

## INTRODUCTION:

### **I. The 2001 Tax Act - The Circus Comes to Town:**

The circus is in town again, and the magicians and clowns are in full bloom. The 2001 Tax Bill has got to be packed with every gimmick and sleight of hand ever invented. Not only have they further **complicated** the law, but they have committed to **phase-outs** and **tax reductions** for the next TEN years. **Ten years!**

I have been doing this a long time, but in tax terminology, a couple of years commitment is long term. These Bozos have a track record of religiously changing the tax law an average of once every four years. The huge problem with this piece of tax legislation is that the biggest tax reduction comes...you guessed it - in year ten.

As P.T. Barnum once said, there is a sucker born every minute, and the Republicans have once again reinforced that theorem. Here we have an American President who got in by an unprecedentedly small majority which hinged on, and I am not proud to say this, my home state's votes - a number which will never be accurately determined. And, he now makes a \$300 rebate per taxpayer the cornerstone of his new tax act!

At first glance, this is a good thing. Giving back to the American taxpayer a part of these Budget surplus. But a \$300 check to every taxpayer - to be received just in time for the November elections? Hum, do I smell fish?

## **II. THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001.**

On June 7, 2001 President Bush signed into law, the largest tax reduction bill in 20 years. This bill significantly affects the following areas of the tax code:

**-Current tax rates**

**-Retirement Planning**

**-Estate Tax Provisions**

This Tax Act makes over 400 changes to the law, but it is the timetable for full enactment, the many phase-outs, and multiple effective dates, which makes this bill so much fun.

### **1. Tax Rate Cuts:**

#### **A) 10% Tax Bracket**

A section of this tax bill reinstates a 10% tax bracket, which replaces the 15% minimum tax rate of the previous law. This provision is grand-fathered back to January 1, 2001. Because of the way it is structured, most peoples' taxes will be reduced by 5% of the first \$6,000 of taxable income (\$300 single; \$600 married). The bottom line is that this cut becomes maximized at the following levels:

- \$600 - married filing jointly (\$12,000 X 5%)

- \$300 - single tax payers (\$6,000 x 5%)

- \$500 - single parent - head of household (\$10,000 x 5%),

Hence some basis for the rebate checks I previously mentioned.

## **B) Upper Brackets Reduced**

More significant (although less publicized), there is a general reduction of tax rates which is granted in installments, with the first reduction effective on July 1, 2001. Eventually the top rate will effectively drop from 39.6% to 35%. The rates will decrease in **percentage** points with the schedule looking something like this:

<b><u>Year:</u></b>	<b><u>28% Rate To:</u></b>	<b><u>31% Rate To:</u></b>	<b><u>36% Rate To:</u></b>	<b><u>39.6% Rate To:</u></b>
2001:	27.5%	30.5%	35.5%	39.1%
2002 - 3:	27%	30%	35%	38.5%
2004 - 5:	26%	29%	34%	37.6%
2006 on:	25%	28%	33%	35%

## **C) Capital Gain Rates**

With a few exceptions, the capital gain rates stay the same, for now, at a 20% maximum rate for any capital asset held for a year or more. The two most common exceptions to this are for collectibles (28% maximum) and depreciation recapture (25%). Any capital asset held for less than a year will be taxed at the short term rate (same as ordinary income), and consequently will now benefit from the overall decrease in tax rates.

### *Illustration:*

This is a comparison of what typical tax savings could look like for three tax payers based on the combination of decreases discussed above:

<u>Taxable Income:</u>	<u>Filing Status:</u>	<u>Saved In - 2001:</u>	<u>Saved In - 2002:</u>	<u>Saved in - 2010:</u>
\$100,000	Single	\$669	\$1,038	\$2,513
	Married	\$881	\$1,162	\$2,730
\$500,000	Single	\$2,669	\$5,038	\$17,889
	Married	\$2,881	\$5,162	\$18,116
\$2,000,000	Single	\$10,169	\$20,038	\$86,899
	Married	\$10,381	\$20,162	\$90,987

As you can see by the above chart, the true savings kick in during the last phase of this bill, and this is especially true if you have taxable income of over \$1,000,000. Please note that the above chart does not consider the Alternative Minimum Tax (AMT). More on the AMT in subsequent sections of the book. It is estimated, however, that the number of taxpayers impacted by the AMT will increase significantly under the new Tax Act.

#### **D) Marriage Tax Penalty:**

Starting in 2008 the Law will be changed so that two people earning the same amounts after they are married, but now filing jointly, will be taxed at roughly the same rate as they were previously, as single people. This essentially does away with the antiquated system of penalizing married people, by accelerating the tax brackets at a geometric rate, rather than arithmetically. This fundamental has been at the core of our tax system, since the inception of the tax system in the early 20<sup>th</sup> century.

