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Collin W. Fritz and Associates, Inc.,
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IRAs, and Federal Estate Taxes

EGTRRA contains some important estate tax law changes. The purpose of this article is to summarize these changes and also to explain how and why IRAs need to be considered for estate tax purposes, even after EGTRRA.

There has been a federal estate tax since 1916. Since 1976, there has been a unified set of laws for transfers while alive or after death. A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The general rule is that all of a person's property must be included in an estate for federal estate tax purposes after that person's death. A person's taxable estate is defined as the value of the gross estate less certain permitted deductions. As with income taxes, there are marginal tax rates applied to the taxable estate.

An IRA's fair market value is fully included in a decedent's estate for federal estate tax purposes, and there is no reduction to reflect the fact that there will be a substantial depletion of the IRA because ultimately the deferred income taxes will need to be paid.

For example, a person, age 64, with a $1,000,000 IRA would pay approximately $396,000 in federal income taxes if he or she were to receive the IRA assets in one lump sum. Federal estate tax law imposes the federal estate tax on the $1,000,000 and not on $604,000 ($1,000,000 - $396,000) even though it is known that the income tax liability will need to be paid. One could certainly argue the fairness of this approach.

To arrive at the tax liability owing on an estate, the general formulas are:

gross estate - allowable deductions = taxable estate

taxable estate x tax rate = tentative amount owing

tentative amount owing - unified credit = tax liability

In 2001, the unified credit is $220,500; this equates to a taxable estate of $675,000. Consequently, if an individual dies with an estate of $675,000 or less, then no estate tax will be owing.

As with the federal income tax laws, there are ever-increasing estate tax rates (i.e. progressive). Immediately prior to EGTRRA, the effective estate tax rates ranged from 18% to 55%.

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IRAs and Estimated Tax Payment Rules

The estimated tax rules require that a taxpayer pay periodically a portion of his or her estimated tax liability at various points throughout the year. The due dates are: April 15, June 15, September 15, and January 15 of the next year.

The tax rules do not permit a taxpayer to wait until April 15th of the following year to pay their tax liability. These rules are summarized at the end of this article. If timely payments are not made, just as in other "late payment" situations, the law imposes a penalty for paying late plus requires that interest be paid with respect to these late payments.

In IRS Service Center Advice 20015062, the IRS confirmed that the estimated tax payment rules apply to distributions from a traditional IRA, even one which is converted to a Roth IRA.

The IRS had received a number of requests to waive the assessment of the underpayment penalty with respect to taxpayers who had failed to include the income which had to be recognized on account of a

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Set forth below are the estate tax rates which will apply for 2001-2009 and 2011. THERE IS NO FEDERAL ESTATE TAX FOR DECEDENTS DYING IN 2010. The upper rates will be reduced over time to a maximum rate of 45% for 2007-2009. The lower rates were not changed.

The 2001 (and 2011) estate tax rate brackets are:

Value of Estate From	To	Tax	Rate on Excess
$0	$10,000	$0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	10,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	238,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,880	49%
2,500,000	3,000,000	1,025,800	53%
3,000,000	10,000,000	1,290,800	55%
10,000,000	17,184,000	5,140,800	60%
17,184,000		9,451,200	55%

Listed below are the amounts which change from the above chart — they are in bold

The 2002 estate tax rate brackets are:

1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,880	49%
2,500,000	**no limit**	1,025,800	**50%**

The 2003 estate tax rate brackets are:

1,500,000	2,000,000	555,800	45%
2,000,000	**no limit**	780,880	49%

The 2004 estate tax rate brackets are:

1,500,000	2,000,000	555,800	45%
2,000,000	**no limit**	780,880	**48%**

The 2005 estate tax rate brackets are:

1,500,000	2,000,000	555,800	45%
2,000,000	**no limit**	780,880	**47%**

The 2006 estate tax rate brackets are:

1,500,000	2,000,000	555,800	45%
2,000,000	**no limit**	780,880	**46%**

The 2007 - 2009 estate tax rate brackets are:

1,500,000	**no limit**	555,800	45%

The 55% rate applies when the taxable estate is $3,000,000. Because of the applicable credit as discussed below, the effective marginal tax rate starts at the rate of 37%. There is a special 5-percent surtax imposed on transfers between $10 million and $17,184,000, which has the effect of phasing out the graduated rates. Therefore, estates over $17,184,000 are subject to a flat rate of 55%.

