TAX RELIEF: THE NEW ACT AND WHAT IT MEANS FOR INDIVIDUALS

By Clark M. Blackman II and Ellen J. Boling

In addition to adopting the largest of the president's tax cut proposals, Congress included a substantial number of reforms that provide significant increases to the maximum contributions allowed for IRAs, Roth IRAs, 401(k) plans, and other retirement savings vehicles.

Congress adopted the Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act) on May 26, 2001. These tax cuts are the largest since 1981. President Bush asked Congress to focus on a short list of essential tax reductions and to defer action on other tax changes until later in 2001 or next year. Congress responded by adopting a modified version of the president's core tax cut proposals, which include:

- Significant tax rate reductions;
- Lower taxes for married couples;
- A substantial increase in the child credit; and
- Repeal of the estate tax.

In addition to adopting the largest of the president's tax cut proposals, Congress included a substantial number of new education incentives and a package of pension reforms that provides significant increases in the contribution limits for IRAs, Roth IRAs, 401(k) plans, and other retirement savings vehicles.

This article is the first of two in which we'll review the specific changes and planning opportunities for individuals as a result of the Act.

Part 1 focuses on the changes to individual income taxes and retirement savings alternatives.

Part 2 will focus on changes to estate and gift tax laws. A summary of the changes, including when they take effect, is shown in Table 1.

INCOME TAX REDUCTIONS

The 2001 Act centers on across-the-board tax rate reductions, including an immediate rebate. It eliminates both the phase-out of personal exemptions and the 3% reduction of itemized deductions for high-income taxpayers. For families, it provides a more generous 15% tax bracket and a higher standard deduction for married couples, increases the child credit to $1,000, and expands a number of education incentives.

The Rate Cuts

Over time, the Act lowers the 28%, 31%, 36%, and 39.6% brackets to 25%, 28%, 33%, and 35%. It also creates a new bracket by splitting the existing 15% bracket into two brackets—a 10% and a 15% tax bracket. The Act provides an immediate tax benefit by making the new 10% bracket retroactive to the beginning of 2001. The 10% bracket encompasses the first $6,000 ($7,000 after 2007) of taxable income for singles and the first $12,000 ($14,000 after 2007) for married couples filing jointly.

Rate reductions in higher brackets also begin in 2001 and will be fully phased in by 2006. Table 2 shows the applicable rates for each of the current

Clark M. Blackman II, CPA/PFS, CFA, CFP, is managing director of Post Oak Capital Advisors, in Houston, Texas. Ellen J. Boling, CFP, is director of Private Client Advisors for Deloitte & Touche LLP in Cincinnati, Ohio.

The authors give special thanks to Deloitte & Touche LLP for permission to use the book "Seeds of Change, the 2001 Tax Cut" as the basis for this article. However, the authors are solely responsible for the article's content.

brackets as they phase in. Note that from any one year to the next, the drop in rates is typically no more than one percentage point.

The Act's new 10% tax bracket provides immediate relief this year to everyone who pays income taxes. This retroactive relief, designed to boost the economy by quickly putting spending money back into the pockets of taxpayers, will provide modest first-year tax savings, ranging from $300 for singles to $600 for married couples.

The immediate tax benefit created by the new 10% rate bracket will come in the form of a credit, which will be distributed to most taxpayers by check before October 1, 2001.

Savings in ensuing years will become more dramatic, with further rate reductions scheduled for higher tax brackets. For example, a couple who this year earns $150,000, might reasonably expect a reduction in 2001 taxes of $950. But in 2010, they could expect a savings of about $3,800. This includes additional savings from new "marriage penalty" relief provisions. Table 3 estimates the savings for various households as if the Act were fully effective in 2001.

Planning for Rate Drops

A basic strategy of personal tax planning requires consideration of deferring income and accelerating deductions. If you report taxable income during the years in which marginal tax rates are dropping, you can expect to realize tax savings under the Act; however, with planning, these potential savings can be maximized. As with any analysis of a deferral opportunity, consideration must be given not only to the potential tax savings from shifting income or deductions, but also to the attendant economic risks and alternative minimum tax (AMT) exposures. Generally, taxpayers who are not subject to AMT should consider deferring income to years that have lower marginal rates and accelerating deductions to years with higher rates. These measures will net the largest savings.

