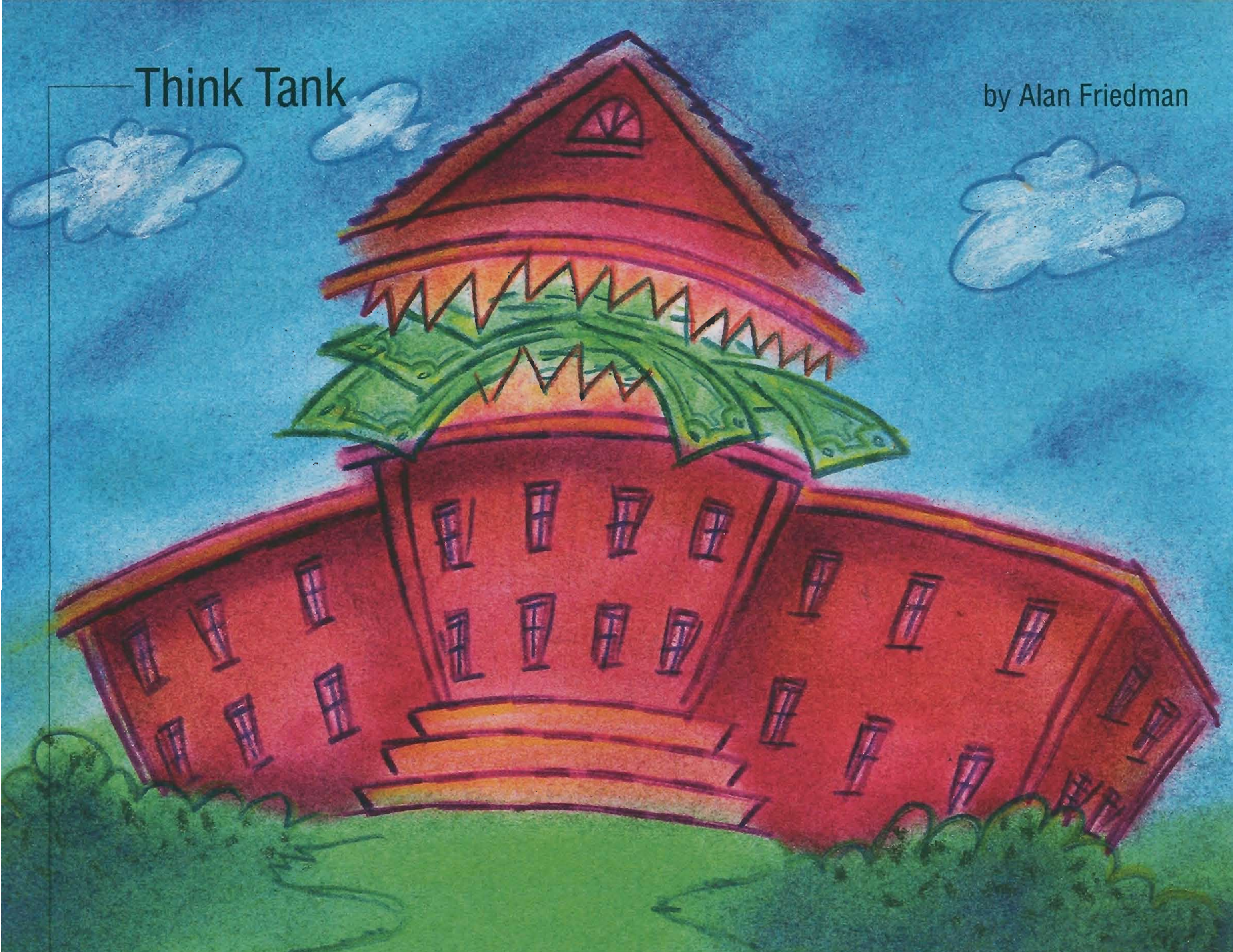
by Alan Friedman



The Taxes Chainsaw Massacre

The Economic Growth and Tax Relief Reconciliation Act of 2001. Why can't the government just stick to something simple like "The 2001 Tax Act" or "The New and Improved Tax Act" or "2001: A Tax Odyssey." No, just like the tax laws themselves, the name has to be complicated.

