



# Current Report

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## Economic Growth and Tax Relief Reconciliation Act of 2001: Provisions Effective in 2001-2002

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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 the changes in income tax law that will be effective in 2001 and 2002. Provisions that will become effective in tax years 2003 through 2009 are discussed in a future current report. 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

- Tax rate reductions—a new 10% bracket takes effect for 2001, and the current law’s 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 But after these taxes are repealed, the current law’s basis-step-up rule will be replaced with a modified carryover basis rule that generally will give recipients a basis equal to the lesser of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 also will 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.

### New 10% Income Tax Rate Bracket is Carved Out of 15% Bracket Retroactive to Start of 2001

For tax years beginning after 2000, the Act creates a new 10% tax bracket that applies to:

- The first \$6,000 of taxable income for single individuals and married taxpayers filing separately.
- The first \$10,000 for heads of household.
- The first \$12,000 for married joint return filers and surviving spouses.

In 2001, the 10% rate will save a maximum of \$300 for single taxpayers, \$500 for heads of household, and \$600 for married joint filers. The 10% rate actually will not be fully

effective until 2002. For 2001, the benefit of that lower rate will be received through a credit/rebate mechanism.

There is no 10% bracket for estates and trusts, and no cost-of-living adjustments (COLA) will be made to the 10% rate brackets before the 2009 tax year. The 15% tax rate continues to apply to taxable income in excess of the amounts subject to the 10% rate, up to the maximum dollar amounts for the 15% bracket.

## Rate-reduction Credit in Lieu of 10% Rate for 2001

To accelerate the benefit of the 10% rate bracket as an economic stimulus, a rate-reduction credit will apply in lieu of the 10% rate in 2001, computed as follows: Individuals would be entitled to a nonrefundable credit in 2001 of 5% of the amount of their income otherwise eligible for the 10% rate.

Most taxpayers, however, will receive this credit in the form of a check issued by the Treasury, computed in the same manner as the credit but on the basis of their 2000 tax returns (instead of 2001). In other words, the benefit of the credit is being accelerated and figured as if the credit applied on the taxpayer's 2000 return. On their 2001 returns, taxpayers will have to reconcile the amount of the credit with the check they receive by completing a worksheet calculating the credit based on their 2001 tax return. They will then subtract from the credit the amount of the check they received.

For many taxpayers, these two amounts will be the same. If, however, the result is a positive number (because the taxpayer paid no tax for 2000 but owes tax for 2001), the taxpayer may claim that amount as a credit against 2001 tax liability. If, however, the result is negative (because the taxpayer paid tax in 2000 but owes no tax for 2001), the taxpayer will not have to repay that amount to the IRS.

## 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%

For 2001, the tax rates above 15% are blended rates. Thus, for 2001 the blended rates would be 27.5%, 30.5%, 35.5%, and 39.1%. Cost-of-living adjustments will be made to the reduced rate brackets. Thus, the bracket ranges will continue to be inflation-indexed during the period while the rates are decreasing.

## Temporary Boost in Alternative Minimum Tax (AMT) Exemption Amount for Individuals

Effective for tax years beginning in 2001 through 2004, the AMT exemption amounts for individuals are increased by

\$4,000 for married taxpayers filing jointly and \$2,000 for all others. The dollar levels at which the AMT exemption begins to phase out for individuals are not changed, and neither is the exemption phase-out percentage. As a result, the AMT exemption amounts and phase-outs for 2001 through 2006 are as follows:

1. Married individuals filing jointly and surviving spouses: \$49,000 less 25% of AMTI exceeding \$150,000 (zero exemption when AMTI is \$346,000).
2. Unmarried individuals: \$35,750 less 25% of AMTI exceeding \$112,500 (zero exemption when AMTI is \$255,500).
3. Married individuals filing separately: \$24,500 less 25% of AMTI exceeding \$75,000 (zero exemption when AMTI is \$173,000). But AMTI of married individuals filing separately must be increased by the lesser of \$24,500 or 25% of the excess of AMTI (before considering this increase) over \$173,000.

