Understanding the Effects of the 2001, 2003, and 2004 Income Tax Cuts

The major tax laws of the past 4-5 years have probably had a significant impact on your paycheck and your overall "tax bill." Among other changes, they have

- decreased income tax rates.
- provided partial relief from the "marriage penalty,"
- increased the Child Tax Credit,
- increased the amount you could put away in tax-preferred savings plans,
- created a tax credit you could take if you participated in certain retirement savings plans,
- extended the ability of your employer to provide you with non-job-related educational assistance, and
- allowed many taxpayers to save on a tax-preferred basis for future medical expenses – even expenses that will be incurred in future years.

Read on to learn more and to make sure that you are taking advantage of all the tax cuts you can.

Overview

There have been a lot of important new tax laws since 2001. Here are the acronyms and names of some of these big events.

2001: EGTRRA: Economic Growth and Tax Relief Reconciliation Act
2003: JGTRRA: Jobs and Growth Tax Relief Reconciliation Act
MPDIMA: Medicare, Prescription Drug, Improvement, and Modernization Act
2004: WFTRA: Working Families Tax Relief Act
AJCA: American Jobs Creation Act

EGTRRA (2001) is the one that started the series of tax cuts that have the most impact on the average person's pay check. It set up a schedule under which the tax rates would slowly go down and certain tax benefits would slowly increase. These various increases and decreases were to take place over a 5- to 7-year period – there were different implementation schedules for the different changes. Two years later, JGTRRA (2003) accelerated the implementation schedule for many of those changes, bringing them into full bloom, so to speak, but only for 2003 and 2004. After that, they'd go back to the schedule set up under EGTRRA. The next year, WFTRA (2004) made those accelerations permanent, with a few exceptions. Many of the tax cuts expire completely after 2010, unless Congress and the President enact another tax cut. Details are below.

MPDIMA's big tax impact is the establishment of Health Savings Accounts (not the same as Flexible Spending Accounts). AJCA made an important clarification with regard to stock option plans and set up a special tax withholding procedure for the very highly paid employees. Again, details are below.

Creation of a new tax bracket
Before EGTRRA, we had five income tax brackets. An income tax bracket represents a portion of income that is subject to a certain tax rate. For example, before EGTRRA, the first $27,050 of taxable income of someone filing as “single” was subject to a 15% tax rate. EGTRRA carved out a portion of that, creating a sixth income tax bracket, to be subject to only a 10% income tax rate. Currently, the 10% rate applies to the first $7,300 of taxable income of “single” and “married filing separately” filers, the first $14,600 of those who are “married filing jointly,” and the first $10,450 of “heads of household.” Remember that your taxable income is what's left on your personal income tax return after you subtract your standard or itemized deductions and your personal exemption amounts. So, some of your income is not subject to any tax at all.

This new tax bracket benefits even the highest-income taxpayers, because under our progressive tax system, the first portion of someone’s taxable income is taxed at the lowest tax rate, the next portion is taxed at the second-lowest tax rate, and so on.

This is one of the items that will expire on December 31, 2010.

Decrease in individual income tax rates
This chart shows the different tax rates across the six income tax brackets. As mentioned above, the tax cuts were going to be more gradually phased in, with the final rate reductions taking place in 2006. However, JGTRRA and WFTRA accelerated the tax reductions.

EGTRRA also set the supplemental wage withholding rate (for bonuses, retroactive wages, etc.) at the third lowest tax rate, currently 25%.

This is one of the items that will expire on December 31, 2010. Without another tax cut, the rates in 2011 will look like those on the line below for “Before the cuts.”

Year		Income Tax Percentages				
Before the cuts *	15	15	28	31	36	39.6
2001 **	10	15	27.5	30.5	35.5	39.1
2002	10	15	27	30	35	38.6
2003 and forward***	10	15	25	28	33	35

* Before the tax cuts, there were only five tax brackets and five corresponding tax rates, but since the 2001 tax cut split the 15% tax bracket into two brackets – 10% and 15% – the 15% tax bracket is represented twice for comparison to rates in subsequent years.

** The tax cut was signed into law in the middle of 2001, but the rate reductions were retroactive to the beginning of the year. Because some of the wages that had been subject to 15% withholding were now subject to only 10% taxation, which was a greater percentage reduction than any other cut that year or since that year, rebate checks were sent out by the U.S. Treasury.

