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Economic Growth and Tax Relief Reconciliation Act of 2001: Provisions Effective in 2003-2009

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Congress has passed and the President has signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (The Act). It is the biggest tax reduction since 1981. The Act is very complex and is likely to try the patience of tax preparers and taxpayers alike, as well as "tax" the resources of the IRS. The Act uses complex phase ins (and phase outs) to achieve its central goals, and to stay within budget limitations as to the allowable size of the tax cut. Taxpayers will never realize many of the tax benefits promised in future years. In addition, the alternative minimum tax will negate much of the allowed tax savings. This current report will discuss provisions that will become effective in tax years 2003 through 2009. The changes in income tax law that will be effective in 2001 and 2002 are discussed in current report CR-958. The estate tax provisions contained in this law are discussed in current report CR-959, "Estate Tax Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001." For specific questions, contact your local County Extension Director, Area Farm Management Specialist, or state Tax Specialist.

Major provisions in the Act include

- Tax rate reductions—a new 10% bracket takes effect for 2001, and the current 28%, 31%, 36%, and 39.6% brackets will be cut to 25%, 28%, 33%, and 35%, respectively, over a period of six years. The 2001 tax year will be especially challenging because of a mid-year tax rate reduction and a "rate reduction credit" designed to give most individuals a refund check before October 1.
- Marriage penalty relief—higher standard deductions and an expanded 15% tax bracket for married taxpayers filing jointly will phase in over a period of years beginning in 2005.
- Estate and generation skipping transfer taxes—these taxes will be reduced from 2002 through 2009 via a complex mechanism, with outright repeal of both taxes in 2010. But after these taxes are repealed, the current law's basis-step-up rule will be replaced with a modified carryover basis rule that generally will give recipients a basis equal to the lesser of the decedent's adjusted basis in the property or its FMV on the date of death. Numerous exceptions, however, will permit executors to increase the basis of a significant amount of assets. Gift taxes are not repealed, but they are lowered.
- Pension liberalization and reform—virtually every important qualified plan dollar limit and percentage figure will be increased, many of them over a period of years, with additional "catch-up" contributions and other modified rules for those age 50 or older. Traditional and Roth IRA dollar limits will also rise significantly, once again over a period of years.

Other changes in the 2001 Act include AMT relief for individuals; eventual repeal of the AGI-based phase outs of itemized deductions and personal exemptions; boosted child credits; broadened tax breaks for education, including a beefed-up education IRA that can be used for elementary and secondary school expenses (public, private, or religious); and expanded qualified tuition programs.

Long-range planning for taxpayers will take on a new dimension, especially in view of the fact that the Act's changes are not permanent. Because of congressional budget reconciliation rules, all of the Act's provisions sunset. The Act specifically provides that they will not have any effect in tax years beginning after December 31, 2010. It's unlikely that Congress would allow the entire Act to sunset. However, many of the provisions in the Act may be substantially changed or repealed by subsequent Congressional action before they go into effect.

Phased-in reduction of individual income tax brackets above 15%

Beginning after June 30, 2001, each individual income tax bracket that is higher than the 15% bracket will be reduced as follows:

Tax Year	Tax Rates
2001 (pre-7/1)	28% 31% 36% 39.6%
2001 (post-6/30)-2003	27% 30% 35% 38.6%
2004-2005	26% 29% 34% 37.6%
2006 and later	25% 28% 33% 35%

In 2006, when the rate cuts are fully phased in and inflation adjustments are made, it is projected that the rate brackets will be as follows:

Single Individuals

Tax Rate	Taxable Income
10%	$0 to $6,000
15%	Over $6,000 to $30,950
25%	Over $30,950 to $74,950
28%	Over $74,950 to $156,300
33%	Over $156,300 to $339,850
35%	Over $339,850

Married Joint Return Filers

Tax Rate	Taxable Income
10%	$0 to $12,000
15%	Over $12,000 to $57,850*
25%	Over $57,850 to $124,900
28%	Over $124,900 to $190,300
33%	Over $190,300 to $339,850
35%	Over $339,850

*The end point of the 15% bracket for joint filers includes the phased-in increase in the size of the bracket to double that for single filers.

