# Willson & Pechacek, P.L.C. Newsletter

**Special Issue** | **Tax Relief Act of 2001** | **August 2001**

## OOPS! TAXES INCREASED?

*by Frank W. Pechacek, Jr.*

The Economic Growth and Tax Relief Reconciliation Act of 2001 is claimed to be the largest tax cut in 20 years. However, some taxes are going up, not down.

Family Businesses. The special additional deduction from federal estate tax for a family-owned business interest (currently $675,000), known as Family Owned Business Deduction (FOBD), is repealed for individuals dying after 2003. The current law allows for a husband and wife, who are both active in a family-owned business and meet the requirements of FOBD, to deduct an additional $1.35 million of assets, which, together with the $1.35 million of personal exemption equivalents from the federal estate tax, makes a total of $2.7 million not subject to the federal estate tax under current law, per business couple. The repeal of FOBD for individuals dying after 2003 means that the possibility of a decrease in the federal estate tax for family-owned businesses, including family-owned farms, does not really occur until 2006.

Return of the Federal Estate Tax. The exemption from the federal estate tax is complete in 2010, but within 12 months, 2011, the old estate rules again take effect and the exemption from federal estate tax reverts back to $1 million. Making the assumption that there will be at least an inflationary growth if not a real growth in a person's estate between now and the year 2011, the reversion to a $1 million exemption is actually a large increase in the federal estate tax.

Carryover Basis. Property inherited after 2009 no longer receives a stepped-up basis to its value at death. Instead, the basis in the property in the hands of the decedent carries over to the decedent's heirs. Currently, the basis that the decedent had in the property is stepped up to the value of the property at the time of death. Currently, when the heirs sell the inherited property, they have no tax to pay on the difference between what they realized on the sale and the decedent's original basis. This exemption from paying income tax on capital gains ends in 2010. The exceptions to the disallowance of a stepped-up basis are as follows:

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## EDUCATIONAL INCENTIVES

*by Bruce B. Green*

The miracle of birth awakens a wide range of emotions in new parents. Tremendous elation, joy and bliss can quickly turn to sheer terror — can we save enough to send this child to college? With new changes in the tax code, parents, grandparents, friends and other concerned individuals will be better equipped to fight the rising cost of educating a child.

Education IRAs. Under the current tax law, parents, grandparents, friends and any other interested persons, in certain income brackets, can save for a child's education by collectively contributing $500 per year to an education IRA. Although the amount contributed is non-deductible, it grows tax deferred. More importantly, withdrawals from the IRA are tax-free if used to pay for "qualified educational expenses", such as college tuition, books, supplies, room and board, but not expenses associated with elementary or high school.

Recent tax relief legislation continues many of these benefits, with a few noteworthy improvements. Beginning in 2002, parents and other interested persons will be able to contribute up to $2,000 annually per child. Contributors will have until April 15 of the following calendar year to contribute to the IRA for the preceding tax year. Qualified education expenses will now also include the costs of public, private, or religious elementary and high school.

The new tax law allows a taxpayer to take advantage of the education IRA's benefits and still claim either the HOPE credit (a $1,500 credit for tuition and fees for a full-time student in the first two years of a degree or certification program) and the Lifetime Learning credit (a tax credit for tuition and fees paid for any student not claiming the Hope credit for that year). The IRA distributions, however, must not be used for the same educational expenses. Similarly, it eliminates the excise tax currently assessed to contributions made on behalf of an IRA beneficiary who is also a beneficiary under a qualified state tuition program.

Finally, more people can take advantage of education IRAs. Married couples making less than $190,000 per year (modified adjusted gross income) can take full advantage of this tax benefit. The benefit is phased out for married taxpayers who will earn between $190,000 and $220,000.

Private Prepaid Tuition Programs. Current tax law permits any individual, irrespective of income, to "prepay" college expenses at participating public colleges and universities. Parents,

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# FEDERAL ESTATE TAX CHANGES

*by Trent D. Reinert*

The federal estate tax, often referred to as the death tax, is a transfer tax that is levied against an individual's estate at the time of his or her death. The death tax has long been a thorn in the side of individuals wishing to pass assets to their heirs, and much debate has occurred over the past several years concerning its fairness. The recent passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 has significantly modified the federal estate tax laws.

Currently, for deaths occurring in 2001, the unified credit effective exemption amount is $675,000, meaning that each individual may transfer $675,000 worth of assets during his or her life or at the time of death without subjecting their estate to the death tax. For estates that exceed the exemption amount, the tax rate begins at 37% and increases to 55% for taxable estates larger than $3 million. If death tax is due, the entire amount must be paid within nine months of the decedent's death.

The new law changes the unified credit effective exemption amount for deaths occurring after December 31, 2001. The exemption amount is increased to $1 million for 2002 through 2003, to $1.5 million for 2004 through 2005, to $2 million for 2006 through 2008 and to $3.5 million for 2009. The federal estate tax is completely repealed in 2010, but for deaths occurring after December 31, 2010, the tax is reinstated and the exemption amount reverts back to $1 million.

