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A Somewhat Skeptical Look at 2001 Tax Relief

George Pfeiffer
University of Nebraska - Lincoln, gpfeiffer1@unl.edu

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Perhaps it is the best one could hope for from a government directed by a President selected without a plurality of the popular vote, a closely divided House of Representatives, and a Senate whose majority party is in the process of changing for the third time in 6 months. In any case, the Senate and House have agreed on, and the President will soon sign the first major federal tax reduction bill since 1981. What a difference two decades make! The tax reductions and the massive restructuring of the tax system that were passed in the Reagan revolution of 1981 were almost universally made retroactive to January 1, 1981. Most of the real changes passed in the 2001 tax bill do not become effective until 2005, and many do not become effective until 2010. To further hedge its commitment to tax relief, Congress added a provision that “sunsets” parts of the bill out of existence after 2010, unless reaffirmed by a future Congress and signed by a future President. In any case, we will now look at some of the provisions of the bill, and when they are scheduled to go into effect.

Tax rates have been changed, including a new 10% rate on the first $12,000 of a married couple’s income, retroactive to January 1, 2001. In an unusual move, the rate cut will be refunded in advance, beginning late this summer or early fall. Married taxpayers who earned sufficient income in 2000 may expect to receive a refund of $600, and singles $300 as an early tax refund. Other tax brackets (except the 15% bracket) decline effective 2001 by one-half percent, but are not subject to the advanced refund. Beginning in 2002, all brackets above the 15% bracket decrease an additional one-half percent for 2001-2002, an additional 1% for 2004-2005, and beginning in 2006, an additional 1% except the highest bracket which decreases an additional 1.6%. This makes the highest 2006 and later marginal rate 35% for married couples with income in excess of about $340,000. Of additional benefit to the highest income taxpayers is the elimination of the “phantom” tax which
results from the “phase out” of itemized deductions and personal exemptions that affect roughly the highest 10% of income earning taxpayers. Again, gratification is deferred, as these provisions begin only in 2006 and are not fully implemented until 2010.

Much has been made in recent years about the so called “marriage penalty:” the provisions of the tax code which result in dual career high income earning couples paying substantially more than they would if they were single. Congress addressed this perceived problem, but not immediately. Relief comes in the form of higher standard deductions for joint filers (providing no relief for those who itemize deductions), and an increase of the income that is subject to a 15% tax for couples (providing no relief for those already in the 15% tax bracket). Those affected by the “marriage penalty,” will have to wait until 2005 for any relief and 2008 for full implementation of the provisions. Even with the relief provided, some “marriage penalty” will continue to exist for many dual career married taxpayers.

If the changes described so far seem relatively simple, what Congress has (or has not) done to the Alternative Minimum Tax (AMT) will surely be a boon to tax preparers, accountants and lawyers. Originally enacted in the 60’s to prevent certain high income taxpayers with inordinately large tax preference deductions from paying little or no tax, the AMT calculates tax liability based on an entirely different set of rules. Those subject to AMT pay the greater of their ordinary income tax or the AMT figured tax. Because the AMT is not indexed for inflation, the Wall Street Journal estimates that the approximately 1 million taxpayers who now pay AMT under current law would swell to 17.5 million by 2010. Under the new law that number doubles to some 35.5 million by 2010. Anyone who has labored to complete an AMT form may receive some comfort in their new found companionship, but may find little if any tax relief.

Finally, Congress labored mightily over estate taxes or “death taxes” as critics choose to call them. While those opposing the taxation of estates were able to marshal the political power to enact repeal, they were not able to marshal the power to enact repeal until 2011. Even more curiously, the repeal itself is repealed in 2011 unless reenacted by a later Congress, seemingly giving those wealthy individuals who wish to avoid estate taxes a brief 12 month window during which to die untaxed. Between now and 2010, the estate size exempt from taxation increases progressively to $1 million in 2002, $1.5 million in 2004, $2 million in 2006 and $3.5 million in 2009. Once the estate tax is repealed (and assuming it stays repealed), further complications arise. At that time, the recipient’s basis for most inherited property will revert to the lower of the decedent’s basis or fair market value, whichever is lower, instead of the stepped up fair market value basis as is currently the case. Some who have found the estate tax so distasteful may find the income tax consequences of its repeal equally bitter.

The tax reform act of 1981 lasted five years before a Congress, chastened by the fiscal impacts of excessive tax reductions (or excessive spending in the view of some), passed three consecutive tax reform bills increasing most income taxes in 1986, 1990 and 1993. The result of these tax increases, along with 10 years of unprecedented prosperity, was the budget surpluses we enjoy today. Only time will tell whether tax relief enacted in 2001 will live as long, or whether new Congresses and/or Presidents will take back some or all of the phased in reductions before they occur. Regardless of what happens, one may be confident that a willing Congress has provided ample grist for a whole new generation of tax analysts, accountants and attorneys. One day, a restless or weary public may demand true tax simplification. That day did not occur in 2001.

George Pfeiffer, (402) 472-1775
Farm and Ranch Management

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