Dependent-care credit liberalized after 2002

A taxpayer who maintains a household that includes one or more qualifying individuals (generally, a dependent under age 13, or a spouse or dependent incapable of self-care) may claim a nonrefundable income tax credit for up to 30% of a limited amount of employment-related expenses ($2,400 for one qualifying individual or $4,800 for two or more). Thus, the maximum credit is $720 if there is one qualifying individual and $1,440 if there are two or more. The 30% credit rate is reduced, but not below 20%, by one percentage point for each $2,000 of AGI (or fraction thereof) above $10,000.

New law. For tax years after 2002, the Act will increase the maximum amount of eligible employment-related expenses from $2,400 to $3,000 for one qualifying individual (and from $4,800 to $6,000 for two or more qualifying individuals). It also will increase the maximum credit from 30% to 35%. Thus, the maximum credit will be $1,050 if there is one qualifying individual and $2,100 if there are two or more.

The Act also will modify the phase-down of the credit: The maximum 35% credit rate will be reduced, but not below 20%, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000. Therefore, the credit percentage will be reduced to 20% for taxpayers with adjusted gross income over $43,000.

Thus, the maximum and minimum credits will be larger, and more individuals will qualify for more than the minimum credit.

New above-the-line deduction for higher-education expenses from 2002-2005

Under pre-Act law, there is no deduction for higher-education expenses of an employee. An employee's job-related education expenses are claimed as miscellaneous itemized deductions subject to the 2%-of-AGI floor.

New law. For tax years beginning after 2001 and before 2006, eligible taxpayers will be able to claim an above-the-line deduction for qualified higher education expenses (defined in the same way as for HOPE credit purposes). In other words, the taxpayer does not have to itemize deductions to get the tax benefit. In 2002 and 2003, taxpayers whose AGI is less than or equal to $65,000 ($130,000 for married couples filing jointly) will be able to claim a maximum annual deduction of $3,000. In 2004 and 2005, taxpayers whose AGI does not exceed $65,000 ($130,000 in the case of married taxpayers filing jointly) will be able to claim a maximum deduction of $4,000, and taxpayers whose AGI does not exceed $80,000 ($160,000 in the case of married taxpayers filing jointly) will be able to claim a maximum deduction of $2,000.

The deduction will not be available if AGI exceeds the applicable dollar threshold, nor will it be available to married taxpayers filing separate returns. A taxpayer will not be able to claim the higher-education deduction for a tax year for an individual if he or any other person elects to claim a HOPE or lifetime learning credit in that year for the same individual. Additionally, a taxpayer will not be able to deduct amounts taken into account when determining the amount of a Coverdell Education Savings Account that is excludible (i.e., the earnings and contribution portions of a distribution), or the amount of interest excludible on an education savings bond. A taxpayer also will not be able to deduct the excludible part of a qualified tuition plan distribution, but will be able to claim a deduction for the return-of-contributions portion of the qualified tuition plan distribution. So if a taxpayer receives a distribution of $100 from a qualified tuition plan that is used for tuition, $10 of which represents earnings, he could claim the deduction for the $90 return-of-contributions portion. But if the distribution were from an education IRA, none of it would be eligible for the deduction.

Certain U.S. awards that require performance of services will be tax-free after 2001

The scholarship exclusion does not apply to any amount received by a student that represents payment for teaching, research, or other services required as a condition for receiving the scholarship or tuition reduction. Pre-Act law did not specifically except any awards from this rule.

New law. For amounts received in tax years beginning after 2001, awards received by an individual under the NHSC (National Health Service Corps) Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program will be eligible for tax-free treatment as qualified scholarships, without regard to any service obligation by the recipient. As with other qualified scholarships, the tax-free treatment does not apply to amounts received for regular living expenses, including room and board.

Marriage Penalty Relief

A so-called marriage penalty exists when the combined tax liability of a married couple filing jointly is greater than their tax liabilities would be if they were not married. The Act will provide the following marriage penalty relief, beginning in 2005:

- Phased-in increase of the basic standard deduction for joint filers to double that for singles.
- Phased-in increase of the size of the 15% bracket for joint filers to twice that for single taxpayers.
- $3,000 increases in the beginning and end points of the earned income tax credit phase out range for joint filers.

Marriage penalty in standard deduction will phase out between 2005 and 2009. Individuals who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable), which is subtracted from AGI in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2001, the basic standard deduction for single filers is 60% of the basic standard deduction for married joint return filers. Thus, the standard deductions of two unmarried individuals together exceed the standard deduction for a married couple filing a joint return.