## Provisions Affecting Children

### Child Credit Begins to Increase to \$1,000 Beginning in 2001

Under pre-Act law, an individual may claim a \$500 tax credit for each son or daughter (or descendent of either), stepson or stepdaughter, or eligible foster child under the age of 17 whom the taxpayer can claim as a dependent. The credit is not adjusted annually for inflation. The otherwise available credit is reduced by \$50 for each \$1,000 (or part of \$1,000) of modified AGI over \$75,000 for singles or heads of household, \$110,000 for joint return filers, and \$55,000 for marrieds filing separately. The Act increases the maximum credit to \$1,000 per child under the following schedule. These increased child credit amounts will not be indexed for inflation.

Calendar Year	Credit Amount Per Child
2001-2004	\$600
2005-2008	\$700
2009	\$800
2010 and later	\$1,000

### Child Credit is Made Refundable for Some Starting in 2001

Under pre-Act law, the child credit generally is nonrefundable. However, for families with three or more qualifying children, an additional child credit is refundable up to the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit. For tax years 2001-2004, the Act makes the child credit refundable to the extent of the greater of:

1. 10% of earned income above \$10,000.
2. For taxpayers with three or more qualifying children, the excess of the taxpayer's social security taxes for the tax year over the taxpayer's earned income credit for the year.

For tax years beginning after 2001, the \$10,000 refundable earned-income threshold will be indexed for inflation. This will operate to increase the earnings level at which the child credit begins to be refundable.

## **Child Credit Permanently Allowed Against AMT**

Effective after 2001, the Act permanently allows the child tax credit to be taken against AMT. Specifically, the child tax credit will be allowed against the regular income tax plus the AMT, less other nonrefundable credits and the foreign tax credit. The Act also repeals the alternative minimum tax offset of refundable credits, effective for tax years beginning after 2000.

## **Adoption Credit and Exclusion Increased After 2001 and Made Permanent**

The Act permanently extends the adoption credit for children other than special needs children (for whom the credit already was permanent). After 2001, the maximum credit is increased to \$10,000 per eligible child, including special needs children. The phase-out range is increased to \$150,000-\$190,000 of modified AGI. In addition, the adoption credit is allowed, permanently, against the alternative minimum tax.

The income exclusion for employer-provided adoption assistance also is made permanent, and after 2001 is increased to a maximum of \$10,000 per eligible child, including special needs children, and the phase-out range is increased to \$150,000-\$190,000 of modified AGI. The amounts of the allowable credit and/or exclusion, and the limitation amounts, will be indexed for inflation in tax years beginning after 2002. Qualified expenses paid or incurred in tax years beginning before 2002 remain subject to the present-law dollar limits. After 2002, the \$10,000 credit and the \$10,000 exclusion are available for special needs adoptions in the year the adoption becomes finalized, regardless of whether the taxpayer has qualified adoption expenses.

## **Employer Credits for Childcare Expenses After 2001**

For tax years beginning after 2001, there will be new tax credits for costs related to employer-provided childcare facilities. One credit will equal 25% of qualified expenses for employee childcare and another will be 10% of qualified expenses for childcare resource and referral services. The maximum total credit will be \$150,000 per tax year. Qualified childcare expenses will include costs paid or incurred:

1. To acquire, construct, rehabilitate, or expand property to be used as part of the taxpayer's qualified childcare facility.
2. For the facility's operation, including training and certain compensation costs for its employees.
3. Under a contract with a qualified childcare facility to provide childcare services to employees of the taxpayer.

The principal use of the facility will have to be for childcare (unless it is the principal residence of the taxpayer), and the facility will have to meet all applicable state and local laws and regulations, including any licensing laws. It will also have to have open enrollment to the taxpayer's employees and not discriminate in favor of highly compensated employees. If the facility is the taxpayer's principal trade or business, at least 30% of the children enrolled in the center will have to be dependents of the taxpayer's employees.

