THE EFFECT OF THE ECONOMIC GROWTH & TAX RELIEF RECONCILIATION ACT OF 2001 ON REAL ESTATE INVESTORS

by J. Russell Hardin & Jack R. Fay

ABOUT THE AUTHORS

J. Russell Hardin *is an assistant professor of accounting at Pittsburg State University in Pittsburg, Kansas. He is also a CPA and teaches tax courses and financial accounting. Hardin has published several articles and books in the accounting, tax, and international business fields.* [illegible])

Jack R. Fay *is an associate professor of accounting at Pittsburg State University in Pittsburg, Kansas. He is also a CPA and teaches primarily tax courses. Fay has published several articles and books in the tax and accounting fields.* [illegible])

INTRODUCTION

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On June 7, 2001, President George W. Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (hereinafter Act). This sweeping piece of legislation contains numerous amendments to the Internal Revenue Code that will cut federal taxes by $1.35 trillion between now and 2011. Several of the provisions of the Act have implications for real estate investors.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code, that pertain to real estate investments, that are now the law or that will soon become the law. Investors in real estate are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bill that, directly or indirectly, affect real estate investments. Some suggestions for tax planning are also included in the discussions. To determine what effect, if any, each of these provisions will have on a particular investment, a reader should consult with his/her CPA, tax attorney, or other tax professional.

INCOME TAX RATE CUTS

The centerpiece of the new tax law is an across-the-board cut in individual income tax rates. The Act does not provide any major corporate tax relief, reflecting the Bush Administration's effort to limit tax relief to individuals. However, the individual rate cuts will provide relief to real estate investors who conduct business through sole proprietorships, partnerships, and S Corporations.

Prior to the new law, rates ranged from 15 percent to 39.6 percent. The Act makes three major changes to the tax-rate structure:

1. The Act creates a new 10 percent tax bracket.
2. The Act gradually lowers the highest tax rate to 35 percent.
3. The Act cuts most other tax rates by three percentage points.

The new tax law lowers the 15 percent bracket to 10 percent on the first $12,000 of taxable income on a joint return, $6,000 for singles, $10,000 for heads of household, and $6,000 for married persons filing separate returns. This new 10 percent tax bracket provides up to $600 in tax relief for married couples and up to $300 for single individuals. In addition, in 2008, the amount of income subject to the 10 percent bracket increases to $14,000 for married couples filing jointly and $7,000 for single taxpayers.

The highest tax rate (currently 39.6 percent) will be lowered by 4.6 percentage points to 35 percent while all other rates (except for the 15 percent rate) will be lowered by 3 percentage points. The first cut took effect on July 1, 2001, the second cut will take effect in 2004, and the third in 2006. The top rate will eventually drop to 35 percent, the 36 percent rate will drop to 33 percent, the 31 percent rate will drop to 28 percent, and the 28 percent rate will drop to 25 percent (see *Table 1*).

Tax Planning Tip: Individuals should consider deferring ordinary income into subsequent tax years to take advantage of the reduced rates. For example, a taxpayer could receive a year-end bonus on January 1 of next year rather than receiving it on December 31 of the current year to take advantage of the lower tax rate. On the other hand, taxpayers could reduce their tax liability by accelerating deductions to gain the maximum benefit from a tax deduction. For example, a taxpayer could make deductible state estimated tax payments in December, rather than in January. A taxpayer could also make charitable contributions sooner rather than later while still in a higher tax bracket. Finally, individuals should be able to lower their estimated tax payments to reflect the lower tax rates.

REPEAL OF ITEMIZED DEDUCTION LIMITATION

The Act eliminates the overall limitation on certain itemized deductions for high-income taxpayers. Current law subjects most taxpayers with six-figure incomes to an automatic reduction of their itemized deductions (except for medical expenses, casualty and theft losses, and investment interest expense). Specifically in 2001, taxpayers must reduce their itemized deductions by 3 percent of adjusted gross income (AGI) in excess of $132,950 for single individuals and married couples filing joint returns—$66,475 for married individuals filing separate returns. The Act eliminates this overall limitation on itemized deductions over a five-year period. The limitation will be 2 percent of AGI for the 2006 and 2007 tax years, 1 percent of AGI for the 2008 and 2009 tax years, and it will be eliminated completely for tax years beginning after 2009.

Tax Planning Tip: To maximize the benefit of itemized deductions, higher income taxpayers should consider postponing certain itemized deductions (such as employee business expenses) until a future

Table 1

Taxable Years Beginning In:	The corresponding percentages shall be substituted for the following percentages:			
	28.0%	31.0%	36.0%	39.6%
2001	27.5%	30.5%	35.5%	39.1%
2002 and 2003	27.0%	30.0%	35.0%	38.6%
2004 and 2005	26.0%	29.0%	34.0%	27.6%
2006 and thereafter	25.0%	28.0%	33.0%	35.0%

year when a larger portion of the expense will be deductible. However, taxpayers must also consider that tax rates will be lowered over the next several years and that could reduce the tax savings from postponing an itemized deduction into a future taxable year.