Marginal rates will be lower in 2002 than in 2001, so taxpayers can expect a benefit from deferral of income. Benefits from income deferral will occur each time marginal tax rates are reduced under the Act.

The effect of declining tax rates on the decision to defer income should not be overstated. As in other years, the advantages of deferring income arise primarily from the opportunity to save and invest tax dollars that otherwise would be due. For example, a $20,000 deferral of income from December of Year One to January of Year Two could result in a $7,200 reduction in tax for a 36% taxpayer in Year One. Placed in the bank for a year, this could in turn generate investment income of $432, assuming a 6% rate of return for the year of deferral.

The actual tax reduction from deferring the $20,000 of income into the next year, when the tax rate will be 35%, would be $200. However, between 2001 and 2002, the rates decline by only 0.5%. In this example, that would generate $100 of permanent tax savings, plus the

TABLE 1. A CALENDAR OVERVIEW OF THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

Provision	Current	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Income Tax Rates											
Rates	39.6%	39.1%	38.6%		37.6%		35% fully effective				
	36.0%	35.5%	35.0%		34.0%		33% fully effective				
	31.0%	30.5%	30.0%		29.0%		28% fully effective				
	28.0%	27.5%	27.0%		26.0%		25% fully effective				
	15.0%	10% for first $6,000 for singles, $12,000 for married couples Remaining portion of 15% bracket unchanged							10% bracket: $7,000 & $14,000	Thresholds indexed for inflation	
Marriage Penalty Relief											
Standard Deduction		No Change				Gradually increased for married couples				Twice single level fully effective	
15% Bracket		No Change				Gradually increased for married			Twice single level fully effective		
Child Credit	$500	$600				$700				$800	$1,000 fully effective
Repeal of Personal **Exemption** Limits		No Change					Phase-in period				Repealed
IRA Limit	$2,000	No Change	$3,000			$4,000			$5,000	Index $5,000 for inflation	
AMT Exemption	$33,750 Single; $45,000 Married	$35,750 Single $49,000 Married				$33,750 Single $45,000 Married					
Estate Tax											
Top Rate	55%		50%	49%	48%	47%	46%	45%			Repealed
Exemption	$675,000		$1 million		$1.5 million		$2 million			$3.5 mil	Repealed

TABLE 2. THE PHASE-IN OF MARGINAL INCOME TAX RATE REDUCTIONS

Calendar Year	Part of 15% Rate Reduced to	28% Rate Reduced to	31% Rate Reduced to	36% Rate Reduced to	39.6% Rate Reduced to
2001	10.0	27.5	30.5	35.5	39.1
2002 to 2003	10.0	27.0	30.0	35.0	38.6
2004 to 2005	10.0	26.0	29.0	34.0	37.6
2006 and later	10.0	25.0	28.0	33.0	35.0

Other portion of 15% bracket will remain as under current law.

income earned from the deferral of income into a subsequent tax year. Note that this example assumes, perhaps unrealistically, that an increase in withholding (or "estimated payments") would not result in Year Two due to the deferral. If such an increase were to occur, it would necessarily reduce the amount of income earned on the invested difference.

For calendar-year taxpayers, methods for deferring tax liability include:

- Delaying the receipt of bonuses or the exercise of non-qualified stock options until January;
- Participating in qualified retirement plans;
- Prepaying annual charitable contributions in December rather than January; and
- Prepaying state tax liabilities—for instance, paying the fourth quarter estimated tax payment, and any anticipated return balance due, in December rather than January and April.

Planning for the AMT

Without question, over the next 10 years more taxpayers will fall within the reach of the AMT—unless Congress takes additional efforts to reform the AMT system. The drop in rates is expected to exacerbate the unintended reach of the AMT into the middle class. This is true because the AMT rates are not reduced from their level of 26% and 28%, while regular tax rates *are* reduced. However, the AMT exeption level is raised for years 2001 through 2004; they then drop back to current levels.