Qualified childcare resource and referral expenses are amounts paid or incurred under a contract to provide childcare resource and referral services to the taxpayer's employees, which must be provided in a nondiscriminatory way. Any amounts for which the taxpayer may otherwise claim a related tax deduction will have to be reduced by the amount of these credits. Similarly, credits for expenses of acquiring, constructing, rehabilitating, or expanding a facility, will reduce the taxpayer's basis in the facility. Recapture provisions will apply for the first 10 years after the facility is placed in service.

## **Tax Benefits for Education**

### **Coverdell Education Savings Account (formerly Education IRA) Rules Before 2002**

Allowable annual contributions to tax-exempt education IRAs are not deductible, but distributions for an individual beneficiary's qualified higher education expenses are tax-free. These expenses include tuition, fees, and expenses of the beneficiary's undergraduate- or graduate-level attendance at an eligible educational institution, and, for half-time or greater students, basic room and board (or \$2,500 per year for off-campus away-from-home students), reduced by tax-free scholarships and similar excluded payments. The education IRA balance must be distributed to the beneficiary within 30 days after the beneficiary turns age 30, or, if sooner, to the beneficiary's estate within 30 days after his or her death, unless transferred to a family member's education IRA.

Annual contributions to education IRAs for any beneficiary cannot exceed \$500 and cannot be made after the beneficiary turns age 18. The contribution limit phases out for contributors with modified AGI between \$95,000 and \$110,000 (\$150,000 and \$160,000 for joint filers). Contributions to an education IRA, which cannot be made by a corporation, partnership, estate or trust, are taken into account in the tax year in which they are made. A 6% excise tax applies on contributions to an education IRA in a year when contributions are made to a qualified state tuition program for the same beneficiary.

Distributions in excess of qualified higher education expenses are taxable and generally are subject to a 10% additional tax unless one of several exceptions applies, including an exception for contributions withdrawn by the beneficiary's tax return due date (including extensions), or, generally, April 15 if the beneficiary does not have to file a return. No HOPE scholarship credit or Lifetime Learning credit is allowed for an individual's education expenses for a tax year if a tax-free education IRA distribution is made for that year.

### **Coverdell Education Savings Account Rules Liberalized after 2001**

For tax years beginning after 2001, the per-beneficiary contribution limit will increase to \$2,000 per year, and the definition of qualified education expenses will include the following:

1. Elementary (including kindergarten) and secondary public, private, or religious school tuition and expenses, including tutoring, room and board, uniforms, and extended-day program costs, and special needs services for a special needs beneficiary. The Conference Agreement says regulations are to define special needs beneficiaries to include individuals who because of a physical, mental,

or emotional condition (including a learning disability) require additional time to complete their education.

2. The purchase of computer technology or equipment (including software), and Internet access and services, if they are to be used by the beneficiary and his or her family during any of the beneficiary's school years. Sports, game, or hobby software will qualify only if predominantly educational in nature.

These additional changes also take effect for tax years beginning after 2001:

- The contribution phase-out range for joint filers will increase to \$190,000-\$220,000, double the phase-out range for single filers.
- Coverdell Education Savings Account (CESA) contributions for special-needs beneficiaries will be allowed after they attain age 18, and deemed distributions of CESA balances will not occur when those beneficiaries reach age 30.
- Corporations and other entities, including tax-exempts, will be able to contribute to CESA, regardless of the entity's income.
- Individuals will be allowed to make a CESA contribution for a tax year as late as their unextended due date for filing that year's return (generally April 15 of the following year).
- Taxpayers will be able to claim HOPE and Lifetime Learning credits for a student in a year when excluded distributions are made from a CESA for that student, as long as credits are not claimed for amounts paid with tax-free distributions.
- There will be no excise tax if contributions to a CESA for a beneficiary are made in a year when a contribution also is made to a state tuition program for the same beneficiary.
- The 10% additional tax on taxable distributions will not apply to income on contributions withdrawn before the first day of the sixth month of the year following the year of the contribution.
- If annual distributions from CESAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary will have to allocate the expenses between the distributions to find the amount includible in income.