REPEAL OF PERSONAL EXEMPTION PHASEOUT

Under present law, deductions for personal exemptions are reduced or eliminated for higher-income taxpayers. The personal exemption deduction for 2001 is reduced by two percent for each $2,500 ($1,250 for married individuals filing separate returns), or fraction thereof, by which the taxpayer's AGI exceeds $199,450 for joint returns, $99,725 for married individuals filing separate returns, $166,250 for heads of households, and $132,950 for single taxpayers. This means that for 2001, personal exemptions and dependency deductions are completely phased out at $321,950 for joint returns and at $255,450 for single returns.

The Act eliminates the phaseout of personal and dependency exemptions by the year 2010. The Act provides that the current phaseout is reduced by one-third of the disallowance amount in taxable years beginning in 2006 and 2007. This fraction increases to two-thirds for taxable years beginning in 2008 and 2009. Finally, the overall limitation ceases entirely for taxable years beginning in 2010. *Tax Planning Tip*: The effect of the phaseout of the personal exemption limitation (and the itemized deduction limitation) is to further lower marginal tax rates for higher-income taxpayers. Therefore, taxpayers should consider paying a lesser amount of estimated tax during the years of the phaseout.

INCREASE IN THE ALTERNATIVE MINIMUM TAX EXEMPTION

The Act is a double-edged sword when it comes to the Alternative Minimum Tax (hereinafter AMT). The Act increases the individual AMT exemption amount by $4,000 for married couples filing jointly and by $2,000 for all other taxpayers. Even though this increase in the exemption is effective for 2001, the provision expires at the end of 2004. This provision is a stop-gap measure to provide some AMT relief until Congress can address the issue in detail. However, if Congress takes no action to revise (or eliminate) the AMT provisions, the number of higher-income and middle-income taxpayers subject to the AMT could rise from 1.4 million this year to 35.5 million by 2010 when the ACT is fully phased in. Part of the increase is due to the lack of an inflation adjustment to the AMT exemption and part of it is due to the new lower tax rates. As a result, millions of taxpayers will realize little or no benefit from the new lower tax rates.

Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act.

ESTATE TAX AND GST TAX REPEAL

From 2001 through 2009, the estate tax and the generation-skipping transfer (GST) tax will be phased out. If Congress makes no changes to this provision in the future, the estate and GST taxes will be repealed in the year 2010. During this 10-year period the maximum estate tax rate will be reduced gradually while the unified credit will increase rather significantly. In 2001 the threshold (exclusion amount) for estate taxes is $675,000, the unified credit is $220,550, and the maximum tax rate is 55 percent. For the next 10 years the amounts are as follows:

Year	Maximum Tax Rate	Estate Tax Exclusion
2002	50 percent	$1 Million
2003	49 percent	$1 Million
2004	48 percent	$1.5 Million
2005	47 percent	$1.5 Million
2006	46 percent	$2 Million
2007	45 percent	$2 Million
2008	45 percent	$2 Million
2009	45 percent	$3.5 Million
2010	0 percent	$0
2011	55 percent	$1 Million

In the year 2011, the maximum tax rate reverts to the 2001 rate, but the exclusion amount reverts to the 2002 rate.

A strange provision in the new laws relates to the "step-up in basis" for inherited property. From 2001 to 2009 the rule will remain the same; that is, inherited property's basis will be stepped up to its fair

market value at date of death. The step-up in basis will be reduced in 2010. This automatic step-up in basis in 2010 will apply only to the first $1.3 million in the estate, plus an additional $3 million for any transfer to a surviving spouse. For any estates above these amounts, the executor will be able to choose which assets would receive the step-up in basis.

Another change affecting federal estate taxes is a change in the state death tax credit deduction. The state death tax credit that can be deducted against the federal estate tax will be reduced by 25 percent in 2002, 50 percent in 2003, 75 percent in 2004, and then the credit will be repealed for tax years beginning on January 1, 2005.

GIFT TAX CHANGES

The gift tax is not going to be repealed. There is a major change, however. Beginning in 2002, a $1 million lifetime gift tax exclusion will apply. This exclusion will pertain to taxable gifts (gifts in excess of $10,000 per year per donee or $20,000 for married donors per year per donee). Besides the lifetime gift tax exclusion, the gift tax rates will decline from the current maximum rate of 55 percent until 2010, when the maximum rate will be 35 percent.

Tax Planning Tip: Taxpayers who plan to make gifts to relatives or anyone else should take advantage of this lifetime exclusion of $1 million during the next 10 years. If they plan to donate more than $1 million, they should defer any excess until later taxable years when the gift tax rates will be significantly lower.

INSTALLMENT PAYMENTS OF ESTATE TAXES

In the past, estates and beneficiaries have often had serious liquidity problems when closely held business interests have been involved. To help eliminate some of these problems, provisions now prescribe that qualifying estates may defer an estate tax related to a closely held business on an installment basis for a period of up to 14 years at a low interest rate. This new installment relief is for certain qualified lending and finance interests (as well as for certain holding company stock). It also increases the maximum number of partners or shareholders in a qualifying closely held business from 15 to 45 to be eligible for the relief.

