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Tax Power News & Research Reports

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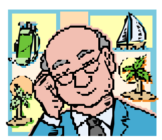
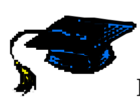
Special Report Tax Relief Reconciliation Act of 2001

Independence Day Bar-B-Qs, firework displays and family gatherings celebrate the birth of this great nation. But how many of us today stop to remember the event that sparked the Revolutionary War that led to our independence from Britain on July 4, 1776. Following the enactment of The Sugar Act of 1764, the Stamp Act of 1765 and the Townshend Acts of 1767, on May 10, 1773 the British Parliament enacted the Tea Act that maintained a three penny per pound import tariff on tea arriving in the colonies. "Taxation Without Representation" became the plea of 60 colonist activists who, on December 16, 1773 disguised as Mohawk Indians, boarded British ships in Boston Harbor dumping 342 containers of tea into the harbor rather than pay the tax on it. Following our independence in 1776, the citizens of the new United States of America were free of federal taxation until the Revenue Act of 1813 permitted the imposition of taxes on a "when and as needed" basis. Finally in 1913 the 16th Amendment to the Constitution introduced our first income tax. The rest, as they say, is history.

On June 7 President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. This huge $1.35 trillion once in a lifetime tax cut package contains a complicated array of unprecedented time delayed tax benefits affecting millions of taxpayers during the next ten years, making tax planning a must. This is the biggest tax cut seen by the American people in twenty years; however due to the back-loaded benefits and so called sunset clauses, Congress has created a nightmare of challenges for tax practitioners and the American public with this budgetary sleight-of-hand. Over the next ten years tax changes will gradually phase in, when in Year 2011 the American public will be thrust back in time when federal tax rates and estate tax provisions revert to what they were before the bill was passed, thus leaving our fate to the hands of future Congress. Some of the provisions that look likely for follow up legislation later this year are capital gains tax reduction, more small business tax breaks, bankruptcy tax reform, relief regarding alternative minimum tax (AMT) as well as technical corrections that inevitably follow major tax reform. Here's how it all works:



Retirement Savings tax incentives make up one third of the text of the new tax law by gradually increasing the contribution limits for both traditional and Roth IRAs from $2,000 to $5,000 per year between 2002 and 2008 along with substantial increases to the limits that may be contributed to employer 401(k) plans. Tax free catch-up contributions will be allowed for certain taxpayers. Joint filers with earnings under $30,000 will be permitted a 50% tax credit instead of a deduction for contributions to retirement savings. A complete analysis will be the subject of future Tax Research Reports.



Education Tax Relief in the form of increased student loan interest deductions, temporary "above the line" college tuition deductions, increased Educational IRA limits and other education incentives are included in the new legislation. The details of this topic will be covered in depth in future Tax Power News & Research Reports.

Rate Cuts. Although initially Congress had intended to reduce the number of tax rate brackets from five to four with a cap of 33%, the final result was an increase to 6 brackets by carving out a new 10 percent rate out of the existing 15% bracket for a couple's first $12,000 of taxable income ($6,000 for singles and $10,000 for head of household). Although the change technically is effective January 1, 2002, a credit for 2001 (and a tax refund check for many taxpayers) has the effect of accelerating the new bracket to January 1, 2001. Taxpayers who have already filed their Year 2000 tax returns will receive by October an advance refund check of up to $300 ($600 for couples and $500 for head of household). Taxpayers who are claimed as a dependent on someone else's tax return will not get a check.

Beginning in 2008 the taxable income amounts to which the new 10% bracket will apply for persons filing married, single and head of household will increase to $14,000/$7,000/$10,000 and adjusted for inflation thereafter. The remaining 28, 31, 36 and 39.6 percent marginal tax rate brackets gradually reduce beginning in 2001 until they reach 25, 28, 33 and 35 percent in 2006.

Here are some other changes that affect us:

- **The Child Tax Credit** increases gradually from $500 to $1,000 over the next ten years and is permanently available as an AMT offset

- **Marriage Penalty Relief** is delayed until 2005 when joint filers begin to enjoy a gradually phased in doubling of the standard deduction between 2005 and 2008 and the elimination of the marriage penalty in the 15% tax bracket by expanding the high end of income falling in that bracket to twice that of single taxpayers. The earned income credit rules are also adjusted to help reduce taxes for lower income taxpayers.

- **Itemized Deduction and Personal Exemption Limitations** that penalize upper income taxpayers will be gradually eliminated beginning in 2006 until the penalty is completely eliminated in 2010.

- **The Unified Estate and Gift Tax** is scheduled to be repealed in 2010 after a gradual increase in the Lifetime Exemption beginning in 2002 and a rate reduction beginning in 2003; however to prevent the use of gifts to transfer income swollen assets the gift tax scheme is preserved with the effective exemption amount staying at $1 million beginning in 2002 and starting in 2010, gifts in excess of $1million would be subject to a top tax rate equal to the top marginal income tax rate at that time. This does not spell the end of estate planning problems however. Beginning in 2010 when the estate tax provisions are repealed the income tax rules are changed so that instead of inheriting property with a tax basis equal to the fair market value at the time of inheritance and paying income tax (i.e. capital gains tax) only on the increase in value from that amount, the property will then have a tax basis equal to that of the decedent (usually original cost). Better keep those old records and receipts. Other changes are scheduled as well.

- **Alternative Minimum Tax (AMT)** relief is limited and those who are subject to AMT will receive no rate reduction; however some relief is addressed through the increase of the AMT exemption between 2001 and 2004 (only) as well as the repeal of AMT offsets to refundable credits.

I would like to take this opportunity to thank the clients of Powers & Company for the faith and trust that you place in us and for your continued patronage since our beginnings in 1965.

Andrew J. Powers Jr.