tax rate, dependant child income tax credits (see next page for details on each) and proper financial planning, the conversion provision offers a unique opportunity in 1998.

Another new type of IRA, the **Education IRA**, will also be available in 1998. Established for educational purposes only, annual contributions are limited to \$500 per beneficiary under age 18 and phased out for those with higher income levels. But these contributions can be made above and beyond contributions to either a regular or Roth IRA. Earnings will accumulate tax-free and withdrawals can be used for tuition, books and/or room and board at qualified educational institutions. Provided the income limits are met, grandparents or others may establish Education IRAs for the benefit of children under 18. It must be used by the time the person is 30. If the money is not used for that child's education it may be rolled into the account of another family member. Distributions not made for education are subject to a 10% penalty plus income tax. Furthermore, there are new tax credits for educational costs that operate in conjunction with the Education IRA.

IRAs are a great idea. That's one reason they are so popular. Expanding their scope is a trend we feel is sure to continue. The new laws are complex and this article covers only the very basics. But our research is ongoing and we will keep you as up to date as possible. We look forward to discussing, in detail, all of your IRA opportunities and how they fit into your overall financial plan. We'll cover the above personally when you come in for your next annual review. ☺☺☺☺☺

TAX CHANGES

Estate Tax Changes. The lifetime estate and gift tax exclusion, or unified credit (the amount your estate may pass to your heirs without paying federal tax), has been pegged at \$600,000 for a single individual and \$1,200,000 for a married couple for years. (See the Spring 1997 issue of the Sgroi Financial). Those numbers are increasing over the next ten years so that by the year 2006 it will have been increased to \$1,000,000 for a single and \$2,000,000 for married couples. The chart below shows the numbers and as you can see the majority of the increases do not take place until the last 3 years. In most cases the married couple amount is not available unless very careful estate planning is put to use.

Child Tax Credits. A tax credit represents a reduction in the

Year	Single Exclusion	Married Couples
1997	\$600,000	\$1,200,000
1998	\$625,000	\$1,250,000
1999	\$650,000	\$1,300,000
2000	\$675,000	\$1,350,000
2001	\$675,000	\$1,350,000
2002	\$700,000	\$1,400,000
2003	\$700,000	\$1,400,000
2004	\$850,000	\$1,700,000
2005	\$950,000	\$1,900,000
2006	\$1,000,000	\$2,000,000

amount of income tax owed by an individual or organized entity. They are awarded for specifically defined reasons. A tax credit is different from a tax deduction. A deduction is an expenditure of funds for a defined purpose that results in the reduction of ones taxable income. Examples of such would be mortgage interest or charitable gifts. With a tax credit one is getting a dollar for dollar *reduction in ones tax bill*. The easiest example would be if you overpaid your income tax and had that amount credited toward your next years tax bill. This is essentially how your payroll withholding taxes function. There are even a few selected investments that are designed specifically to generate tax credits. Should you be interested we can certainly assist you.

The Child Tax Credit is a federal income tax credit for taxpayers with children under 17 years old. In 1998 the credit is equal to \$400 per child. This amount increases to \$500 in 1999. It phases out for single filers with incomes over \$75,000 and for those filing jointly at \$110,000.

Capital Gains Taxes. The term "capital gain" can be defined as such: when an investment increases in value, the amount of that increase is the capital gain. If the investor holds the investment, the gain has not been realized. Should the investor sell it, at the increased value, at a profit if you will, then the gain has been realized and in our country it gets taxed. It's referred to as a "taxable event".

There are a lot of complicated regulations in the new

law and we've done our best to make sense of it, but realize up to 12 different rules may apply if a capital gain is realized.

☺ With investments held for 1 year or less, *short-term gains*, and sold at a profit, the gains are taxed as ordinary income.

☺ With investments held from 12 to 18 months the top rate will be 28%. These are now called *mid-term gains*.

☺ For investments held longer than 18 months the new top rate of taxation will be 20%. If your federal income tax rate is 15% then the top capital gains rate drops to 10%.

☺ There are a lot of rules concerning specific dates of sale during 1997. We'll give them to you if needed or check with your accountant. But if you haven't sold anything at a gain during this year, spare yourself.

☺ On depreciated real estate the top rate will be 25% to the extent depreciation has been taken.

☺ Starting in 2001, the top rate will drop from 20% to 18% for property acquired that year or later. There are other rules connected with this on investments acquired prior to that, so once again consult your tax adviser.

☺ Also starting in 2001, taxpayers in the 15% bracket will see their top gains rate drop from 10% to 8% .

