

NEW TAX LAW SUMMARY-- JUST WHAT WILL IT DO FOR YOU?

By now that you have read or heard at least one of the headlines: “Largest Tax Cut in 20 Years!” “Relief from the Marriage Penalty” “Tax Rate Cuts” “\$1.35 Trillion Federal Tax Cut” “Repeal of the Estate Tax” “Advance Rebate Checks to Millions of Taxpayers”. This is all of result of “Economic Growth and Tax Relief Reconciliation Act of 2001”, signed into law by President Bush on June 7, 2001. You are probably asking “What does this mean to me? The following summarizes the major provisions of this new law.

“Advance Refund” Checks and Tax Rate Cuts

A new 10% tax bracket has been created. This new rate is retroactive to January 1, 2001. The new 10% rate applies to the first \$6,000 of taxable income for single filers, the first \$10,000 for heads of households, and the first \$12,000 for joint filers. Since this new rate is five percentage points less than the former lowest rate, and applies retroactively, the effect will be to reduce individual federal income tax for 2001 by a maximum of \$300 for single filers (5% of \$6,000), \$500 for heads of households (5% of \$10,000) and \$600 for joint filers (5% of \$12,000). Rather than adjusting the of the 2001 tax rate schedules for this 10% rate, the law instructs the Treasury to mail “advance rebate” checks. This credit is calculated based on each taxpayer’s 2000 income tax return information. Most individuals who filed their 2000 tax returns by the April 16th deadline will receive their checks by the last week in September. Taxpayers filing their 2000 income tax return after the April 16th deadline, even with a valid extension will receive their check later in the fall. No checks will be issued after December 31, 2001. If you do not receive an advance refund check but are entitled to it, it will simply be claimed as a credit on the 2001 return. A reconciliation on the 2001 tax return will need to be performed. The rationale for this advance credit was to provide a stimulus to the economy.

In addition to creating a new 10% bracket, Congress mandated rate reductions in other tax brackets, beginning after June 30, 2001, except for the 15% bracket. Wage withholding tables were revised effective July 1, 2001 as follows

	2001	2002-2003	2004-2005	2006 and after
28% rate reduced to :	27.5%	27%	26%	25%
31% rate reduced to:	30.5%	30%	29%	28%
36% rate reduced to:	35.5%	35%	34%	33%
39.6% rate reduced to:	39.1%	38.6%	37.6%	35%

Alternative Minimum Tax (AMT) Relief for Individuals

The legislation provides temporary, but immediate, relief from the individual alternative minimum tax (AMT) by increasing the exemption to \$49,000 for joint filers (a \$4,000 increase), \$24,500 for married taxpayers filing separately (a \$2,000 increase) and \$35,750 for other individuals (a \$2,000 increase) in 2001 through 2004.

Child Related Provisions

The new law covers four broad areas relating to children. Here are the highlights.

Child Tax Credit. The legislation retroactively increases the child tax credit for 2001 from \$500 per child to \$600 per child. The \$600 limit is to apply through 2004, then increase in stages until reaching \$1,000 in 2010.

Adoption Expenses. The legislation permanently extends both the adoption credit and the exclusion to employer-provided adoption assistance, which were scheduled to expire after this year, and increases the maximum amount of each from \$5,000 to \$10,000. Perhaps more important for many taxpayers, however, is that it raises the income level at which the benefits begin to be phased out to \$150,000 (verses \$75,000 in 2001).

Employer-Provided Child Care Facilities. The legislation creates a new credit of up to \$150,000 per year for employers who provide employees with child care facilities or child care resource and referral services. The new credit applies in taxable years beginning after December 31, 2001.

Dependent Care Credit. The legislation also provides more generous dependent care credit limitations that will increase the maximum credit for many taxpayers, but these provisions do not take effect until 2003.

Marriage Penalty Relief

A “marriage penalty” exists when the combined tax liability of a married couple filing jointly is greater than the sum of their tax liabilities computed as though they were two unmarried filers. The new law also promises relief from the “marriage penalty,” but most affected taxpayers will have to wait until 2005 to benefit.

One provision will increase the standard deduction for joint filers by making it twice the amount available to single filers. Another provision will stretch the 15% bracket for joint filers to twice the size for single taxpayers, thus taxing a greater portion of joint filers’ income at 15% before subjecting their remaining income to higher rates. These provisions will not begin to take effect, however, until 2005. The standard deduction provision is to be phased in over a five-year period and the 15% bracket increase over a four-year period.

A provision that will begin to take effect in 2002 (and be fully phased in after 2007) will increase the earned income credit (EIC) available to joint filers by increasing the earned income phase-out amount. Another provision taking effect in 2002 will simplify the EIC computation.

A more targeted “marriage penalty”-related provision, which also takes effect in 2002, increases the income phase-out range to permit more joint filers to qualify for “Education IRAs,” discussed below.

Education Provisions

The new law contains several education-related benefits, most of which will go into effect next year. Here’s a brief summary.

Education IRA’s. Beginning in 2002, the legislation significantly expands and liberalizes the “education IRA” provisions. Perhaps the most notable change is an expanded definition of tax-free “qualified education expenses,” formerly limited to post-secondary education that includes similar expenses (e.g., tuition) for attending elementary and secondary schools. The new law also increases the annual contribution limit to \$2,000 per beneficiary (from \$500) and increases the phase-out range for joint filers to twice the amount for singles, thus making the phase-out range \$190,000 to \$220,000 of “modified adjusted gross income”.