As more taxpayers find a substantial portion of their income taxed at 10%, 15%, and 25%, the risk increases that the 26% AMT rate will force them to pay additional tax.

Taxpayers who were subject to AMT under prior law may find that they receive no benefit from the tax cuts in the Act. Taxpayers who fall into the AMT as a result of the Act are still likely to derive some tax benefit from the Act's marginal rate cuts even though the AMT reduces that benefit.

Due to the complexity of the interplay between regular tax and AMT, we encourage you to consult with a tax professional to better understand how AMT may affect you. Or, contact your congressman and ask him to do your tax return for you; or better yet, ask him to remove the AMT altogether.

ESTIMATED TAXES

The changes made by the Act will permit individuals paying estimated taxes to reduce the payments they would otherwise make.

Taxpayers with adjusted gross income (AGI) over $150,000 in the previous year must pay estimated tax on the basis of either 90% of the current year's liability or 110% of the prior year's liability.

When current-year tax rates are lower than prior-year tax rates (which will occur as the Act phases in), reliance on the 110% safe harbor is more likely to result in the overpayment of estimated tax.

Careful "estimated tax" planning will minimize overpayments and alert taxpayers and their advisors to opportunities related to the AMT, charitable giving, capital gains and losses, and incentive stock option planning.

THE HIDDEN RATES

Two existing tax law provisions that effectively increase marginal income tax rates will be eliminated under the Act:

- *Repeal of the Phase-Out of Itemized Deductions:* The Act eliminates the "phase-out" of itemized deductions for all taxpayers, starting in 2010. Currently under this "phase-out"

TABLE 3. ANNUAL ESTIMATED TAX SAVINGS AFTER 2001 TAX ACT BECOMES FULLY EFFECTIVE

Filing Status	$36,000	$60,00	$100,000	$150,000	$400,000	$1 million
Single	$ 395	$ 802	$1,822	$3,336	$14,056	$43,816
Head of House, 1 Child	1,000	1,089	1,609	2,965	14,945	44,705
Married, Joint, o Children	925	700	2,430	3,819	13,989	45,527
Married, Joint, 2 Children	1,925	1,700	2,790	2,753	13,989	47,557

ssumptions: Savings calculated on the basis of 2001 rates and phase-out thresholds, and as if the ct is fully effective in 2001 even though some provisions are not effective until later years.

TABLE 4. THE EDUCATION IRA ADVANTAGE: AN EXAMPLE

nnual Contributions: $2,000
nnual Investment Return: 7%

ge	Cumulative Contributions ($)	Tax-Free Earnings ($)	Total ccount alue ($)
0	2,000	140	2,140
5	12,000	3,308	15,308
10	22,000	11,777	33,777
15	32,000	27,680	59,680
18	36,000	36,758	72,758

rule, itemized deductions are reduced by 3% of a taxpayer's AGI over a given threshold amount. The result is to increase an affected taxpayer's marginal rate to 103% of what the rate would otherwise have been. The repeal will be "phased in" beginning in 2006.

- *Repeal of the Phase-Out of Personal Exemptions:* The Act repeals the "phase-out" of personal exemptions beginning in taxable year 2010. The repeal will be "phased in" beginning in 2006. Until 2010, taxpayers with AGI above stated threshold amounts must continue to reduce some portion of the amount of claimed personal exemptions (currently $2,900 for the taxpayer and each dependent). In 2001, the thresholds are $132,950 for single filers; $199,450 for married couples filing jointly; $166,200 for heads of households; and $99,725 for married couples filing separately. This repeal effectively lowers the marginal tax rate of taxpayers previously subject to the limitation.

"MARRIAGE PENALTY" RELIEF

Under the graduated rates of our income tax system, married couples will find that their income may be taxed to a greater or lesser degree than that of comparably compensated singles (depending on the relative share of income earned by each spouse). When couples have income that is split more evenly than 70% and 30%, they are likely to suffer a "marriage penalty": that is, they are likely to pay more than they would have if they were not married.

Conversely, couples whose income is split less evenly, or couples with only one spouse earning taxable income, tend to receive a "marriage bonus." The bonus results when they pay less tax than they would have if they were single.