Under EGTRRA, the marginal rates will stay as under current law with the following changes. The two highest brackets with tax rates of 53% and 55% will now have a rate of 50% for decedents dying and gifts made in 2002; 49% for 2003; 48% for 2004; 47% for 2005; 46% for 2006; 45% for 2007, 2008, and 2009; and 0% for 2010. The five percent surtax is repealed for decedents dying after December 31, 2001.

Example: Assume Barb has a taxable estate equal to $10,000,000 at death. Depending on the year Barb died, her estate tax would be:

Year	Tax Owing
2001	$5,140,800
2002	$4,775,800
2003	$4,700,800
2004	$4,620,800
2005	$4,540,800
2006	$4,460,800
2007-2009	$4,380,800
2010	$ -0-
2011	$5,140,800

The law provides a unified credit to be applied against the amount of estate tax owing. The existence of this credit effectively exempts the following levels of transfers from the estate tax. The following chart shows how this credit and the applicable exemption equivalent will be gradually increased over the next few years:

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Year	Applicable Exemption Equivalent Under		
	Unified Credit	Pre-EGTRRA	EGTRRA
2001	$220,500	$675,000	N/A
2002 & 2003	$345,800	$700,000	$1,000,000
2004	$555,800	$850,000	$1,500,000
2005	$555,800	$950,000	$1,500,000
2006	$780,800	$1,000,000	$2,000,000
2007 & 2008	$780,800	$1,000,000	$2,000,00
2009	$1,455,800	$1,000,000	$3,500,000
2010	N/A	$1,000,000	N/A
2011	$345,800	$1,800,000	N/A

The federal estate laws do allow certain deductions which reduce the amount of the taxable federal estate. The primary deductions are: expenses, claims and debts under section 2053, charitable contributions under section 2055 and transfers to one's spouse under section 2056.

Deduction for Charitable Contributions

A decedent's estate is given a 100% deduction for its qualifying charitable contributions. That is, no estate tax will ever be paid with respect to the decedent's property which is given to a qualifying charitable entity. And the charitable organization will not be required to pay any income tax on the IRA funds because it is a tax-exempt entity. These are two very favorable tax results.

An IRA accountholder who withdraws funds from his or her IRA while living and gives it to a charitable organization also is doing estate planning. The accountholder's estate has been reduced. Since the accountholder no longer owns the amount withdrawn, it will not be included in his or her estate for federal estate tax purposes. The IRA accountholder is granted a limited ability to offset having to include in income the IRA distribution by the ability to claim a deduction for the charitable contribution. However, it is an "itemized" deduction and is subject to a number of limits. So, the accountholder will not be able to eliminate all of the income tax associated with the IRA distribution.

Deduction for Certain Marital Transfer

A decedent's estate is also given a 100% (i.e. unlimited) deduction for any property which is "passed" (i.e. given or transferred) to his or her surviving spouse. There are, of course, requirements to be met to receive this favorable tax treatment. They are:

1. There must be a surviving spouse;
2. The property is being transferred from the decedent to the surviving spouse;
3. The property being transferred must be included in the decedent's spouse's gross estate;
4. The surviving spouse must be a U.S. citizen except to the extent the property passes to a Qualified Domestic Trust.
5. The transfer must not pass in the form of a nondeductible terminable interest.

The general marital deduction serves only to defer when the estate tax will be paid. The estate of the first-to-die will not pay an estate tax. However, estate taxes will be paid in the estate of the second spouse to die.

A decedent's estate is also given a 100% (i.e. unlimited) deduction if there is a properly designated marital deduction trust such as a QTIP trust, estate/general power of appointment trust, or estate trust which has been designated as the beneficiary.