☺ Capital gains from the sale of a principal residence, owned for only 2 years or more, may be excluded up to \$250,000 for a single filer and \$500,000 for those filing joint. This is a huge improvement as there is no age restriction and you may exercise this option on more than one occasion.

☺ Gains from the sale of stock of certain small businesses will not be taxed if they have been held for six months or more and are reinvested in another small business.

While we have tried to cover the high points of the new legislation, please be aware that there is much more. Please contact your accountant for specific tax advice.

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EXTRA, EXTRA, STOP THE PRESSES!!!

THIS LATE BREAKING DEVELOPMENT JUST CAME IN: THE MAXIMUM ANNUAL LIMIT ON TSA AND 401 (K) CONTRIBUTIONS HAS BEEN **INCREASED TO \$10,000** (FROM \$9,500) BEGINNING 1/1/98

☺☺☺☺☺☺

H. Joseph Sgroi and Associates Financial Growth Sheet

Why it's important to pay yourself first

33% Assumed Tax Bracket

Weekly Contribution of \$25.00

Employee Contribution:	\$25.00	\$1,300.00	Weekly Net Cost:	\$16.75
Total Contribution:	\$25.00	\$1,300.00	Annual Net Cost:	\$871.00

Year	6%	8%	10%	12%	14%
1	\$1,378.00	\$1,404.00	\$1,430.00	\$1,456.00	\$1,482.00
5	\$7,767.91	\$8,236.71	\$8,730.29	\$9,249.75	\$9,796.17
10	\$18,163.14	\$20,339.13	\$22,790.52	\$25,550.96	\$28,657.87
15	\$32,074.29	\$38,121.57	\$45,434.65	\$54,279.26	\$64,974.46
20	\$50,690.54	\$64,249.80	\$81,903.25	\$104,908.36	\$134,898.94
25	\$75,603.30	\$102,640.74	\$140,636.29	\$194,134.11	\$269,532.57

Weekly Contribution of \$50.00

Employee Contribution:	\$50.00	\$2,600.00	Weekly Net Cost:	\$33.50
Total Contribution:	\$50.00	\$2,600.00	Annual Net Cost:	\$1,742.00

Year	6%	8%	10%	12%	14%
1	\$2,756.00	\$2,808.00	\$2,860.00	\$2,912.00	\$2,964.00
5	\$15,535.83	\$16,473.42	\$17,460.59	\$18,499.49	\$19,592.35
10	\$36,326.27	\$40,678.27	\$45,581.03	\$51,101.92	\$57,315.74
15	\$64,148.57	\$76,243.14	\$90,869.30	\$108,558.53	\$129,948.92
20	\$101,381.09	\$128,499.60	\$163,806.50	\$209,816.71	\$269,797.89
25	\$151,206.60	\$205,281.48	\$281,272.59	\$388,268.23	\$539,065.13

Weekly Contribution of \$115.39

Employee Contribution:	\$115.39	\$6,000.28	Weekly Net Cost:	\$77.31
Total Contribution:	\$115.39	\$6,000.28	Annual Net Cost:	\$4,020.19

Year	6%	8%	10%	12%	14%
1	\$6,360.30	\$6,480.30	\$6,600.31	\$6,720.31	\$6,840.32
5	\$35,853.58	\$38,017.35	\$40,295.54	\$42,693.13	\$45,215.22
10	\$83,833.77	\$93,877.31	\$105,191.91	\$117,933.00	\$132,273.27
15	\$148,042.08	\$175,953.91	\$209,708.17	\$250,531.37	\$299,896.11
20	\$233,967.28	\$296,551.37	\$378,032.64	\$484,215.01	\$622,639.56
25	\$348,954.58	\$473,748.60	\$649,120.88	\$896,045.42	\$1,244,054.51

Weekly Contribution of \$182.69

Employee Contribution:	\$182.69	\$9,499.88	Weekly Net Cost:	\$122.40
Total Contribution:	\$182.69	\$9,499.88	Annual Net Cost:	\$6,364.92

Year	6%	8%	10%	12%	14%
1	\$10,069.87	\$10,259.87	\$10,449.87	\$10,639.87	\$10,829.86
5	\$56,764.81	\$60,190.57	\$63,797.49	\$67,593.44	\$71,586.52
10	\$132,728.93	\$148,630.25	\$166,543.98	\$186,716.18	\$209,420.26
15	\$234,386.06	\$278,577.17	\$332,018.24	\$396,651.15	\$474,807.35
20	\$370,426.22	\$469,511.82	\$598,516.18	\$766,628.30	\$985,787.51
25	\$552,478.66	\$750,057.47	\$1,027,713.79	\$1,418,654.46	\$1,969,636.18

This illustration employs assumed rates of return, it is hypothetical and does not represent the return of any particular investment.

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