And as if the old tax laws weren't bizarre enough, the 2001 tax act takes taxation to a new level of confusion and complexity: 85 major provisions and 441 IRS code changes described in 291 pages of official bill text.

The good news is the new tax law, which passed on May 26th, will produce $1.35 trillion in tax cuts (the largest tax cut in 20 years). It will benefit nearly every taxpayer through a focus on the family and retirement savings. But these tax savings will make it very difficult for future Congresses to leave this law alone. If the White House or Congress changes hands, many of the prospective tax cuts will vanish. And if politics don't change the law, a "sunset provision" kicks in and the bill self-destructs in 2010.

The challenge for taxpayers and their tax preparers will be to understand and consider a myriad of tax planning assumptions. The new law imposes a complicated array of unprecedented "back-loaded" (i.e. time-delayed) benefits, with varying effective dates that span over the 10 years. Some provisions are retroactive, some start next year but require immediate planning to maximize benefits, and other provisions won't start until five or even 10 years from now.

The bottom line? Get ready to crunch numbers. Time-based, phase-in provisions will drive you and your accountant nuts over the next 10 years, as you search for tax-reducing strategies. And let's not forget the added complication of more tax legislation that is sure to follow. Just as every other tax act has, the new law raises many opportunities, pitfalls and, of course, confusion.

Without using this article as an antidote for insomnia, I thought

I'd briefly highlight some of the new tax provisions that affect all individual taxpayers, and offer some "cynical commentary" on each part of the law we discuss—my favorite thing to do. OK, stay awake, here we go:

Income Tax Rate Cuts. The centerpiece of the new law is a $958 billion consolidation and reduction of the marginal tax rates for individuals. Most taxpayers come out ahead under these rate cuts, which start with the creation of a new 10 percent rate bracket that will result in "advance refund" checks issued to most taxpayers by the time you read this article. All other individual tax rates (except the 15 percent rate) are also cut for 2001, by a .5 percent decrease in each rate.

The retroactive rate cuts for 2001 (to bracket rates of 10-, 15-, 27.5-, 35.5- and 39.1-percent) may amount to "small change." But the tax savings substantially grow over the next five years, as all rates are reduced (10-, 15-, 25-, 28-, 33- and a top rate of 35-percent).

Comment: The 2006 start date of the full effect of the lower rates is just another example of the widespread back-loading of tax benefits in this bill that get you all excited, but won't allow you to feel good for five years. It's like taking Viagra in the morning and your wife isn't available until the evening.

Marriage Penalty Relief. The marriage penalty—the phenomena of two married people paying more pro-rata share of tax than they would if they were single—will finally see some relief with the new act, although a "penalty" will still exist in part. But before you kiss your congressional rep, understand that this relief doesn't kick in until 2005, and phases in over the course of four years.

The relief comes in two forms. It will include giving joint filers a standard deduction that is double the amount of that of a single filer, as well as expand the high end of the 15-percent bracket—effectively taxing more income at a lower rate.

Comment: Statistically, most taxpayers above the new 25-percent bracket won't be taking the standard deduction and therefore will remain subject to the current marriage penalty. As if marriage wasn't taxing enough.

Child Tax Credit. The new law doubles the current child credit to $1,000—phased in over 10 years, of course. The increase is effective for 2001.

Comment: Only parents of a child younger than eight years of age will realize the $1,000 credit for that child by the time the law fully phases in. Assuming a typical 3.25-percent inflation rate, the $1,000 credit will be worth only $747 in current dollars by 2010. Here's an idea: Lie about your kid's age just like they do in little league baseball (just kidding).

Adoption Tax Credit. The new law increases the credit for adoptions to $10,000 for both special needs adoptions (currently at $6,000) and non-special needs adoptions (currently at $5,000). It also doubles the income phase-out range's starting point from $75,000 to $150,000. These new limits start in 2002.