### **Qualified Tuition Programs will Include Private Institutions; Payouts from Qualified Tuition Programs will be Excluded**

Under pre-Act law, qualified state tuition programs give tax breaks to taxpayers who save for college on a pre-paid basis. These state-sponsored programs allow a taxpayer to: (a) buy tuition credits or certificates for a designated beneficiary (e.g., the taxpayer's child) who would then be entitled to a waiver or payment of qualified higher educational expenses, or (b) contribute to an account set up to meet the qualified higher educational expenses of a designated beneficiary. In general, qualified higher educational expenses are tuition, fees, books, supplies, and equipment, plus reasonable room and board costs for students under guaranteed plans who are pursuing a course of study on at least a half-time basis.

Qualified state tuition programs allow beneficiary changes only between members of the same family as specially defined. Neither the parent (or other contributor) nor the child (or other beneficiary) is taxed currently on earnings on contributions to the programs. Under pre-Act law:

- The beneficiary is taxed on the earnings when distributions or educational benefits are provided to him.
- Amounts refunded are taxed to the contributor to the extent of earnings (and there must be more than a de minimis penalty imposed on the refund).

To the extent that distributions from qualified State tuition programs are used to pay for qualified tuition and related expenses, the beneficiary (or someone claiming the beneficiary as a dependent) may claim the HOPE or Lifetime Learning credit for those tuition and related expenses (assuming that the credit-qualification requirements are met).

**New law.** Generally for tax years beginning after 2001, the Act expands and liberalizes prepaid tuition programs as follows:

Private institutions may be sponsors. The definition of a "qualified tuition program" will include certain prepaid tuition programs established and maintained by eligible educational institutions (including private institutions) that (1) satisfy the requirements (other than the pre-Act State sponsorship rule) and get an IRS ruling to that effect, and (2) have their assets held in a trust created or organized in the U.S. for the exclusive benefit of designated beneficiaries. Individuals will be able to buy tuition credits or certificates for a designated beneficiary from a private eligible educational institution, but will not be able to contribute to a savings account plan set up to meet the beneficiary's qualifying educational expenses.

Exclusion for qualifying payouts. Distributions will be excluded from gross income to the extent they are used to pay for qualified higher education expenses. The exclusion will apply to post-2001 payouts from qualified state tuition programs, and to post-2003 payouts from qualified tuition programs established and maintained by entities other than a State (or agency or instrumentality). The Act also makes these changes to qualified tuition programs:

1. Qualified higher education expenses will include special needs services for special needs beneficiaries (to be defined in the same way as for education IRA purposes) in connection with their enrollment at an eligible education institution.
2. The rule requiring a tuition program to impose more than a de minimis penalty on refunds will be repealed and replaced with a 10% penalty tax on the amount of the distribution includible in income. During the same tax year, taxpayers will be able to claim a HOPE or Lifetime Learning credit and exclude amounts distributed from a qualified tuition program for the same student as long as the distribution is not used for the same expenses for which a credit will be claimed.
3. A transfer from one qualified tuition plan to another benefiting the same designated beneficiary will not be treated as a distribution, but this tax-free rollover treatment will not apply to more than one transfer within any 12-month period with respect to the same beneficiary.
4. The definition of a family member for purposes of beneficiary changes and rollovers will include first cousins of the original beneficiary.

After the Act's changes, CESAs and qualified tuition programs offer essentially the same income tax benefit, namely tax-free earnings if payouts are made for qualified educational purposes. However, each offers a unique combination of benefits and limitations. For example, a CESA can be used for elementary and secondary school expenses or college costs, but annual contributions are limited to \$2,000 per beneficiary and an individual's contributions are subject to AGI phase-outs. The qualified tuition program, on the other hand, does not restrict contributions, but must be used for higher education. The best savings vehicle ultimately will depend on the needs of the donor and the beneficiary who will receive the education.

### Exclusion for Employer-paid Education will Cover Graduate School and will be Made Permanent

Employers can set up educational assistance programs under which employees can receive up to \$5,250 per year of educational assistance tax-free, whether or not job-related. Under pre-Act law, the exclusion does not apply to graduate-level courses.