New law. In 2005, the Act will begin to phase in an increase in the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The increase will be phased in over five years and will be fully active in 2009.

The following table shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase in.

Phase in of Standard Deduction Increase For Joint-Return Filers

Calendar Year	Percentage of Singles' Standard Deduction
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

The increase in the basic standard deduction for joint return filers to twice that for single filers provides tax savings to all joint filers, not just those who were hit with a marriage penalty. Thus, couples who claim the standard deduction and are in a more favorable tax position because of their joint filing status than they would be filing as two single taxpayers (a so-called marriage bonus, usually because one of them has all or the vast majority of the income) will have even more of a marriage bonus under the Act.

After 2004, the Act also repeals the specific basic standard deduction amount and special inflation-indexing rules for married taxpayers filing separate returns. Instead, the basic standard deduction for single individuals also will apply to separately filing married individuals.

Thus starting in 2005, the basic standard deduction for a married taxpayer filing separately will jump in one step to equal that of a single taxpayer, and will be more than half of the basic standard deduction of a married couple filing jointly. Only when the basic standard deduction for married joint filers increases to double that of single filers in 2009 and later years will the basic standard deduction for separately filing married filers again be just half that of joint filers. This would be a factor weighing in favor of separate filing beginning in 2005.

Marriage penalty in 15% bracket will phase out between 2005 and 2008

Separate income tax rate schedules apply to different filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. In general, the bracket dollar breakpoints for single individuals are approximately 60% of the breakpoints for married couples filing joint returns. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns.

New law. The Act gradually increases the size of the 15% bracket for married joint filers to twice the amount of the 15% bracket for singles, phased in over five years starting in 2005, as shown in the following table.

Phase in of Standard Deduction Increase for Joint-Return Filers

Calendar Year	Percentage of Singles' Standard Deduction
2005	180%
2006	187%
2007	193%
2008 and later	200%

For married taxpayers filing separately, the top of the 15% bracket will be equal to one-half of that for joint filers. Expansion of the 15% bracket for married taxpayers provides tax savings for all married couples, even if they are in a marriage-bonus situation (as is often the case where one spouse has all or the vast majority of a couple's income) rather than suffering a marriage penalty.

This provision decreases the marriage penalty impact only in the 15% bracket. Since the new 10% bracket for joint filers applies to twice the amount of taxable income as it does for single filers, there also is no marriage penalty effect in that bracket. However, a marriage penalty effect will still operate in the higher tax brackets, with the greatest impact being in the top bracket, which begins at the same dollar level both for singles and joint filers. A higher phase out range will lessen the marriage penalty for joint filers in earned income tax credit after 2001.

Personal exemption phase out will be lessened after 2005 and eliminated after 2009

The deduction for personal exemptions is phased out ratably for taxpayers with AGI over certain thresholds ($132,950 for singles; $199,450 for joint return filers; $166,200 for heads of households; and $99,725 for marrieds filing separately, as adjusted for inflation for 2001). The total amount of exemptions to which a taxpayer is otherwise entitled is reduced by 2% for each $2,500 (or part of $2,500) by which the taxpayer's AGI exceeds the threshold. For marrieds filing separately, the

phase out rate is 2% for each $1,250 of AGI (or part of $1,250) above the applicable threshold.

The Act will reduce the personal exemption phase out beginning in 2006 and repeal it after 2009. Under the five-year phase in, the otherwise applicable personal exemption phase out will be reduced by one-third in 2006 and 2007, then by two-thirds in 2008 and 2009. The repeal will be fully effective for tax years beginning after 2009.

Since the personal exemption phase out indirectly increases the marginal tax rates of individuals in the 31% or higher tax brackets, this change will effectively lower rates for these taxpayers by more than the 3-percentage-point reduction in the current 31% and 36% brackets and by more than the 4.6-percentage-point reduction that will take effect for those in the 39.6% rate bracket.

Overall limitation on itemized deductions will phase down starting in 2006 and be repealed in 2010

The total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the taxpayer's AGI in excess of $132,950 in 2001 ($66,475 for married couples filing separate returns). These amounts are adjusted annually for inflation. The otherwise allowable itemized deductions may not be reduced by more than 80%.