Comment: It's about time. This old law was really starting to piss me off. It's usually the more financially secure families that are allowed to adopt, which means they can't use the credit because they make too much under the old law. Finally, somebody grew a brain.

Dependent Care Tax Credit. The law increases the dependent care credit rate to 35 percent, increases the amount of eligible (employment related) expenses to a maximum of $3,000 for one child ($6,000 for two or more), and increases the beginning point of phase-out income to $15,000 of Adjusted Gross Income (AGI) starting in 2002.

Comment: Terrific. Now you can spend these tax savings on increased tax preparer fees, comprehensive tax preparation software or pain relief medication as you try to do your own tax return.

Estate Tax Relief. Some in Congress claim to have repealed the estate tax. More precisely, however, the new law repeals the estate tax (a.k.a. "death tax") for one year—2010. Due to budgetary restrictions, the new law allows the current estate tax rules, rates and exemptions to come back in full force in 2011. Thus, under the new law, estate taxes continue until 2010, when it is repealed for that one year only. The only good news is the increase in estate tax exemption from $1 million to $3.5

million in 2009.

Comment: What the hell is this crap? The prospect of the automatic reinstatement of 2001 estate tax rules in 2011 will force Congress to face the entire issue again, perhaps under entirely different political circumstances. This means that most Americans will face an even larger estate tax burden unless congress takes further action. My advice: Plan as if it's going to kick back in.

College Tuition Deductions. The new law introduces a package of education-related tax breaks, including a "temporary" college-tuition deduction. For 2002-2003, a $3,000 (before AGI) deduction will be allowed for taxpayers with AGI below $65,000 if single, and $130,000 if married. For subsequent years, the deduction changes, income limits change and goes away after 2005 in order to fit within the bill's budget restrictions.

Comment: Talk about a tease—and this deduction cannot be claimed in the same year as a HOPE or Lifetime Learning Credit for the same student.

Enhanced Student Loan Deduction. The new law allows a more generous deduction for student loan interest. Current rules permit taxpayers to deduct up to $2,500 in student loan interest above the AGI line. The deduction had also been severely limited by AGI cut-offs, which have been changed by the new law. The new law raises AGI limits and repeals the annual dollar limit on the amount of the deduction.

Comment: Good. Keep it coming, as the cost of private college now approaches $40,000 per year!

Changes to IRA Contribution Limits and Payments. The contribution limits for both traditional and Roth IRAs will rise from the current $2,000 annual cap to $5,000 ($3,000 for 2002-2004, $4,000 for 2005-2007, and $5,000

for 2008 and thereafter), with annual adjustments for inflation after 2008.

Also, taxpayers who are age 50 and above will be permitted to contribute "catch-ups" to their IRAs ($500 in 2002-2005, and $1,000 in 2006 and thereafter). These catch-up payments can either be deductible or made to a Roth IRA, if AGI limits are not exceeded.

Comment: Another good thing, as Americans see the current value of their retirement investments sink deeper in the toilet. Let's hope the stock market rebounds, as history tells us it will.

Pension Plan Changes. Starting in 2002, the limit on annual additions to a defined contribution plan will rise to $40,000. The annual limit on benefits under a defined benefit plan will rise from $140,000 to $160,000. The limit on salary reduction contributions to 401(k) type plans—including 403(b) and SEP plans—will rise from $10,500 to $15,000 by 2006.

Comment: See my last comment—it's the same.

Some Final Thoughts

With the dramatic changes in the new tax act, careful tax planning will be more important than ever. The provisions of the new rules are as complex as our entire tax system. Certain provisions start at different times, phase in and phase out at differing income levels, and evaporate as quickly as they came in.

While this article may shed light on certain tax savings that can benefit you, there's still no substitution for consulting a professional tax advisor. He or she can discuss the specifics of the new law with regard to your financial situation and appropriate tax strategies, letting you develop and implement a truly effective tax plan for 2001 and beyond. Wow—what a plug.

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