**New law.** The Act makes the exclusion for employer-paid education permanent and extends it to employer-paid graduate education, effective for expenses relating to courses beginning after 2001. Employer-paid education or training that is not excludible because it exceeds \$5,250 may be excluded from income if it qualifies as a working condition fringe benefit.

### More Taxpayers will be Eligible for Student-loan Interest Deduction after 2001

For tax years ending after 2001, the income phase-out ranges for eligibility for the student loan interest deduction will increase from \$50,000 to \$65,000 for single taxpayers and from \$100,000 to \$130,000 for married taxpayers filing joint returns. Additionally, effective for loan interest paid after 2001, in tax years ending after 2001, the Act repeals both the 60-month limit on interest deductibility and the rule preventing a deduction for voluntary payments of interest.

### 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 does not exceed \$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/she 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 in determining the amount of an education IRA 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 which 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.

### Higher phase-out range will lessen marriage penalty for joint filers in earned income tax credit after 2001

Certain low-income workers are allowed a refundable earned income credit, computed by multiplying the credit percentage by the individual's earned income up to a specified inflation-adjusted amount. These amounts vary depending on the number of the taxpayer's "qualifying children." For 2001, these amounts are:

Qualifying children	Credit percentage	Earned income amount	Maximum
One	34%	\$7,140	\$2,428
Two	40%	\$10,020	\$4,008
None	7.65%	\$4,760	\$364

The credit is phased out for taxpayers whose earned income (or modified AGI, if greater) exceeds a phase-out amount. The maximum credit amount is reduced by the phase-out percentage multiplied by the earned income (or modified AGI) in excess of the phase-out amount. For 2001, these amounts and the amount at which the phase-out ends and the credit is zero are:

Qualifying children	Phase out percentage	Completed phase out amount	Phase out level
One	15.98%	\$13,090	\$28,281
Two	21.06%	\$13,090	\$32,121
None	7.65%	\$5,950	\$10,710

Married individuals must file jointly to claim the credit. For them, the earned income credit is based on their combined income. This resulted in a marriage penalty for some individuals who receive a smaller earned income credit when they marry than if they had remained single.

For example, an unmarried man and woman each with one qualifying child and earned income of \$13,090 for 2001 may each claim the maximum earned income credit of \$2,428, for a combined credit of \$4,856. If they married during 2001, they could claim a credit of only \$1,251, which is the \$4,008 maximum credit for two qualifying children, reduced by a \$2,757 phase-out amount based on a combined total income of \$26,180.

**New law.** Beginning in 2002, the Act will gradually increase the earned income credit phase-out amounts for joint return filers by \$3,000; which will be adjusted for future inflation. The phase-out amount will increase by:

- \$1,000 for 2002, 2003, and 2004.
- \$2,000 for 2005, 2006, and 2007.
- \$3,000 for 2008 and later years.

The \$3,000 will be adjusted annually for inflation after 2008 if the couple in the preceding illustration married after the \$3,000 phase-in was complete (and assuming for illustrative purposes no indexing change to the phase-out amounts), they could claim a credit of \$1,883, which is \$632 higher than they could claim under pre-Act law.

## Earned Income Credit will be Liberalized after 2001 — Overview

Beginning with the 2002 tax year:

- The phase-out amounts will gradually be increased by \$3,000 for joint return filers (see the marriage-penalty relief section).
- The EIC will be able to be claimed against the alternative minimum tax. EIC calculation will be simplified by using AGI instead of modified AGI, and by simplifying the definition of earned income for EIC purposes to exclude nontaxable earned income amounts. The one-year residency requirement for foster children will be eliminated.
- The current tie-breaking rules that apply where more than one person can claim an earned income credit because of a child will be simplified. If more than one taxpayer claims the earned income credit with respect to a child, then:
  - o If one of the individuals is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent (or parents).
  - o If both parents claim the child and the parents do not file a joint return together, the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year, and second of the parent with the highest AGI.
  - o If no one claiming the child is the child's parent, the child is considered a qualifying child of the taxpayer with the highest AGI.
- Starting in 2004, IRS will be able to use math error authority to deny the EIC to certain noncustodial parents.