Over time, the Act reduces taxes for potentially all taxpaying married couples by increasing the standard deduction for joint filers to twice that of singles, and widening the 15% tax bracket for joint filers to twice that of singles. Beginning in 2005, the standard deduction for joint filers will increase each year until 2009, when it reaches a level of twice the single standard deduction. Changes to the tax bracket will begin in 2005.

In 2008, the size of the 15% tax bracket for married couples filing jointly will be twice the size of the corresponding rate bracket for singles.

After 2008, married couples who claim the standard deduction and have taxable income beyond the scope of the expanded 15% bracket will stand to save the most under the marriage penalty relief provisions. Those who itemize deductions will benefit slightly less. In the latter case, the married couple benefits only from the change in marginal rates.

EDUCATION PROVISIONS

The Act provides roughly $29 billion in direct tax and savings incentives to help families educate their children, help single individuals finance their own educations, and allow breadwinners to continue their education. These provisions include:

- A permanent extension of the employee exclusion for employer-provided educational assistance;
- Increased contribution limits for education IRAs;
- An above-the-line deduction for qualified higher education expenses;
- Expansion of qualified state tuition plans to include approved private colleges and universities; and
- Exclusion of distributions from qualified tuition plans from gross income.

Education IRAs

The Act increases contribution limits on education IRAs from $500 to $2,000. Individuals now have until April 15 of the year following the taxable year (instead of December 31 of the taxable year under the old law) to make contributions for the taxable year. Contributions are not deductible, but earnings accumulate on a tax-free basis. Parents and grandparents may make contributions (within the dollar caps) to education IRAs for the benefit of children and grandchildren. The AGI "phase-out" range for joint filers is increased from $150,000 to $160,000 under prior law, to $190,000 to $220,000—twice the range of single filers. In other words, a joint filer whose AGI is more than $160,000 may not contribute to an education IRA. Beginning in 2002, a joint filer whose AGI is more than $220,000 may not contribute.

The example in Table 4 projects the likely balance of an education IRA at age 18, assuming a maximum annual contribution of $2,000 is made at the beginning of each year (starting with the beneficiary's

birth), and the account provides a 7% annual rate of return.

In the example, a $36,000 investment would earn $36,758 and yield $72,758 available for qualified education expenses. To the extent the funds distributed exceed qualified education expenses, the earnings portion of the account would be included ratably as income of the beneficiary.

The Act expands the definition of "qualified education expenses" to include expenses most frequently and directly related to elementary and secondary school education. The Act waives both the contribution and distribution age limitations for special needs students.

The education IRA provisions are effective for tax years beginning after 2001.

Qualified Tuition

The Act expands eligible "qualified state tuition programs" (sometimes referred to as Section 529 plans) to include those established by educational institutions, which may also be private colleges and universities. Contributors can now purchase tuition credits or certificates for beneficiaries from private educational institutions. Under prior law, only states could establish such programs.

The Act permits tax-free distributions from qualified tuition plans, provided distributions are used to pay for qualified higher education expenses.

The Act makes qualified tuition plans more flexible by easing the tax-free rollover rules and allowing one transfer within any 12-month period for the same beneficiary (e.g., transfer between a prepaid tuition program and savings plan maintained by the same state or vice versa). The Act expands the scope of qualified higher education expenses to include actual living expenses and necessary expenses incurred by "special needs" students in connection with enrollment or attendance.

Coordination of Qualified Tuition Program and Qualified Higher Education Deduction

A taxpayer cannot claim a deduction for the amount of a distribution from a qualified tuition plan that is excludable from income. However, a taxpayer may claim a deduction for the amount of a distribution from a qualified tuition plan that is *not* attributable to earnings. For example, if a taxpayer uses a $100 distribution from a qualified tuition plan for tuition, and the distribution represents $90 of contributions and $10 of earnings, the taxpayer would be entitled to claim a deduction for the $90 representing a return of contributions.

The provision is effective for tax years beginning after 2001. However, the provision allowing income exclusion for certain distributions from qualified tuition programs *established and maintained by non-state entities* is effective for tax years beginning after 2003.