*** The tax cut was signed into law in the middle of 2003, but the rate reductions were retroactive to the beginning of the year.

“Marriage Penalty” relief
The tax cuts increased the size of the “standard deduction” for a married couple filing a joint personal income tax return to exactly double that of an unmarried individual filing a single income tax return. The standard deduction is an amount that you get to subtract from your gross income to arrive at your taxable income, and it is supposed to represent a portion of the most basic of living expenses that shouldn’t be subject to tax. It varies by filing status, but now, a married couple (two persons) gets to claim twice that of a single filer (one person).

In addition, the tax cuts increased the size of the 15% tax bracket for joint-filing, married couples to be exactly double that of single filer’s income subject to the 15% tax rate. That is, the amount of income subject to the 15% rate (instead of being subject to a higher tax rate) for two persons is twice as much as the amount of income subject to the 15% rate for one person.

This is another of the items that will expire on December 31, 2010.

Increase in Child Tax Credit
Before the tax cuts, you could take a tax credit of a maximum of $500 per qualifying child under age 17. The tax cut laws increased that maximum to $1,000 per qualifying child under age 17. A “tax credit” is even better than a “tax deduction,” because instead of reducing your taxable income, it comes right off your tax liability. And you can adjust your withholding on Form W-4 to take advantage of it now, instead of waiting until you file your personal income tax return, and get more money in each paycheck.

Check out the rules at http://www.irs.gov/newsroom/article/0,,id=106182,00.html and get a Form W-4 at http://www.irs.gov/pub/irs-pdf/fw4.pdf.

Without another tax law change, the maximum tax credit will go back down to $500 as of 2011.

Increase in limits on tax-preferred savings plans
EGTRRA set in motion a year-by-year significant increase in the amounts you could set aside in various tax-preferred savings plans. In the case of 401(k), 403(b), 457, and SIMPLE plans, these amounts are taken as pre-tax deductions from your pay, thereby decreasing the amount of your wages subject to income tax.

The maximum amounts for each plan are listed in the chart below. There were increases in the years 2002-2004, but we’re just showing you the facts for the current year and forward. Where it says “inflation” or “inflation adjustment,” that means that the prior year’s limit may be adjusted, in $500 increments, depending on inflation.

Your company’s plan may set other limits on the amount you may set aside, such as a limit based on a percentage of your wages or a limit on contributions for highly compensated individuals.

Year	401(k) & 403(b)	457 *	SIMPLE	IRA
Before the cuts	$10,500	$8,500	$6,500	$2,000
2005	$14,000	$14,000	$10,000	$4,000
2006	$15,000	$15,000	inflation	$4,000
2007	inflation	inflation	inflation	$4,000
2008	inflation	inflation	inflation	$5,000
2009	------------------- inflation adjustment ------------------			

* For 457 plans: in the three years prior to retirement, these limits are doubled.

Unless Congress and the President enact a change, as of 2011, all the limits will change to amounts based on ten years of inflation adjustments (2001-2010) to the “Before the cuts” amounts.

Additional contributions for individuals age 50 or older
If you are 50 or older at any time during the year, you may make additional contributions to your plan, up to the amounts below. These are not subject to any other limitations, such as those that could be set by your company’s plan (mentioned in the section prior to this).

Year	401(k) & 403(b)	457	SIMPLE	IRA
2005	$4,000	$4,000	$2,000	$500
2006	$5,000	$5,000	$2,500	$1,000
2007	------------------- inflation adjustment ------------------			

“Inflation adjustment” means that the prior year’s amount may be adjusted, in $500 increments, depending on inflation.

Without another tax law change, these additional contributions will not be allowed as of 2011.

Saver’s Tax Credit
EGTRRA created a tax credit for participating in certain employer-sponsored retirement savings plans and even traditional IRAs and Roth IRAs. Depending on your filing status and the adjusted gross income on your personal income tax return, you can take a credit as high as 50% of the first $2,000 you put aside (see table below). That’s a direct saving of as much as $1,000 off of your tax bill. And that’s in addition to the fact that the money put into savings usually reduces your wages subject to taxes.