Special rules allow certain types of trusts to be set up so that they can "benefit" the surviving spouse, yet there will be a marital deduction available for such property in the first to die spouse's estate and then such property will not have to be included in the second to die spouse's estate.

One of these trusts is called the qualified terminable interest trust (QTIP). Many times IRA accountholders designate a QTIP trust as the beneficiary of their IRA.

In order for the property of a trust to qualify as a QTIP (qualified terminable interest property) the property must pass or transfer from the decedent; the surviving spouse must have a "qualifying income interest for life," and an election under these rules applies. A "qualifying income interest for life" exists if (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use the property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

With respect to the requirement to distribute income annually to the surviving spouse, the governing regulation requires that either the assets in the trust must actually be income producing, or the surviving spouse must have the right to demand that the trustee convert unproductive assets to productive assets or distribute other assets equal in value to the income that would have been produced by the unproductive assets if it were productive. In fact, the IRS has ruled that if IRAs are part of the assets of the QTIP, then the IRA must pay out to the QTIP at least annually, the income earned by the IRA assets, and such income must be distributed by the QTIP to the spouse.

Obviously, a spouse beneficiary who is paid funds from the deceased spouse's IRA will have to include such property in his or her estate, regardless if he or she rolls them over to another IRA, but the unlimited marital deduction should apply.

The optimum marital deduction plan for a married couple generally involves establishing a non-marital trust (normally

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called credit shelter trust) and a marital trust. The non-marital trust is funded with assets worth $675,000 (i.e. the amount equivalent to the unified credit). The balance is allocated to a marital trust for the benefit of the surviving spouse. For example, let's assume "A" is married to "S." His estate will not owe any federal estate tax if he structures his estate as follows: $675,000 is passed to his credit shelter trust and the remaining $1,325,000 is transferred to a QTIP trust for "S."

Alternatively, he could simply transfer the $1,325,000 to "S" and because of the unlimited marital deduction "A's" estate would not owe any federal estate tax. Once "S" dies and assuming the value of the estate remains at $1,325,000, the estate of "S" will pay an estate tax of $211,300 calculated as follows :

Gross Estate	$1,325,000	
Exemption Equivalent	$675,000	
Taxable Estate	$650,000	
Tax Liability	$155,800	(first $500,000)
Tax Liability	$55,500	(37% x $150,000)
	$211,300	

If "A" had not done any estate planning and had transferred the entire $2,000,000 to "S" and "S" had then died, then the estate of "S" would have a taxable estate of $1,325,000 ($2,000,000 - $675,000). The estate tax liability would be $480,550. Since only one of the two spouse would have used the $675,000 exemption equivalent, an additional $269,250 will be owed .

The above examples illustrate that the estate tax liability with respect to an estate of $2,000,000 may range from 0 to $480,550 depending upon whether or nor there has been any estate planning implemented. These examples should illustrate that some estate planning is necessary if a person may have an estate with a value of more than $675,000. As housing prices continue to increase and as IRA and 401(k) balances grow, more and more people are exceeding the $675,000 limit.

A question which always arises is whether or not IRA funds and other pension funds are income in respect to a decedent. The answer is "yes." Set forth below is a summary of this topic which impacts both federal income tax calculations as well as federal estate tax calculations.

Income in Respect to a Decedent (IRD)

It is defined as "those amounts to which a decedent was entitled as gross income, but which were not properly includable in computing the decedent's taxable income for the tax year ending with his or her death or for a previous year under the method of accounting employed by the decedent."

IRD is subject to both the estate tax and to the income tax. IRD is property includable in the decedent's estate. IRD will be includable in the income of the recipient when it is received.

The recipient on the IRD will report the income arising from the IRD item when cash or property is received in satisfaction of that right to income. Note, it is not the receipt of the right to the income which is IRD, but it is the actual receipt of the income which is IRD.

The character of the IRD to the recipient is determined by reference to the character as it was in the hands of the decedent.