RETIREMENT SAVINGS

Congress also made many changes to encourage individuals to build retirement assets during their working years and to allow those assets to continue to be held in qualified retirement savings plans.

The Act's retirement savings reforms address both individual participant and employer needs. For individual participants, the Act:

- Increases limits on contributions to qualified retirement plans;
- Provides greater security for funds in plans; and
- Allows greater flexibility with respect to withdrawals, rollovers, and continuation of plans.

The most widely publicized changes in the Act affecting retirement savings are its increases in the amounts that employees may contribute to their retirement savings plans.

IRA Limit Increases

The maximum annual individual retirement account (IRA) contribution, which had been set at $2,000 for the last 20 years, is raised as follows:

- Years 2002 – 2004 = $3,000;
- Years 2005 – 2007 = $4,000;
- Year 2008 = $5,000.

Thereafter, the limit is indexed for inflation annually (in $500 increments). Individuals age 50 and over are permitted to make additional annual IRA contributions of $500 for 2002 – 2005 and $1,000 for 2006 and thereafter.

401(k) Plan Limit Increases

The Act enhances the value of 401(k) plans by increasing the general contribution limit and allowing individuals over age 50 to make additional contributions. The Act also allows individuals to contribute amounts that are not excluded from income to a 401(k) plan in a manner similar to Roth IRA contributions.

The limits on 401(k) contributions are increased from $10,500 in 2001 to $15,000 by 2006. The "phased-in" increase of the new limit, which is indexed for inflation in $500 increments beginning in 2006, is:

- Year 2002 = $11,000;
- Year 2003 = $12,000;
- Year 2004 = $13,000;
- Year 2005 = $14,000;
- Year 2006 = $15,000.

In several important ways, 401(k) plans can be superior savings vehicles to IRAs:

- Many employers match part of their workers' 401(k) contributions, resulting in potentially greater build-up of savings in a 401(k) plan than in an IRA.
- Participants in 401(k) plans can take tax-free loans from their account, which is not permitted for IRAs. (Individuals have unlimited ability, subject to a 10% penalty tax, to withdraw funds from an IRA, while 401(k) withdrawals typically require a demonstration of hardship.)
- The payroll reduction feature of the 401(k) results in gradual

forced saving of money that the employee does not have the chance to spend. Brokerage houses have automatic deposit programs for IRAs, but unfortunately they are far less commonly used.

- From an employer's perspective, the growing number of employees with a significant percentage of their 401(k) assets in the company's stock gives workers a stake in the company's success. The Act modestly loosens fairly minor restrictions in the 1997 Taxpayer Relief Act on the investment of 401(k) funds in the sponsoring employer's stock.

Concern about a drop-off in contributions to qualified plans may be mitigated by a provision in the Act allowing employers to establish IRAs inside their qualified plans. Under this provision, effective beginning in 2003, an employer can allow employees to make voluntary contributions to separate accounts inside the employer's retirement plan. Plans that are permitted to establish such accounts include qualified plans, 403(b) arrangements, and section 457 arrangements of state and local governments. These accounts will be treated as IRAs and are not subject to the normal rules that apply to qualified plans (except for the fiduciary requirements under the Employee Retirement Income Security Act (ERISA)). These may be either regular IRAs or Roth IRAs. Only employees of the employer are eligible to make contributions to these accounts.

The Act also allows individuals age 50 and over to make additional annual contributions to salary reduction plans (i.e., 401(k) plans and 403(b) and 457(b) arrangements). These individuals can make "catch-up" contributions of $1,000 in 2002; $2,000 in 2003; $3,000 in 2004; $4,000 in 2005; and $5,000 in 2006 and thereafter. "Catch-up" contributions allow for making up underfunded contributions in prior years. Catch-up contribution limits are indexed for inflation beginning in 2007.

Roth Contribution Program

Effective in 2006, the Act allows employers to create a new type of elective deferral program, referred to as a "Qualified Roth Contribution Program," under which participants contributing to a 401(k) plan or a 403(b) annuity program may designate a portion of their contributions as Roth contributions.