New law. The Act gradually repeals the overall limitation on itemized deductions for all taxpayers. The repeal is phased in over five years. The amount by which itemized deductions would otherwise be reduced under the pre-Act law phase out rules will be reduced by one-third in 2006 and 2007 and by two-thirds in 2008 and 2009. The overall limitation will be repealed for tax years beginning after 2009.

Since the phase out of itemized deductions serves indirectly to increase a taxpayer's marginal tax rate, these changes will effectively lower rates for some taxpayers more than the 3-percentage-point reduction in each rate bracket above 15% (or more than the 4.6-percentage-point reduction for those in the 39.6% marginal rate).

IRA and Pension Benefits

Higher IRA contribution limits starting in 2002

The maximum annual dollar contribution limit for IRA contributions will increase to the following levels:

Tax Years Beginning in	Maximum Deductible IRA Amount
2002-2004	$3,000
2005-2007	$4,000
2008 and later	$5,000

After 2008, the limit will be adjusted annually for inflation in $500 increments.

Extra contributions for those age 50 or older. After 2001, individuals who attain age 50 before the close of the tax year will be able to make additional catch-up IRA contributions. The otherwise allowable maximum contribution limit (before applying the AGI phase out limits) for these individuals will be increased by $500 for 2002 through 2005, $1,000 for 2006 and later years. (Code Sec. 408, as amended by Act Sec. 601)

Under the Act, the maximum annual IRA deduction for those age 50 or older will be as follows:

Tax Years Beginning in	Maximum Deductible IRA Amount (Age 50& Older)
2002-2004	$3,500
2005	$4,500
2006-2007	$5,000
2008 and later	$6,000

The higher IRA contribution limits also mean higher annual contribution limits for Roth IRAs. Annual nondeductible contributions to Roth IRAs can be made up to the amount that would be allowed as a deductible contribution to a traditional IRA, reduced by the amount of contributions for the tax year made to all other IRAs (other than Roth IRAs) but not reduced by contributions to a SEP or SIMPLE plan. The allowable Roth IRA contribution phases out over $150,000-$160,000 of AGI for joint filers ($0-$10,000 for marrieds filing separately; $95,000-$110,000 for others).

The higher annual deductible IRA contribution limits also result in higher annual nondeductible traditional IRA contributions. These can be made by a taxpayer not eligible to make deductible IRA contributions (in whole or in part) because of the active-participant AGI phase outs. The annual nondeductible traditional IRA contribution limit is equal to the amount that would be allowed as an IRA deduction (but for the active-participant AGI phase outs) less the amount actually allowed as a deduction. Nondeductible contributions to traditional IRAs generally would be made only by those with AGI above the Roth IRA contribution threshold.

Qualified plans will be able to include voluntary traditional IRA or Roth IRA feature after 2002

Under pre-Act law, an employer-sponsored retirement plan cannot allow employees to make traditional or Roth IRA contributions within the plan.

New law. For plan years beginning after 2002, eligible retirement plans (which include qualified plans under Code Sec. 401[a], tax-sheltered annuities under Code Sec. 403[b], and governmental Code Sec. 457 plans) will be able to offer a new feature allowing employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs. Voluntary employee contributions to these separate accounts or annuities will be treated as made to a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. The deemed traditional or Roth IRA, and contributions to it, will not be subject to the Code rules applying to the qualified retirement plan and will not be taken into account in applying these rules to any other plan contributions. The deemed traditional or Roth IRA, and contributions to it, will be subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and will not be subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the qualified retirement plan.

This new elective feature for eligible retirement plans would make it more convenient for employees to save for retirement with a traditional or Roth IRA. For example, they presumably would be able to direct their employer to automatically deduct amounts from their pay and set them aside in the traditional or Roth IRA set up by their employer plan.

Post-2001 increases in Sec. 457 elective deferral limit

Under pre-Act law, the maximum annual deferral in a deferred compensation plan of a state or local government or a tax-exempt organization (a Sec. 457 plan) is the lesser of $8,500 (for 2001) or 33 1/3% of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the plan may provide that, for one or more of the participant's last three preretirement years, the otherwise applicable limit is increased to the lesser of $15,000 or the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

New law. The dollar limit on deferrals in a Sec. 457 plan will be $11,000 in 2002. In 2003 and later years, the limit will increase in $1,000 annual increments until it reaches $15,000 in 2006, with annual adjustments for inflation in $500 increments after 2006. The dollar limit under the special catch-up rule will be twice the otherwise applicable dollar limit in the three years prior to retirement.