The recipient may be entitled to claim a deduction on his or her income tax return for the estate tax attributable to the inclusion of the IRD in the decedent's gross estate.

There are many common examples of IRD:

1. The decedent's interest in an IRA;
2. The decedent's interest in qualified pension plans;
3. The decedent's interest in salary or wages earned, but not yet paid prior to his or her death;
4. The decedent's interest in non-qualified deferred compensation and bonuses awarded to the decedent before his or her death;
5. Accounts Receivable—amounts owed the decedent as o the time of his or her death;
6. Accrued interest owed the decedent as of the time of his or her death; and
7. The gain to be realized under an installment sale which the decedent entered into prior to his or her death.
8. Dividends which had been declared as of the decedent's death (i.e. they were owed to him or her).

The general rule is that all IRA assets and other retirement assets are treated as IRD upon the accountholder's death. However, since the recipient acquires the same attributes as the decedent had, the after-tax contributions will not result in any income which must be included in income. If there are pure insurance death benefits to be paid from the retirement plan, they too may be excluded from income.

In summary, because IRA and other retirement plan assets are IRD, the following consequences result:

1. There is no step-up in basis as there is with certain other property upon the decedent's death.
2. The recipient will include the IRD item in his or her income when RECEIVED.
3. When the IRD is received, the ultimate recipient is entitled to an income tax deduction for the federal estate tax attributable to the IRD. ◆

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IRAs and Subchapter S Corporations

These corporations should be mutually exclusive for the following reasons. But as the discussion below illustrates there may be situations where they are involved with each other.

In order for a corporation to qualify as an S corporation, it must meet certain rules. An S corporation is not permitted to have a shareholder other than a person, an estate, certain trusts, and certain organizations described in section 1361(c)(6). If there is a nonqualifying shareholder, then the purported S corporation fails, and it will be taxed as a C corporation.

A qualified plan/trust described in section 401(a) or 501(c)(3) which is not taxable under section 501(a) is listed under section 1361(c)(6). An Employee Stock Ownership Plan (ESOP) is a type of qualified plan. Consequently, an ESOP is eligible to be a shareholder of an S corporation.

The S corporation rules still do not define an IRA as a permissible shareholder.

There are also some special rules which apply to qualified plans and ESOPs which will lead, in some situations, to an IRA being a "momentary" owner of an S corporation. ESOP rules mandate that an ESOP primarily invest in employer stock (i.e. Subchapter S stock) and that it distribute such shares to a participant upon termination. ESOPs generally are written to include a provision which requires the sponsoring corporation to immediately purchase any distributed stock when the sponsoring corporation has a subchapter S election in effect, and Internal Revenue Code section 401(a)(31) mandates that a plan, to be qualified, must contain provisions which allow a terminating participant the right to have a direct rollover from the qualified plan to an IRA. Thus, many participants have the right to be distributed employer stock and to directly rollover such stock to their IRA. Will the S corporation election fail in those situations?

The IRS addresses this situation in private letter ruling 200122034. The IRS rules that the momentary designation of the IRA custodian as the owner of the stock of a subchapter S corporation will not cause the election to fail. The reality is – the IRA never really is the owner since the corporation by-laws and the plan document mandate that the corporation repurchase such stock.

Note that there are no IRA laws or rules which prevent an IRA from owning corporate stock with an S corporation election impermissible. It is the subchapter S rules which prohibit an IRA from being a shareholder. ◆

Qualified Plan Audit — What to Expect

Should any of your qualified plan customers be audited by the IRS, listed below is what will be required of them. The IRS letter received by one of CWF's customers reads as follows.

"Dear Sir:

I am examining your returns(s) identified above (Plan year Ending December 31, 1998), and have arranged the appointment indicated (July 24, 2001 at 8:30 a.m., at your office). To help make the examination as brief as possible, please have the items available that I have listed at the end of this letter.

If you have any questions or cannot keep the scheduled appointment, please contact me.

Thank you for your cooperation.

Please have the following items available during the examination:

Copy of the determination letter that applies to the year(s) under examination.

Copies of the plan, the trust, and all amendments.