Qualified Tuition Plans (also called college savings plans or “Section 529 plans”). Also effective in 2002, the legislation contains several provisions liberalizing the rules governing these plans, including a provision that allows funds to be rolled over from one plan to another plan

maintained for the same beneficiary. The new law also extends this program, currently restricted to state-sponsored plans, to educational institutions (which may be private institutions) meeting certain requirements. Tax-free distributions from private plans, however, will not be available until 2004. Also, tuition credits or certificates will be available from private plans, but such plans will not be able to receive contributions to a savings account.

Employer Provided Educational Assistance. The legislation makes the exclusion, which was scheduled to expire at the end of this year, permanent, and extends the exclusion to graduate level courses beginning after December 31, 2001.

Student Loan Interest Deduction. Beginning in 2002, the new law increases the income phase-out range for eligibility, currently set at \$40,000 to \$55,000 of “modified adjusted gross income” for single filers and \$60,000 to \$75,000 for joint filers. The new phase out ranges will be \$50,000 to \$65,000 (single filers) and \$100,000 to \$130,000 (joint filers), with inflation adjustments after 2002. The rule that limits the deduction to interest paid during the first 60 months in which interest is required is eliminated.

Above the line Deduction for Qualified Higher Education Expenses. Under this temporary provision, applicable from 2002 through 2005, eligible taxpayers can deduct “qualified tuition and related expenses,” as defined for purposes of the HOPE credit, without having to itemize or be subject to the “miscellaneous itemized deductions” limitation. The maximum deduction is \$3,000 in 2002 and 2003 and is limited to taxpayers having adjusted gross incomes (as specially defined) of up to \$65,000, or for joint filers, \$130,000.

Retirement Savings Provisions

The new law largely incorporates another piece of legislation, called the “Comprehensive Retirement Security and Pension Reform Act of 2001.” Here are some highlights.

Increases in IRA Contribution Limits. The legislation increases the contribution limits for IRAs and creates a new “catch-up” rule that raises the contribution limits for people aged 50 and above by an additional \$500. The new contribution limits for traditional and Roth IRAs will be \$3,000 in 2002 and will gradually increase to \$5,000 in 2008.

Increased Benefit and Contribution Limits for Qualified Retirement Plans. Effective for years beginning after 2001, the legislation:

- Increases the limit on annual compensation that may be taken into account for determining, among other things, contributions and benefits under a qualified

plan, to \$200,000 (from \$170,000), with indexing in \$5,000 increments thereafter;

- Increases the limit on annual additions to a defined contribution plan to \$40,000 (from \$35,000), with indexing in \$1,000 increments thereafter;
- Increases the limit on annual benefits that may be received under a defined benefit plan to \$160,000 (from \$140,000), with inflation adjustments thereafter in \$5,000 increments, as under current law;
- Increases the dollar limit on elective deferrals under section 401(k) plans, tax-sheltered annuities (“section 403(b) annuities”), and salary reduction simplified employee pension plans (“SEP’s”) to \$11,000 (from \$10,500). The limit is to increase in \$1,000 increments in later years until it reaches \$15,000 in 2006, with indexing in \$500 increments thereafter;
- Increases the dollar limit on annual deferral under “section 457 plans,” i.e. deferred compensation plans of state or local governments or tax-exempt organizations, to \$11,000 (from \$8,500). The limit is to increase in \$1,000 increments in later years until it reaches \$15,000 in 2006, with indexing in \$500 increments thereafter;
- Increases the dollar limit on annual elective deferrals to a SIMPLE plan to \$7,000 (from \$6,500). The limit is to increase in \$1,000 increments in later years until it reaches \$10,000 in 2005, with indexing in \$500 increments thereafter.

Plan Loans to Owners. The new law should benefit the owners of many closely held businesses by generally eliminating the special rules relating to plan loans to S corporation shareholders, partners, and sole proprietors, thus permitting such loans without automatically triggering a violation of the “prohibited transaction” rules.

Death Tax Repeal

The legislation technically repeals the federal “death taxes,” but provides a decade-long phase-in period, several changes to the current rules in the interim, and a “carryover basis” provision that is sure to cause confusion and potentially unpleasant income tax consequences to the beneficiaries of many estates. Moreover, further changes in the rules are almost a certainty. Here are a few points to keep in mind.

- The repeal applies to the federal estate and generation-skipping taxes. It does **not** repeal the federal gift tax. Also, the

legislation **does not eliminate any state “death taxes:**

- Complete repeal will not occur until 2010;
- Death tax repeal may eliminate the income tax savings achieved through a “step up” in the basis of property received from a decedent. As a result, families may not be able to take advantage of the potential benefits of death tax repeal without **careful planning.**

“Sunset” in 2011

One final aspect of the legislation merits comment. Technically, the changes made by the new laws, including the “death tax repeal,” will cease to apply after 2010! As a result, the provisions in effect in 2001 will become the law once again on January 1, 2011, if Congress takes no intervening action. This highly unusual provision was included to insure technical compliance with the federal budget law. The lawmakers obviously assume that this provision will be eliminated in future legislation.

What does this mean to me?

So how does all of this affect you? To estimate your savings under the new laws, check out the tax savings calculator developed by Intuit, the maker of personal financial software. The calculator does not adjust for future changes in income or deductions. Just fill in the blanks at www.quicken.com/taxes/taxrelief/estimator/.

We caution that the new tax laws are complex, and information provided in this newsletter is in general terms and is not intended to be a substitute for specific advice and ways that individual situations may be affected. We urge you to seek professional assistance before acting upon anything you read in this summary.