Elective deferrals will not be taken into account for figuring qualified plan deduction limits after 2001

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. For example, under pre-Act law, for profit-sharing or stock-bonus plans, an employer generally may deduct up to 15% of compensation of the employees covered by the plan for the year. (Under the Act, this will increase to 25% for years beginning after 2001. For purposes of the deduction limits, employee elective deferral contributions to a 401(k) plan are treated under pre-Act law as employer contributions and, thus, are subject to the generally applicable deduction limits.

New law. For years beginning after 2001, elective deferral contributions will not be subject to the deduction limits for stock-bonus and profit-sharing plans under Code Sec. 404(a)(3), combination defined contribution and defined benefit plans under Code Sec. 404(a)(7), and ESOPs under Code Sec. 404(a)(9). Additionally, the application of a deduction limit to any other employer contribution to a qualified retirement plan will not take into account elective deferral contributions.

Repeal of overall deferral limit on deferred compensation plans of governments and tax-exempt organizations after 2001

Under pre-Act law, the maximum permitted annual deferral under a plan of a tax-exempt or state and local government employer plan (a Sec. 457 plan) is the lesser of an inflation-adjusted dollar limit ($8,500 in 2001) or 33 1/3% of compensation. A special catch-up rule allows larger contributions to be made for one or more of the participant's last three years before retirement. The inflation-adjusted dollar limit as modified by the catch-up rule applies to all deferrals under all of an individual's Section 457 plans. In addition, in applying the inflation-adjusted dollar limit, contributions to a 403(b) annuity, elective deferrals to 401(k) plan, salary reduction contributions to a SEP, and contributions to a SIMPLE plan all are taken into account.

New law. For years beginning after 2001, the Act repeals the rules coordinating the Sec. 457 plan inflation-adjusted dollar limit with contributions to other types of plans. However, the maximum amount that an individual will be able to defer under a Sec. 457 plan during any tax year will still be subject to the inflation-adjusted dollar limit (as modified by any adjustment provided by the catch-up rule).

For example, Able works for a tax-exempt organization that offers both a Sec. 457 plan and a 403(b) annuity. In determining his maximum deferral amount to the Sec. 457 plan, Able will no longer have to reduce his otherwise allowable deferral by the amounts he contributed to the 403(b) plan.

Higher deduction limits for profit-sharing plans will limit deductions for money purchase plans after 2001

Under pre-Act law, contributions to a profit-sharing or stock-bonus plan (other than a SIMPLE 401(k) plan) are deductible to the extent they do not exceed 15% of compensation of the employees covered by the plan for the year. For a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year, subject to the Code Sec. 415 annual addition limits.

New law. For years beginning after 2001, contributions to a profit-sharing or stock-bonus plan are deductible to the extent they do not exceed 25% of compensation of the employees covered by the plan for the year. Additionally, except as provided by regulations, defined contribution plans that are subject to the funding standards of Code Sec. 412 (including money purchase and target benefit plans) will be subject to the same limits on deductible employer contributions as profit-sharing or stock-bonus plans.

Compensation will include salary reduction amounts for purposes of deduction limits on qualified plan contributions after 2001

Employer contributions to qualified retirement plans are deductible subject to certain limits. In some cases, the amount of deductible contributions is limited by compensation. For example, for a profit-sharing or stock-bonus plan, the employer generally may deduct an amount equal to 15% of compensation (25% after 2001) of the employees covered by the plan for the year.

Under pre-Act law, "compensation" for purposes of the deduction rules generally includes only taxable compensation, and thus does not include salary reduction amounts such as elective deferrals under a 401(k) plan or a 403(b) annuity, elective contributions under a deferred compensation plan of a tax-exempt organization or a state or local government (Sec. 457 plan), or salary reduction contributions under a Code Sec. 125 cafeteria plan.