Participants can make Roth contributions in much the same manner as elective deferrals, but the participant specifically designates them as such. However, unlike "regular" deferrals, Roth deferrals are not excluded from taxable income. The Roth contribution limit is the maximum dollar amount of elective deferrals a participant can contribute to a plan for a year.

Like Roth IRA contributions, these "qualified" Roth contributions and related earnings are generally not included in gross income when distributed, provided that the distribution is not made before age 59½, death, or disability. For distributions to be tax free, the individual's account must have been in existence for at least five years. Unlike Roth IRAs, no distributions of qualified Roth contributions are permitted for first-time homebuyers.

Virtually all 401(k) participants will face a choice about whether to designate their 401(k) deferrals as Roth deferrals. Factors in the decision are the individual's expected period of time until distribution and anticipated marginal tax brackets at that time. However, there is no "conversion" feature comparable to the conversion of a regular IRA to a Roth IRA. Also, a participant's decision to have a Roth contribution depends on whether the participant's employer offers a Roth contribution feature in its 401(k) plan.

Flexibility in Distributions and Rollovers

The Act builds on recently revised IRS rules that have eased and simplified requirements governing the amount an individual is required to take out of IRAs and qualified plans annually upon reaching age 70½. The Act directs the IRS to update applicable life expectancy tables to reflect increased life expectancies since the last tables were issued. In its regulations, the IRS explicitly declined to do so.

The combination of this provision and the IRS regulatory changes will make it easier for individuals to preserve retirement income over an extended period, which has become more important as people are generally living longer. The changes eliminate significant complexity from the minimum distribution rules and permit participants to make one set of elections for designated beneficiaries. Individuals who calculate 2001 required minimum distributions using the new proposed regulations might find a lower required minimum distribution. Since the designated beneficiary can be determined as late as the end of the year following the year of the account owner's death, there are many post-death planning opportunities available. [We reviewed the effect of these regulation changes in the April and June 2001 issues of the *AAII Journal*—respectively, "The New Improved Rules for Minimum Plan Distributions" and "Beneficiary Designations and IRA Distributions: The New Rules"; these articles are available at AAII.com.]

Increased Portability

The Act includes a number of provisions to enhance portability of retirement account savings for workers who change jobs, effective for distributions made after 2001.

The most significant of these is the expansion of available rollovers.The Act generally allows any pretax IRA funds to be rolled into any other type of retirement plan, such as a qualified plan, 403(b) annuity, or section 457 plan maintained by a state or other political subdivision.

Prior to the Act, IRAs could be rolled over into non-IRA vehicles only if the IRA consisted solely of amounts attributable to a prior plan distribution. This rule required individuals to maintain an IRA for rollovers of prior qualified plan distributions that was separate from all other IRAs.

The Act also generally allows funds in various qualified arrangements—such as qualified plans, 403(b) arrangements, and section 457 plans—to be rolled into any other type of arrangement, rather than merely IRAs. Section 457 arrangements of state governments can accept rollover contributions for the first time, and distributions from such arrangements, as well as rollovers of aftertax employee contributions to qualified plans and 403(b)s. The Act also allows surviving spouses to roll over distributions into any such plan; it gives the IRS authority to waive the so-called “60-day” rollover rule upon a showing of hardship; and it provides for automatic rollover of any automatic cashout distribution of at least $1,000 into an IRA.

Although the rules for rollover contributions are substantially liberalized, rollovers are not possible if the individual is not eligible to receive a distribution from the plan or if the recipient plan does not authorize the rollover contribution.

While we have summarized the Act’s provisions that are designed to simplify retirement savings rules and allow greater contributions to plans, these “simplifications” are perhaps the most complex portion of the Act. We encourage you to consult with a professional tax or financial planning advisor to understand how the new Act impacts your personal planning strategies. ❖

AAII.com

American Association of Individual Investors

Read the articles referred to in this article on our eb site by using the Search tool and typing in “IR ” in the Simple Keyword Search box.

- “The ew Improved Rules For Minimum Plan Distributions”
- “Beneficiary Designations and IR Distributions: The ew Rules”

Share your opinions on the new tax rules on our **Financial Planning Message Board**.

Click on Message Boards under Community on the left-hand side of our home page.