## IRA and Pension Benefits

### Higher IRA Contribution Limits Starting in 2002

Under pre-Act law, an individual may make annual deductible contributions to a traditional IRA up to the lesser of \$2,000 or his or her total compensation if neither the individual nor his or her spouse is an active participant in an employer-

sponsored retirement plan. For a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out if AGI exceeds certain levels for the tax year. For example, for 2001, the IRA deduction for single taxpayers phases out over \$33,000 to \$43,000 of AGI (\$53,000 to \$63,000 for married taxpayers filing jointly). For a non-active participant who has an active-participant spouse, the IRA deduction phase-out begins at \$150,000 of AGI.

**New law.** The maximum annual dollar contribution limit for IRA contributions will increase to the following levels: After 2008, the limit will be adjusted annually for inflation in \$500 increments.

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

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

Tax Years	Maximum Deductible IRA Amount (Age 50 & Older)
Beginning	
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). Nondeductible contributions to traditional IRAs generally would be made only by those with AGI above the Roth IRA contribution threshold.

## Annual Defined Benefit and Defined Contribution Limits will Increase After 2001

For years ending after 2001, the maximum annual defined benefit dollar limit will increase to \$160,000. The dollar limit will be reduced for benefits beginning before age 62 (rather than the social security retirement age) and increased for benefits beginning after age 65 (rather than

the social security retirement age). Special rules will apply to plans for airline pilots. For years beginning after 2001, the defined contribution dollar limit will increase to \$40,000 and will be adjusted annually for inflation in \$1,000 increments. The smaller increment for inflation adjustments means that the defined contribution limit will increase sooner than it would under pre-Act law.

### **Annual Compensation taken into Account for Qualified Plan Purposes will Increase After 2001**

**New law.** For years beginning after 2001, the annual compensation that may be taken into account under a plan will increase to \$200,000 and will be adjusted annually for inflation in \$5,000 increments. Nonqualified deferred compensation plans often are set up for high-earning employees whose contributions and benefits are restricted by the various statutory limitations. The need for these nonqualified plans may diminish somewhat because of the increased compensation limits as well as other changes for qualified retirement plans benefiting top earners.

Also for years beginning after 2001, the Act amends the definition of compensation for purposes of all qualified plans and IRAs (including SIMPLE arrangements) to include an individual's net earnings that would be subject to self-employment taxes but for the fact that he is covered by a religious exemption.

### **Post-2001 Increases in Elective Deferral Limits**

In 2002, the maximum annual elective deferral under 401(k) plans, section 403(b) annuities, and salary reduction SEPs will be \$11,000. 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 in years after 2006. The maximum annual elective deferral to a SIMPLE plan will be \$7,000 for 2002. In 2003 and later years, the SIMPLE limit will be increased in \$1,000 annual increments until it reaches \$10,000 in 2005. After 2005, the \$10,000 dollar limit will be adjusted annually for inflation in \$500 increments.

### **Plan Loans OK'd for S Shareholders, Partners, and Sole Proprietors After 2001**

Qualified plan loans to non-owner-employees are exempt from the prohibited transaction rules if certain conditions are met. However, under pre-Act law, a plan loan to an owner-employee is treated as a prohibited transaction subject to excise taxes. Owner-employees include sole proprietors, partners who own more than a 10% interest in the partnership, more than 5% owner-employees or officers of an S corporation, and IRA owners.

**New law.** For years beginning after 2001, the rule treating plan loans to owner-employees as prohibited transactions will apply only to an IRA participant or beneficiary or an employer or association of employees that establishes an IRA. Loans from SEPs, SIMPLEs, and IRAs will continue to be prohibited transactions.

### **Tax Credit to Help Lower-income Taxpayers Save for Retirement From 2002-2006**

Pre-Act law does not provide a tax credit to encourage participation in any tax-favored retirement-savings vehicles.