Maximum Saver's Credit, based on filing status and adjusted gross income

Joint Filer	Head of Household	All Other Filers	Credit Rate (on first $2,000 only)
$0 - $30,000	$0 - $22,500	$0 - $15,000	50%
$30,001 - $32,500	$22,501 - $24,375	$15,001 - $16,250	20%
$32,501 - $50,000	$24,376 - $37,500	$16,251 - $25,000	10%
over $50,000	over $37,500	over $25,000	0%

This tax credit is available through 2006. For more information, see http://www.irs.gov/publications/p590/ch04.html.

Employer-provided educational assistance

Education related to your job and paid for by your employer has been tax-free for quite some time. But as for non-job-related education paid for by your employer, the rules have frequently changed. EGTRRA allows your employer to pay for up to $5,250 in non-job-related educational assistance (for either undergraduate or graduate education) without having to add that amount to your wages and withhold taxes on it. This is set to expire as of 2011.

Unrelated to the tax cuts discussed in this article, there are many tax credits and deductions you can take for education that you pay for, as well as tax-preferred education savings plans that you can set up. Read about them in IRS' Publication 970, Tax Benefits for Education. http://www.irs.gov/pub/irs-pdf/p970.pdf

You might be able to deduct your sales tax

If you would normally itemize your deductions on your personal income tax return, you have the choice, for tax-year 2005, to take those deductions or the amount of state and local sales taxes, whichever is greater. IRS Publication 600, Optional State Sales Tax Tables, helps you determine your sales tax deduction amount, so you don't have to save all those receipts. Check out http://www.irs.gov/newsroom/article/0,,id=133209,00.html

Uniform definition of "qualifying child"

There is now a uniform definition of a "qualifying child" for purposes of claiming several tax benefits, such as head of household filing status, the exemption for a dependent, the child tax credit, the child and dependent care credit, and the earned income tax credit. Prior to 2005, each of these items defined a "qualifying child" differently, leaving many taxpayers confused. Each benefit still has its own additional rules, though. See http://www.irs.gov/newsroom/article/0,,id=133298,00.html

Health Savings Accounts
HSAs (not to be confused with a medical flexible spending account, or FSA) were authorized under MPDIMA. An HSA is an account an individual can create to save money, on a tax-preferred basis, for the qualified medical expenses of the account holder, his or her spouse, and his or her dependents. Unlike an FSA, it is not subject to an annual use-or-lose risk. So, if you are eligible to have an HSA, you can save now for future medical expenses, including long-term care.

However, the only people who may establish an HSA are those who are covered only by a “high deductible health plan” (HDHP), which is defined as a plan that has an annual deductible of at least $1,000 for individual coverage or $2,000 for family coverage, and that has an out-of-pocket expense limit of no more than $5,100 for individual coverage or $10,200 for family coverage. (The out-of-pocket limits are adjusted annually for inflation.) An HDHP may have a lower deductible or none at all for preventative care. And if the HDHP has different sets of deductibles and expense limits for in-network vs. out-of-network services, it is the in-network dollar amounts that will be considered.

Your employer may allow you to have a pre-tax deduction from your wages to make contributions to your HSA.

IRS has issued a lot of guidance on the new HSAs. As soon as they’d answer one set of questions, they’d be presented with many more puzzlers. And so they’d release more guidance. This happened quite a few times! You can find original documentation of all of the IRS rules on this topic, much of it in an easy-to-read question-and-answer format, at one place within IRS’ Web site: http://www.irs.gov/newsroom/article/0,,id=97322,00.html

Qualified stock option plans
Thanks to AJCA, we have a firm rule that exercises of stock options under qualified plans (incentive stock options and employee stock purchase plans) are not subject to any tax reporting or withholding. (There had been some difference of opinion on this topic.) So, if you are eligible to participate in such a plan, you can acquire stock at a discounted amount and not pay any tax on it until you sell it. If certain requirements are met, you’ll pay tax at the capital gains tax rate, which is generally lower than the income tax rates.

Tax withholding on supplemental wages in excess of $1,000,000
In an effort to collect tax at certain people’s true tax rate, AJCA set a higher withholding rate for anyone whose supplemental wages reaches $1,000,000. For those people, any supplemental wages in excess of that amount will be subject to withholding at 35%, instead of the general 25% supplemental wage withholding rate.