Trustee's or administrator's reports; plan census, ledgers; journals; trust, administrative committee, and invesiment committee minutes; investment analysis, certified audits, and other financial reports such as receipt and disbursement statements, income and expense statements, and balance sheets.

Copy of Forms 5500 or 5500-C/R for the year(s) under audit, as well as two prior and following plan years.

Copy of Forms 5500 or 5500-C/R annual Return/Report of Employee Benefit Plan, for any other deferred pension plans the employer had during each year under examination. Be sure to include copies of all schedules filed such as Schedules, A, B, and SSA, if applicable.

The employer's payroll records that were used to decide employees' eligibility to take part in the plan for the year(s) under examination, such as personnel records, and employment contracts. List of employees ineligible to participate in the plan and the reasons for their ineligibility.

Also include a copy of the Forms 940, Employer's Annual Federal Unemployment Tax Return; 941, Employer's Quarterly Federal Tax Return; and W-2, Wage and Tax Statement, that were filed for the year(s) under examination.

Calculation used to determine if the plan was top heavy.

Participant allocation schedules.

Participant account records and vested interest calculations.

Copies of the trust's or employer's Forms W-2P, statement for Recipients of Periodic Annuities, Pensions, Retired Pay, or

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IRA payments, and copies of the trust's Forms 1099-R, Statement for Recipient of Total Distributions from Profit Sharing, Retirement Plans, and Individual Retirement arrangement, for the year(s) under examination.

Cancelled checks verifying contributions for the year(s) under examination.

Copy of the employer's income tax return (i.e., Form 1120, 1065, 1040) on which the plan contribution was deducted. Include any filing extensions obtained. If the actual deduction per the tax return differs from the actual contribution amount, please explain. For self-employed individuals, please show how the deduction was figured out.

A worksheet showing that the plan properly meets the permitted disparity rules under IRC 401(1).

Evidence of fidelity bond for all people handling trust funds.

Copy of the following items for the year(s) under examination; Plan Description; and the summary Plan Description (SPD), Summary Description of Material Plan Modifications (SSM), and Summary Annual Reports (SAR) required under Title I, section 104, of the Employee Retirement Income Security Act of 1974 (ERISA).

Schedule of trust fund investments and amounts invested in each. Supporting documents for plan assets and liabilities, such as bank and broker's statements, titles, deeds, notes for loans, or insurance contracts. Specifically, if loans were made from trust assets, include copies of the executed loan agreements, amortization tables, evidence that the loans were adequately secured, and the loan's actual repayment schedule.

A worksheet showing that the IRC 415 limits were not exceeded for the highest paid participants.

A schedule demonstrating whether the plan meets the Actual Deferral Percentage test of IRC 401(k)(3).

A schedule demonstrating whether the plan meets the Actual Contribution Percentage test of IRC 401(m)(2).

A schedule demonstrating whether the plan meets the Multiple Use test of Proposed Treas. Regs. 1.401(m)-2(b)(3) and Revenue Procedure 89-65, if applicable.

Completed Form 2848, Power of Attorney. If you would like someone else to represent the plan during this examination, please fill out the enclosed form and send it back to me within the next week.

Sincerely,
Employee Plans Specialist"

As you can see, much documentation is required for this qualified plan audit. Your customers need to keep exceptionally accurate records that are organized and easy to locate. ◆

Three Major Changes in the QP Anti-Cutback Rules – EGTRRA

The first change deals with certain transfers, including plan mergers and other transactions having the effect of a direct transfer, including consolidation of benefits attributable to different employers within a multiple-employer plan.

A transferee plan will not fail because it does not provide some or all of the types of distribution previously available under the transferor plan, as long as all of the following requirements are met:

1. The transfer from the transferor plan to the transferee plan was because of a direct transfer rather than pursuant to a distribution from the transferor plan,
2. The transfer is authorized by both plans.
3. The transfer must be voluntarily elected by the participant or the beneficiary.
4. The election is made after the receipt of a notice describing the consequences of making the election.
5. The transferee plan must provide that any subsequent distribution of such funds be in the form of a single-sum distribution.