New law. For years beginning after 2001, the definition of "compensation" will include:

1. (a) elective deferrals under Code Sec. 402(g)(3) (e.g., to 401[k] plans and 403[b] annuities), and (b) amounts contributed or deferred by an employer at an employee's election under a Code Sec. 125 cafeteria plan or a Code Sec. 457 plan and not includible in the employee's income—as provided in Code Sec. 415(c)(3)(D).
2. The amount of compensation that a participant would have received for the year if he were paid at the rate of compensation paid immediately before becoming permanently and totally disabled—as provided in Code Sec. 415(c)(3)(C).

Post 2005 option to treat elective deferrals as Roth-IRA type contributions

Allowable elective deferrals to 401(k) plans and 403(b) annuities (and earnings on the deferrals) are not included in the participant's income until they are distributed from the plan. Under pre-Act law, participants cannot direct that their elective deferrals be treated as Roth IRA contributions.

New law. For tax years beginning after 2005, a 401(k) plan or 403(b) annuity will be allowed to include a "qualified Roth contribution program" that allows participants to elect to have all or part of their elective deferrals treated as Roth contributions. These deferrals will not be excludible from gross income (in other words, they will be taxed currently). The annual dollar limit on a participant's Roth contributions will be the then-applicable Code Sec. 402(g) limitation on elective deferrals (e.g., $15,000 in 2006, reduced by the elective deferrals that he does not designate as Roth contributions. A Roth contribution will be treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions.

The plan will have to establish a separate account and maintain separate record keeping for a participant's Roth contributions (and earnings that accrue on them). A qualified distribution (as defined for Roth IRA purposes) from a participant's Roth contribution account will not be taxed to the participant.

This new option for elective deferrals will allow taxpayers to make larger annual Roth IRA contributions than they can make with regular Roth IRAs.

Tax credit to help lower-income taxpayers save for retirement from 2002-2006

New law. For tax years beginning after 2001 and before 2007, eligible lower-income taxpayers will be able to claim a nonrefundable tax credit for contributions to certain qualified plans.

The credit rate (50%, 20%, or 10%) depends on the taxpayer's filing status and AGI, as follows:

1. Joint filers: 50% for $0-$30,000; 20% for $30,000-$32,500; and 10% for $32,500 to $50,000 (no credit if AGI is above $50,000).
2. Heads of households: 50% for $0-$22,500; 20% for $22,500-$24,375; and 10% for $24,375-$37,500 (no credit if AGI is above $37,500).
3. All other filers: 50% for $0-$15,000; 20% for $15,000-$16,250; and 10% for $16,250-$25,000 (no credit if AGI is above $25,000).

The maximum annual contribution eligible for the credit is $2,000.

The credit will be in addition to any deduction or exclusion that would otherwise apply for a contribution and will offset AMT as well as regular tax liability. Only an individual who is 18 or older (other than a full-time student, or an individual allowed as a dependent on another taxpayer's return for that tax year) will be eligible for the credit. The credit will be available for elective contributions to 401(k) plans, 403(b) annuities, Sec. 457 plans, SIMPLE or SEP plans, traditional or Roth IRAs, and voluntary after-tax employee contributions to a qualified retirement plan.

The amount of any credit-eligible contribution will be reduced by taxable distributions received by the taxpayer and spouse from any of the above savings arrangements or any other qualified retirement plan during:

1. the tax year for which the credit is claimed,
2. the preceding two tax years, and
3. the period after the end of the tax year and before the due date for filing the taxpayer's return.

This rule will apply to any Roth IRA distributions, whether or not taxable.

Provisions Designed to Enhance Pension Fairness for Women (and Men)

Catch-up contributions for individuals age 50 or older

New law. For tax years beginning after 2001, the otherwise applicable dollar limit on elective deferrals under a Section 401(k) plan, Section 403(b) annuity, SEP, or SIMPLE, or deferrals under a governmental Section 457 plan is increased for individuals who have attained age 50 by the end of the year. The additional amount of contributions that may be made is the lesser of (1) a specified dollar amount or (2) the participant's compensation for the year reduced by his or her other elective deferrals for the year. The dollar amount under a Section 401(k) plan, Section 403(b) annuity, SEP, or Section 457 plan is $1,000 for 2002; $2,000 for 2003; $3,000 for 2004; $4,000 for 2005; and $5,000 for 2006 and later years. The dollar amount under a SIMPLE is $500 for 2002; $1,000 for 2003; $1,500 for 2004; $2,000 for 2005; and $2,500 for 2006 and later years. The $5,000 and $2,500 amounts are adjusted for inflation after 2006.