Furthermore, in 2009 married people will get twice the standard deduction that single people get, (as opposed to the smaller percentage it they currently get today). There Another antiquated section, of the Code, whose time has come. But again, why wait for 2009? Does it really take

eight years to change the law on such a simple, straight-forward, concept.

**A Word on January 1, 2011:**

The huge problem I have with this Tax Act is that this bill will virtually disappear on the above date. That's right - disappear! This bill could have just as well been called "The 2001 Vanishing Tax Act". What I mean by that is that provisions such as this personal exemption penalty and standard deduction penalty are all repealed in 2010. What they don't tell you is what happens on January 1, 2011....you guessed it. Everything that was repealed in 2010 (which may have taken nine years to fully enact) is fully repealed on January 1, 2011! What a deal - huh?

**III. Estate Tax Planning**

This repeal of the estate tax is one of the centerpiece's of the new Tax Act. However, as previously mentioned, this repeal is not effective until January 1, 2010. The uncertainty of all the events that will take place between now and then, and the potential political climate at that time, make reliance on this repeal a poor approach to planning your estate. More appropriate is the use of the Triple Crown, as addressed in detail in my book. Nonetheless, the understanding of what will transpire now and prior to 2010, are important, so here we go:

**A) Provisions effective in 2002**

The following provisions of the Act are effective in 2002:

- 1) Increase in the gift and estate tax unified exemption - increased to **\$1,000,000 from \$675,000.**
- 2) Reduction of the top rate from **55% to 50%**

## B) Provisions after 2002

These are the provisions effective after 2002:

Reduction of the Gift and Estate Tax as illustrated on the following chart.

<u>YEAR</u>	<u>MAXIMUM TAX BRACKET</u>	<u>APPLICABLE LEVEL</u>
2001	55% + 5% Surtax	\$ 675,000
2002	50%	1,000,000 *(Gift = \$1,060,000)
2003	49%	1,000,000 *(Gift = \$1,060,000)
2004	48%	1,500,000
2005	47%	1,500,000
2006	46%	2,000,000
2007-8	45%	2,000,000
2009	45%	3,500,000
2010	Estates are not taxed –Gifts taxed at individual rates	\$0

(\*) Currently, this exemption amount is the same for Gift and Estate Tax, except for the year 2001 - 2003 when it is \$1,000,000 for Estate Taxes, but \$1,060,000 for Gift Tax.

1) Raising of the threshold at which the top bracket begins, so that the maximum rate kicks in at a higher level, thereby reducing the overall gift and estate payable by any individual, see chart above.

2) Full **repeal** of the Estate (but not Gift) Tax in the **year 2010**. Under current law, the repeal only lasts one year; to qualify you must die during this period of time - January 1, 2010, after

12AM, through December 31, 2001, prior to 12AM - Midnight.

3) A change in the manner in which carryover basis of a capital asset is calculated, making it more consistent with other sections of the Tax Code.

4) After December 9, 2009, transfers of wealth to **non-resident aliens**, will be treated as sale of the property. The transferor will recognize income to the extent that the fair market value of the property received by the transferor exceeds the cost basis of the property. All calculations should be clearly indicated on the tax return.

5) The law now directly states that the taxpayer is required to put all detailed information on the Tax Return that applies to this transaction in the year it is required to be reported. This information includes, but is not necessarily limited to:

- Name and address of the recipient
- Identification number (Social Security or EIN.) of the recipient
- Transferor's adjusted basis (cost plus capital improvements).

There is a whole host of items that have not yet been examined in detail. I am certain that this Tax Bill will reopen a box of questions that have been raised previously, but not addressed.

I do not want to make this book so technically detailed that readers will be lost, but it is important

to understand the basics of these principles. One of these areas is that of cost basis and the calculation of a prior gift or inheritance. When this asset is sold by the recipient, how does that get reported? Has any tax been paid on this asset which can be used a credit now? These are questions which should be looked at to ascertain the correct amount of tax due on this sale.

### **What To Do Until 2010**

Whatever your ultimate goals are, it is strongly recommended here that you take advantage of the increased gift and estate tax exemption which goes up to \$1,000,000 in 2001; \$1,500,000 in 2004; \$2,000,000 in 2006; and \$3,500,000 in 2009. In 2009 the top estate tax rate will drop to 45%, and is then repealed to 0% in 2010. You must plan to utilize this amount, no matter if your assets' net worth is greater or lesser than the threshold amounts in the chart on illustrated above. You should consider using the complete exemption as soon as possible, but you should get counsel on how to properly set this up – the difference will be well worth any additional cost to you to do so.

