Tax Relief Act of 2001 - Part II

The 2nd Quarter 2001 Newsletter began an important discussion of the changes resulting from recently enacted tax legislation referred to as the Tax Relief Act of 2001 (Tax Act). This issue of the Newsletter continues the discussion. The major components of the Tax Act discussed in this issue include:

- Individual Tax Rate Reductions
- Tax Credit Changes

Year-End Planning

A key component of the Tax Act is the gradual reduction in marginal tax rates. As illustrated by the following table, most rate brackets are reduced by .5% from 2001 to 2002, and by 1% every other year thereafter until 2006 when the rates bottom out:

Year	28.0%	31%	36.0%	39.6%
2001	27.5%	30.5%	35.5%	39.1%
2002/3	27.0%	30.0%	35.0%	38.6%
2004/5	26.0%	29.0%	34.0%	37.6%
2006	25.0%	28.0%	33.0%	35.0%

Strategy #1 - Defer Income[1]

Generally, taxpayers expecting to be in the 27.5% or higher rate bracket in 2001 will realize permanent tax savings of 50¢ for each $100 of income deferred into 2002. Consider the following methods for deferring income:

- Contribute to pre-tax retirement accounts.
- Discuss with your employer the possibility of deferring payment of all bonuses and/or taxable reimbursements.[2]
- Postpone billing for services rendered.[3]
- Postpone selling securities with short-term unrealized gains.[4]
- Postpone exercising nonqualified stock options that are in-the-money.

Strategy #2 - Increase 2001 Deductions

Taxpayers who benefit from itemizing deductions will generally realize permanent tax savings by bunching deductions in 2001 versus spreading them between 2001 and 2002[5]. Consider the following methods for bunching deductions in 2001:

- Donate cash or property to a qualified charity. The value of a property donation is generally its fair market value as of the date of the donation.
- Pay estimated state income taxes by December 31 rather than the following January[6].
- Purchase a home and pay points on the home mortgage loan[7].

Expansion of Tax Credits

The Tax Act boosts the number of taxpayers able to utilize many of the existing tax credits. Part of this expansion results from increasing the related phase-out ranges. For example, whereas the adoption credit is currently reduced for taxpayers with $75,000 of adjusted gross income (AGI), after 2001, the phase-out begins at $150,000 of AGI. Note some of the additional changes:

- The per child tax credit increased from $500 in 2000 to $600 in 2001, and will rise to $1,000 in 2010 and beyond.
- The maximum adoption credit will be increased from $5,000 to $10,000 beginning in 2002.
- Expenses considered in the calculation of the dependent care credit are increased from $2,400 to $3,000 beginning in 2003.

[1] The possibility exists that income tax rates may rise in the future, counteracting the current benefit for income deferral. Additionally, income deferral may involve potential AMT and category of income issues.

[2] This change must be made for all employees. Generally, accrual basis employers may deduct in year 1 payments made in the first 2.5 months of year 2 for items earned by employees but not paid to them by the end of year 1.

[3] Applies to cash basis taxpayers only.

[4] Netting capital losses against short-term gains may provide a greater tax savings than income deferral. Additionally, tax implications should not be the sole consideration in determining when to sell securities.

[5] Increasing deductions in the current year may give rise to AMT adjustments.

[6] The taxpayer must have a reasonable expectation that taxes are owing as of the date the estimated payment is made.

[7] Paying points must be an established practice in the area involved.