The second change creates a major exception which allows for the elimination of a type of distribution as long as certain requirements are met. That is, a plan will not fail to qualify merely because a type of distribution previously made available is eliminated, as long as two requirements are met. First, a single-sum payment is available at the same time or times as the type of distribution being eliminated. Second, such single-sum payment is based on the same or greater portion of the participant's account as the type of distribution being eliminated.

These first two changes apply to years beginning after December 31, 2001.

The third change is that EGTRRA creates a major exception to the law which states that a participant's accrued benefit may not be decreased by a plan amendment. Such a decrease will become permissible in limited situations. If the imposition of the law would create significant burdens or complexities for the plan and plan participants and yet not adversely affect the rights of any participant in a more than de minimis manner, then the amendment authorizing the decrease would not cause the plan to fail.

The IRS is to issue such regulations no later than December 31, 2003. Such regulations will apply to plan years beginning after December 31, 2003, or such earlier date as specified. ◆

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Q&A

I wish to withdraw $20,000 from my traditional IRA to pay the "qualified educational expenses" of my son, plus I wish to withdraw an additional amount to pay the taxes which will be owing on this distribution. How much should I withdraw, and are there any other tax issues of which I should be aware? I am 55 years old.

As you know, distributions from a traditional IRA used to pay the qualifying educational expenses of a child are not subject to the 10% excise tax. However, as you are aware, the amount distributed is taxable income to you, and you wish to withdraw an additional amount to cover these taxes. As always, the amount of tax you pay is based on your marginal income tax rate. For this question, let's assume you are in the 25% tax bracket. You would therefore wish to withdraw an additional $5,000 to pay the tax on the $20,000 withdrawal. At this point, another tax issue arises — because the 5,000 is not being used to pay qualifying educational expenses, this amount will be subject to the 10% excise tax, plus the 25% income tax. Nowhere in the Code does it list taxes owing on a distribution to pay qualifying educational expenses as a qualified educational expense. This may seem unfair, but that is the way the current law is written.

You will have to complete Form 5329 and attach it to your Form 1040 to inform the IRS that you do not owe the 10% additional tax on the $20,000, because you are using the "education" exception.

This same type of situation occurs when an individual converts a traditional IRA to a Roth IRA. A person can convert the entire amount withdrawn, in which case the amount is to be included in income, but the 10% additional tax does not apply because the statute provides the 10% additional tax does not apply to any amount which is converted. An individual could also deduct from the distribution the amount necessary to pay the related income tax, and convert the balance. In this situation, the 10% additional tax would be owing, since the amount was not converted, and does not qualify for the conversion exception. ◆

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conversion of a traditional IRA to a Roth IRA in their estimated tax payments.

The IRS concluded they would not waive the underpayment assessment because Code section 6654 defines the situations when a waiver should be issued. The situations are: casualty, disaster or other unusual circumstances. None of these exceptions applied. The IRS did not see this as an unusual situation since the law makes clear that the person will pay income tax on the amount of his or her IRA withdrawal even if it is converted to a Roth IRA.

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CAN YOU UNSCRAMBLE THESE PENSION PLAN WORDS?

1. NPENOIS NPAL
2. NDDUETCOI
3. DLFIEUQAI
4. RROIHTA (two words)
5. NTBOIUCNROTI
6. OHKEG
7. DHRTEIEN
8. FCRBIIEESNEIA
9. TTMNRREEIE
10. RLDDIESTCEEF (hyphenated word)

CAN YOU FIND THE HIDDEN WORDS RELATED TO PENSIONS/INCOME?