In addition to the changes in the exemption amount, the new law changes the maximum federal estate tax rate that applies for deaths occurring after December 31, 2001. The maximum rate is decreased to 50% for 2002, 49% for 2003, 48% for 2004, 47% for 2005, 46% for 2006 and 45% for 2007 through 2009. After the one-year repeal of the federal estate tax for 2010, the maximum tax rate reverts to the current rate of 55%.

The "sunset" provision of the Act that causes reinstatement of the federal estate tax after December 31, 2010, casts a shadow over the federal estate tax portion of the new tax law. While Congress and future administrations will undoubtedly revisit the issue of extending the repeal of the federal estate tax beyond 2010, the new tax law in no way guarantees permanent death tax relief. Individuals should continue to review their estate plans regularly in order to avoid or minimize potential federal estate tax liability.

# NEW RULES FOR RETIREMENT PLANS

*by Douglas D. Murray*

The new tax law greatly expands retirement savings incentives for both individual retirement accounts (IRAs) and employer-sponsored retirement plans. Some of the basic changes are discussed below.

**IRAs (traditional and Roth)**

Increased Contribution Limits. Beginning in 2002, the IRA contribution limit will increase from the current $2,000 limit to $3,000 in 2002, to $4,000 in 2005, and to $5,000 in 2008. These limits continue to be subject to income qualifications for active participants in a retirement plan.

Catch-Up Contributions. The new law allows persons age 50 and over to contribute an additional amount, called a "catch-up", each year to their IRA. From 2002 through 2005, this catch-up is $500 per year. Beginning in 2006, it increases to $1,000 per year. Thus, for example, if you are at least 50 in 2002, the maximum amount that you can contribute to your IRA is $3,500 ($3,000 limit plus $500 catch-up).

**Employer-Sponsored Retirement Plans**

Increased Contribution Limits. Contribution limits are increased for 401(k)s, 403(b) annuities, SEPs and other salary reduction plans. The maximum contribution through elective deferrals by employees increases from $10,500 in 2001, to $11,000 in 2002, and then rises $1,000 annually to $15,000 in 2006.

Catch-Up Contributions. Just as with IRAs, participants in a retirement plan over the age of 50 can make additional "catch-up" contributions. In 2002, the maximum catch-up for a participant is $1,000. This amount increases $1,000 each year to $5,000 in 2006.

**Miscellaneous**

SIMPLE Plans. The maximum employee contribution into a SIMPLE plan increases from $6,500 in 2001 to $7,000 in 2002, then increases $1,000 annually to $10,000 in 2005. Also, persons over 50 can make catch-up contributions. In 2002, the maximum catch-up is $500, increasing $500 each year to $2,500 in 2006.

Roth 401(k)s. In 2006, the new tax law creates a Roth 401(k). Like a Roth IRA, this will allow for after-tax contributions that grow tax-free.

Tax Credit for Retirement Contributions. The new law provides a tax credit to certain individuals who contribute to an IRA or other retirement savings account. This credit is available to married couples filing a joint return with adjusted gross income (AGI) of less than $50,000, heads of household with AGI of less than $37,500, and single individuals (not dependents or full-time students) with AGI under $25,000. The credit rate ranges from 10% to 50% depending upon your AGI. Joint filers with AGI of $30,000 or less, heads of household with AGI of $22,500 or less, and singles with AGI of $15,000 or less will qualify for the full 50% tax credit. This means you may get back 50 cents for every dollar you contribute up to $2,000 per person. However, you will not receive a credit if you do not owe any taxes.

# INCOME TAX RELIEF

*by Robert B. Lundholm*

**Income Tax Rate Reduction**

The new tax law creates a new 10% income tax bracket for a portion of taxable income that is currently taxed at 15%. This new 10% tax bracket applies to the first $6,000 of taxable income for single individuals, $10,000 for heads of household, and $12,000 for married couples filing joint returns. This new bracket will be increased in 2008 to $7,000 for individuals and $14,000 for married couples filing joint returns. For most taxpayers, the benefit of the new bracket in 2001 will be delivered in the form of a check from the Department of the Treasury. If you do not receive a rebate check, you may be able to pick up the extra credit on your 2001 return. The new bracket will go into effect beginning with the 2002 tax returns.

Other income tax rates have also been reduced, effective July 1, 2001. Over the next six years, regular income tax rates will be reduced from 28% to 25%, from 31% to 28%, from 36% to 33%, and from 39.6% to 35%.

The new tax law eliminates the limitation on itemized deductions for all taxpayers over time. The limitation on itemized deductions is reduced by one-third in the 2006 and 2007 tax years, by two-thirds in the 2008 and 2009 tax years, and is eliminated in tax years 2010 and thereafter.

The restriction on personal exemptions is also phased out under the new tax law. The restriction is reduced by one-third in the 2006 and 2007 tax years, by two-thirds in the 2008 and 2009 tax years, and is eliminated for tax years 2010 and thereafter.

**Marriage Penalty Relief**

Standard Deduction. The new tax law increases the basic standard deduction for a married couple filing a joint return to double the standard deduction for an unmarried person filing a single return. The increase is phased in over time, beginning in calendar year 2005, and will be fully phased in by 2009.