Although this change and the other changes discussed in this chapter fall under the Act heading "Enhancing Fairness for Women," they apply equally to men and women.

Division of Section 457 benefits in divorce

Relation order (QDRO) rules that govern payment of qualified plan benefits to alternate payees in marital splits are extended to Section 457 plans.

Rollovers allowed among various types of plans

Various tax-favored retirement plans may accept tax-free rollovers from other (but not all other) tax-favored retirement plans. For example, an "eligible rollover distribution" from

a qualified retirement plan may be rolled over tax free to a traditional IRA or another qualified plan but not to other tax-favored retirement plans, such as a Section 403(b) annuity plan.

New law. For distributions after December 31, 2001, eligible rollover distributions from qualified retirement plans, Section 403(b) annuities, and governmental Section 457 plans, as added by Act Sec. 641(a)(1) generally may be rolled over to any of such plans or arrangements. Similarly, distributions from an IRA generally may be rolled over into a qualified plan, Section 403(b) annuity, or governmental Section 457 plan. The direct rollover and withholding rules are extended to distributions from Section 457 plans, and they must provide written notification regarding eligible rollover distributions. Qualified plans, Section 403(b) annuities, and Section 457 plans are not required to accept rollovers.

The rollover notice (for all plans) must include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different from those that apply to distributions from the distributing plan.

A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under pre-Act law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over; the rollover must be made to a "conduit IRA," and then rolled back into a qualified plan. (Act Sec. 641[f][3])

Amounts distributed from a Section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan.

Rollover of after-tax contributions

After-tax employee contributions to a qualified retirement plan cannot be rolled over into another tax-favored retirement vehicle.

New law. For distributions after December 31, 2001, employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. For a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. A qualified plan cannot accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings on those contributions). After-tax contributions (including nondeductible contributions to an IRA) cannot be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or Section 457 plan. For a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or Section 403(b) annuity.

New law. For distributions after December 31, 2001, surviving spouses qualify for expanded rollover opportunities. They can roll over distributions to a qualified plan, Section 403(b) annuity or governmental Section 457 plan in which the spouse participates. As under pre-Act law, they also can roll over distributions into IRAs.

Purchase of service credit under governmental pension plans

A qualified retirement plan maintained by a state or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits. A participant may not use a rollover or direct transfer of benefits from a Section 403(b) annuity or a Section 457 plan to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

New law. For transfers after December 31, 2001, a participant in a state or local governmental plan is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a Section 403(b) annuity, or a Section 457 plan if the transferred amount is used (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state). Employers may disregard rollovers for purposes of cash-out rules.

Rollover of nonforfeitable accrued benefit

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000.

New law. For distributions after December 31, 2001, a plan may provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of the benefit that's attributable to rollover contributions (and any earnings allocable to those contributions).

Minimum distribution and inclusion requirements for Section 457 plans

Amounts deferred under a Section 457 plan are generally includible in income when paid or made available. Section 457 plans are subject to the minimum distribution rules applicable to qualified pension plans and to additional minimum distribution rules.

New law. For distributions after December 31, 2001, amounts deferred under a Section 457 plan of a state or local government are includible in income when paid. The special minimum distribution rules for Section 457 plans are repealed, and those plans are subject to the minimum distribution rules that apply to qualified plans.

Opportunity to claim otherwise time-barred refunds in connection with special use valuation

For purposes of the estate tax special use valuation rules, a surviving spouse or a lineal descendant of the decedent is not treated as failing to use qualified real property in a qualified use solely because the spouse or descendant rents the property to a member of the family of the spouse

or descendant on a net-cash basis. Before August 5, 1997, the law permitted only surviving spouses to lease specially valued property on a net-cash basis. The change was adopted in 1997 and made retroactive to cash leases entered into after December 31, 1976, but it included no provision to permit refunds that were time-barred or requested more than three years after the return was filed or more than two years after the tax was paid.

New law. Refunds that were time-barred on the date of enactment may be claimed for a period of one year from the date of enactment, notwithstanding that the statute of limitations had run.

Given that the leasing provision was made retroactive to 1976, refunds, when increased by interest, could be substantial.

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