**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: \$0-\$30,000, 50%; \$30,000-\$32,500, 20%; and \$32,500 to \$50,000, 10% (no credit if AGI is above \$50,000).
2. Heads of households: \$0-\$22,500, 50%; \$22,500-\$24,375, 20%; and \$24,375-\$37,500, 10% (no credit if AGI is above \$37,500).
3. All other filers: \$0-\$15,000, 50%; \$15,000-\$16,250, 20%; and \$16,250-\$25,000, 10% (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 over (other than a full-time student, or an individual allowed as a dependent on another taxpayer's return for a tax year beginning in the calendar year in which the individual's tax year begins) 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 for the year. This rule will apply to any Roth IRA distributions, whether or not taxable.

### **Tax Credit will Help Small Businesses Offset the Cost of Setting Up a New Qualified Plan After 2001**

**New law.** For costs paid or incurred in tax years beginning after 2001, small employers will be able to claim a nonrefundable credit for part of the cost of adopting a new qualified retirement plan (including a 401(k), SEP, or SIMPLE plan). The credit will be equal to 50% of administrative and retirement-education expenses for the plan for each of the first three plan years, with a maximum credit of \$500 for each year. It will only be available to businesses that did not employ, in the preceding year, more than 100 employees with compensation of at least \$5,000. To be eligible for the credit, the plan will have to cover at least one non-highly compensated employee. The committee reports say that if the credit is for the cost of a payroll deduction IRA plan, it must be made available to all employees who have worked with the employer for at least three months.

## Provisions Designed to Enhance Pension Fairness for Women (and Men) Catch-up Contributions for Individuals Age 50 or Over

Various rules limit the amount of elective deferrals that may be made to tax-favored retirement plans.

**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, 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.
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 section fall under the Act heading "Enhancing Fairness for Women," they apply equally to men and women.

## Equitable Treatment for Contributions of Employees to Defined Contribution Plans

Various rules limit the amount of contributions that may be made to tax-favored retirement plans. For example, the limit on annual additions that may be made to a defined contribution plan on behalf of an individual is the lesser of \$35,000 (for 2001) or 25% of compensation. Section 403(b) annuities and section 457 plans are subject to their own special limitations.

**New law.** For years beginning after 2001, the 25% of compensation limitation on annual additions under a defined contribution plan is increased to 100%, the special limits for section 403(b) annuities are eliminated, and the limit for section 457 plans is increased.

## Faster Vesting of Certain Employer Matching Contributions

A plan is not qualified unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules.

**New law.** Generally for contributions for plan years beginning after December 31, 2001, faster vesting schedules apply to employer matching contributions. Employer matching contributions must vest at least as rapidly as under one of the following two alternative minimum vesting schedules:

1. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of employer matching contributions on completion of three years of service.
2. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100% after six years of service.

## Hardship Distributions

One requirement for satisfying a regulatory safe harbor for hardship distributions is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.

**New law.** For years beginning after December 31, 2001, IRS is directed to reduce this period to six months.

## Waiver of 60-day Rule

A distribution from a retirement plan must be rolled over within 60 days to be tax-free. IRS does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster.

**New law.** For distributions after December 31, 2001, IRS may waive the 60-day rollover period if the failure to waive would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.

## Time for Payment of Corporate Estimated Taxes

Corporations generally must make quarterly estimated tax payments of their income tax liability. Calendar-year corporations must make payments by April 15, June 15, September 15, and December 15.

**New law.** For corporate estimated tax payments that would have been due on September 17, 2001, the due date is changed to October 1, 2001. For corporate estimated tax payments due on September 15, 2004, 80% must be paid by September 15, 2004, and 20% must be paid by October 1, 2004. (Act Sec. 801)

## Expansion of Authority to Postpone Certain Tax-related Deadlines by Reason of Presidentially Declared Disaster

IRS may specify that certain deadlines are postponed for a period of up to 90 days for taxpayers affected by Presidentially declared disasters.

**New law.** Effective on the date of enactment, the 90-day period is increased to 120 days.

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