15% Regular Income Tax Bracket. The 15% tax bracket for a married couple filing a joint return will increase to twice the size of that tax bracket for individuals who file as single taxpayers. That tax bracket for a married couple filing a joint return is currently 167% of the single bracket. That bracket will increase to 180% of the single bracket in 2005 and will gradually reach the 200% mark in 2008 and thereafter.

Earned Income Credit (EIC). The final step in eliminating the "marriage penalty" pertains to the earned income credit. The EIC is phased out at certain levels of investment income as well as certain levels of overall income. The new tax law increases the beginning and ending points of the EIC phase-out by $1,000 in tax years 2002 to 2004 for married couples filing joint returns. The phase-out is increased by $2,000 in tax years 2005 through 2007, and by $3,000 in tax years 2008 and thereafter. Also, the earned income calculation is simplified by excluding non-taxable employee compensation from the definition of earned income, and also severs the provision that reduces EIC by the amount of alternative minimum tax.

*Education . . . (Continued from page 1)*

grandparents, friends or other interested persons can either purchase tuition credits or certificates (which will entitle the child to a waiver of tuition and other expenses when the child starts college), or fund an account to pay for the child's qualified education expenses. If the child does not attend college, the account may be transferred to another member of the child's family. The State of Iowa participates in this program.

Under the new legislation, beginning in 2002, private institutions, in addition to public schools, will be able to establish and maintain tuition prepayment programs. Thus, parents and other interested persons will be able to purchase tuition credits for a child at any participating private college. The new law does not extend tax benefits to funding programs maintained by private colleges for payment of education expenses.

The new legislation further allows a child to transfer prepaid tuition credits from one school to another, without incurring income tax liability. This will enable a child to transfer his or her prepaid tuition credits from a public school to a private school, or from one public school to another. This rollover treatment, however, is limited to one transfer within any 12 month period.

As with the education IRAs, a taxpayer can reap the benefits of the prepaid tuition program, as well as claim HOPE or Lifetime Learning credits (so long as the distribution under the prepaid tuition program is not used for the same expenses for which a credit was claimed).

Student Loan Interest Deduction. Current tax law allows certain taxpayers to deduct up to $2,500 per year for interest paid on student loans over the first 60 months of the loan. No deduction is allowed for voluntary payments, such as during a period of loan forbearance. Presently, this tax benefit is phased out for single taxpayers earning between $40,000 and $55,000 ($60,000 and $75,000 for married couples filing jointly).

Beginning in 2002, the new tax law will repeal the 60 month limit, and extend the deduction over the life of the loan. Further, even the interest on voluntary payments will be deductible. Most importantly, however, the phase-out ranges will be increased to $50,000-$60,000 for single taxpayers, and $100,000-$130,000 for married taxpayers filing joint returns, allowing more people to take advantage of the tax benefit. These amounts will adjust annually, based on inflation, after 2002.

*Oops . . . (Continued from page 1)*

1. Up to $1.3 million of basis increase can be allocated to appreciated assets passing to any heir.

2. Up to $3 million of additional basis for appreciated assets passing to a surviving spouse.

It will be up to the executor to decide which property can enjoy the stepped-up basis.

The bottom line is that individuals with an estate of $1 million or more must continue to utilize trusts in their estate planning, consider an annual gift program utilizing the gift tax exclusion of $10,000 per recipient, utilize valuation discounts which are available to shareholders of a closely held corporation or limited liability company, and utilize life insurance owned by an irrevocable living trust to provide estate tax liquidity that is not subject to the federal estate tax.

# KID'S KREDITS

*by Michael J. Davenport*

### Child Tax Credit

A taxpayer can claim a tax credit for each dependent child under age 17. For 2000, the credit was $500 for each qualifying child. The Tax Relief Act increases the child tax credit to $1,000 over a ten-year period. The credit increases to $600 for 2001 through 2004. The credit will be $700 for 2005 through 2008, $800 for 2009, and $1,000 for 2010.

### Adoption Credit

Currently, taxpayers can claim an income tax credit for qualifying adoption expenses. The maximum credit is $6,000 for the domestic adoption of a child with special needs and $5,000 for other adoptions.

Starting in 2002, the new law consolidates the special needs adoption credit with the general adoption credit and increases the maximum credit to $10,000 per eligible child. Beginning in 2003, taxpayers can claim the maximum $10,000 credit when the adoption of a special needs child is finalized - regardless of the amount of adoption expenses actually incurred by the taxpayer. In addition, the starting point for the phase-out is doubled to adjusted gross income of $150,000 (up from $75,000).

### Dependent Care Credit

Beginning in 2002, taxpayers will be able to claim a larger dependent care credit. The maximum amount of credit-eligible expenses is increased to $3,000 for one dependent and $6,000 for two or more (up from $2,400 and $4,800, respectively). The new law also raises the maximum credit percentage to 35% (up from 30%). Taxpayers with adjusted gross income of more than $43,000 (up from $28,000) are limited to a 20% credit.

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