E	D	U	C	A	T	I	O	N	I	R	A	P
W	E	A	R	N	D	T	O	I	O	E	P	E
C	D	R	S	S	W	C	Z	T	C	T	N	N
V	U	Y	S	E	A	L	H	U	P	I	M	S
H	C	U	P	F	M	I	I	W	B	R	R	I
U	T	I	O	C	R	O	T	M	E	E	O	O
I	I	K	U	A	Y	I	C	I	I	D	V	N
N	O	G	S	B	R	T	R	N	B	T	C	I
I	N	H	E	R	I	T	E	D	I	R	A	O
X	E	A	S	O	P	B	W	A	U	Q	S	I
F	E	A	T	N	E	M	T	S	E	V	N	I
B	G	L	Y	M	A	X	Y	J	P	W	A	C
T	A	X	D	E	D	U	C	T	I	B	L	E
B	K	D	G	Y	T	U	I	O	W	A	G	E
M	I	L	A	N	O	I	T	I	D	A	R	T

EDUCATION IRA
DEDUCTION
INHERITED IRA
TAX DEDUCTIBLE
ROTH IRA
PENSION
LIMIT
SPOUSE
RETIRED
INVESTMENT
TRADITIONAL
WAGE
EARN
INCOME

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Set forth below is a summary of the estimated tax rules as taken from IRS Publication 505.

Who Must Make Estimated Tax Payments for 2001?

If you had a tax liability for 2000, you may have to pay estimated tax for 2001.

General rule. You must make estimated tax payments for 2001 if you expect to owe at least $1,000 in tax for 2001, after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of:

1) 90% of the tax to be shown on your 2001 tax return, or
2) 100% of the tax shown on your 2000 tax return. Your 2000 tax return must cover all 12 months.

Exceptions. There are exceptions to the general rule for farmers, fishermen, and certain higher income taxpayers.

Farmers and fishermen. If at least two thirds of your gross income for 2000 or 2001 is from farming or fishing, substitute 66 2/3% for 90% in (1) above.

Higher income taxpayers. If your adjusted gross income (AGI) for 2000 was more than $150,000 ($75,000 if your filing status for 2001 is married filing a separate return), substitute 110% for 100% in (2) above. This rule does not apply to farmers and fishermen.

When To Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

Table 2.3

For the period:	Due date:
Jan. 1* through March 31	April 15
April 1 through May 31	June 15
June 1 through August 31	September 15
Sept. 1 through Dec. 31	Jan. 15 next year**

*If your tax year does not begin on January 1, see Fiscal year taxpayers, later.
**See January payment, later.

Saturday, Sunday, holiday rule. If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. For example, a payment due Sunday, April 15, 2001, will be on time if you make it by Monday, April 16, 2001.

January payment. If you file your 2001 Form 1040 or Form 1040A by January 31, 2002, and pay the rest of the tax you owe, you do not need to make your estimated tax payment that would be due on January 15, 2002.

Minimum required each period. You will owe a penalty for any 2001 payment period for which your estimated tax payment plus your withholding for the period and overpayments for previous periods were less than the smaller of:

1) 22.5% of your 2001 tax, or
2) 25% of your 2000 tax. (Your 2000 tax return must cover a 12-month period.)

Note. If you are subject to the rule for higher income taxpayers, discussed earlier, substitute 27.15% for 25% in (2) above.

When penalty is charged. If you miss a payment or you paid less than the minimum required in a period, you may be charged an underpayment penalty from the date the amount was due to the date the payment is made.

No Penalty Situation

Generally, you will not have to pay a penalty for 2001 if any of the following situations applies to you.

- The total of your withholding and estimated tax payments were at least as much as your 2000 tax, you are not subject to the special rule limiting the use of the prior year's tax, and you paid all required estimated tax payments on time.
- The tax balance due on your return is no more than 10% of your total 2001 tax, and you paid all required estimated tax payments on time.
- Your total 2001 tax (defined later) minus your withholding is less than $1,000.
- You did not have a tax liability for 2000.
- You did not have any withholding taxes, and your current-year tax less any household employment taxes is less than $1,000.

Special rules apply if you are a farmer or fisherman. ◆

Puzzle Answers:

1. Pension Plan
2. Deduction
3. Qualified
4. ROTH IRA (two words)
5. Contribution
6. Keogh
7. Inherited
8. Beneficiaries
9. Retirement
10. Self-directed