You should also review your will and make sure the amounts stated do not lock you into small specific amounts that will be useless after this law comes into effect. If the will needs to be changed, I advise doing so, as soon as possible.

### **IV. Retirement Plan Provisions**

The Tax Act increased the **maximum amount of deductible contributions** that can be made to Individual Retirement Accounts (IRAs), Employer Sponsored Salary Deferral Plans (401Ks), Defined Contribution Keogh Plans, Simplified Employee Plans (SEP IRAs), and SIMPLE Plans (Specific Types of IRA). In addition, a **catch-up provision** has been passed which allows individuals who have reached the age of 50.

Because of the new Tax Act, younger taxpayers have been given the benefit of being able to make larger contributions to their retirement plans for a longer period than taxpayers who are closer to retirement age. The **NEW** Tax Act attempts to reduce this imbalance by allowing individuals who are over the age of 50 to make catch-up contributions to their plans. These catch-up contributions are in addition to the annual maximum contributions that can be made. The following chart shows the annual dollar amount of these contributions, based on the type of plan. As you can see, by 2006 these catch-up contributions will be very significant to individuals in employer sponsored plans.

<u>Type of Plan</u>	<u>Initial Year</u>	<u>Maximum Contribution in</u>		
		<u>2002</u>	<u>2003</u>	<u>When Fully Effective</u>
401K/SEP	2002	\$11,000	\$12,000	\$15,000 - 2006
<u>Keogh:</u>				
-Defined Contribution	2002	\$40,000	\$40,000	Same as 2002
-Defined Benefit	2002	\$160,000(*)	\$160,000(*)	Same as 2002
IRA	2002	\$3,000	\$3,000	\$5,000 in 2008
SIMPLE	2002	\$7,000	\$8,000	\$10,000 in 2005
<u>Catch-up Contributions(**)</u>				
-Self Sponsored Plans	2002	\$500	\$500	\$1,000 in 2006
-Employer Sponsored	2002	\$1,000	\$2,000	\$5,000 in 2006
-SIMPLE Plans	2002	\$500	\$2,500	\$2,500 in 2006

## Deemed IRAs Under

Employer Plans	2003	\$3,000	\$3,000	\$5,000 in 2008
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(\*) Funded for this amount of benefit.

(\*\*) For individuals over 49 years of age.

Beyond these increases, the Act permits qualified employer plans to allow employees to elect to treat a portion of their voluntary contributions as contributions to a separately maintained traditional or Roth IRA.

A married couple could gift an additional \$650,000 to their beneficiaries free of gift taxes in 2002 (in addition to the annual exclusion that is normally present). By making a gift in 2002, all future appreciation will be out of your estate.

### **Other Provisions**

- 1) The maximum annual contribution limit for qualified plan purposes increases from \$170,000 to \$200,000 after 2001
- 2) The rules permitting rollovers between various plans have been liberalized
- 3) Plan loans to sole proprietors, partners, and S corporation owners are permitted starting in 2002. The loans must be made available to participants who are not owners as well.

## **V. EDUCATION INCENTIVES**

No Tax Bill would be complete without some tinkering with programs that effect social policy

towards education. This Tax Bill is no different; this Tax Act clearly demonstrates our elected officials' stance on promoting education through various tax incentives.

## **Educational IRAs**

Education IRAs have been expanded significantly to increase both the amount that can be contributed to the plans and the number of individuals that will qualify for the program.

Additionally, tax-free distributions will be allowed for a wider range of qualified education expenses. Here are the key provisions:

- 1) The maximum contribution for each plan is increased to \$2,000 from \$500 under prior law.
- 2) Partial contributions can be made until income exceeds \$220,000.
- 3) You can use the IRA funds to pay for all levels of education, not just college, as was under prior law, and can now be used for grades as low as kindergarten all the way up through grade 12. There is no need any longer to wait to use the funds until college.
- 4) Furthermore, it does not matter if the school is private, public, or religious. It can qualify for use of the funds.
- 5) Qualified education expenses include
  - Tuition
  - Books and supplies
  - Room and board (including extended day programs)
  - Transportation

-Computer equipment, software, and internet access

(Note:Software designed for sports, hobbies, and games are excluded unless predominantly used in education)

-Tutoring

6) Age limitations are waived for children with special needs.

Contributions to Educational IRAs continue to be nondeductible, but the account grows tax free, and distributions are tax free as well. This savings can be significant in future years.

This has been a brief overview of the new tax act. For more information and a specific consultation regarding the new tax law and its application to you, please call our office at

**1-561-865-0071**. We look forward to working with you in the coming years, and assisting you to achieve tax freedom - whether it is given to you by the new tax law, or not. Remember, the best way to avoid paying excessive tax is by learning what is in the law and of benefit to you, and then implementing it into your tax matters, immediately!

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