A lending or finance business must meet several technical requirements to qualify for the installment payment relief. For example, the stock or debt of the corporation could not have been publicly traded at any time within the three years immediately preceding the decedent's death. These changes are effective for decedents dying after 2001.

GAIN EXCLUSION ON SALE OF PRINCIPAL RESIDENCE

The gain exclusion upon the sale of a principal residence ($250,000 for single and $500,000 for married taxpayers) is extended by the Act to residences sold by a decedent's estate and by certain revocable trusts established by the decedent. Unfortunately, this provision only applies to estates of decedents who die in 2010 and thereafter.

OTHER ESTATE TAX ITEMS

The estate tax deduction for a qualified family-owned business interest (QFOBI) is repealed starting in 2004. This deduction is repealed because the estate tax exemption amounts to $1.5 million in 2004 while the QFOBI is limited to $1.3 million, less the estate tax exemption amount.

The 2001 Tax Act provides an estate tax recapture from cash rentals of specially valued property. In addition, the statute of limitations is now waived for a claim of refund or credit in relation to any estate taxes paid on certain specially valued farm property in which the tax overpayment resulted from the application of specific net cash lease arrangements with spouses and lineal descendants of the decedents which may have been considered non-qualified uses of the properties. The claim for the refund or credit must be made within one year of June 7, 2001.

NEW RULES FOR RETIREMENT PLANS

The maximum **IRA** contribution limit is increased from the current maximum of $2,000, starting in 2002. The new maximum limit will be $3,000 for the years of 2002-2004; increased to $4,000 for the years 2005-2007; and further increased to $5,000 for 2008. After 2008, the limit will be indexed annually for inflation in $500 increments.

Also, the maximum contribution limit will be increased by $500 for the years of 2002 through 2005 and $1,000 for years after 2005 (affecting only those taxpayers age 50 and older).

Tax Planning Tip: An individual taxpayer that reaches the age of 50 by the end of the taxable year may make additional catch-up IRA contributions. In addition, taxpayers who have sufficient cash flows should take advantage of these new maximum contribution limits whether or not they receive any current tax deductions from such contributions

since the earnings on the contributions are tax deferred.

Educational IRA rules have been significantly modified. These changes, beginning January 1, 2002, include: (1) the annual limit on educational IRA account contributions will be increased from $500 to $2,000; (2) the phase-out for married taxpayers filing a joint return will be increased to twice the range applicable to single filers—the new range for married taxpayers filing jointly will be from $190,000 to $220,000 of modified AGI; (3) qualified education expenses which may be paid tax-free from an educational IRA will now include elementary and secondary school expenses; (4) taxpayers will be able to claim the HOPE credit or lifetime learning credit and also exclude from gross income amounts, the educational IRA accounts for the same students in the same year—any amount of the distribution which is excluded may not, however, be the same educational expenses for which the credit is claimed; (5) educational IRA age limits will no longer apply to special needs beneficiaries; and (6) corporations and other entities (including tax-exempt organizations) will be able to make contributions to educational IRA accounts regardless of the corporate or other entity's income during the year of contribution.

Tax Planning Tip: Again, any taxpayers who have sufficient cash flows and uses for educational IRA accounts should take advantage of these new tax breaks.

Qualified retirement plans will have increased contribution and benefit limits, starting January 1, 2002. These increases include the following:

1. The current $35,000 limit on annual contributions to defined contribution plans will be raised to $40,000 in 2002 and then indexed for inflation in $1,000 increments thereafter. The current $140,000 annual benefits limit for defined benefit plans will be raised to $160,000 in 2002 and then indexed for inflation in $5,000 increments.
2. The compensation limit which may be taken into account under a qualified plan will be increased to $200,000 in 2002 and then indexed in $5,000 increments.
3. Annual contribution maximums for 401(k) plans, 403(b) annuities, and salary reduction SEPs will be increased to $11,000 in 2002. The maximums will be increased another $1,000 per year until they reach $15,000 in 2006; after 2006 the limits will be indexed in increments of $500.
4. Annual contribution maximum to a SIMPLE plan will be raised to $7,000 in 2002. The limit will be increased another $1,000 per year until it reaches $10,000 in 2005; after 2005 it will be indexed in $500 increments.
5. Annual deferral limit under section 457 will be increased to $11,000 in 2002. The limit will be increased another $1,000 per year until it reaches $15,000 in 2006; after 2006 the limit will be indexed in $500 increments.

The 2001 Tax Act also allows additional contributions to qualified retirement plans (besides the changes mentioned above) for taxpayers who are at least 50 years old. These taxpayers may make additional contributions of $1,000 to 401(k) plans, 403(b) annuities, SEP plans or 457 deferrals in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, $5,000 in 2006, and then indexed in $500 increments starting in 2007. Taxpayers who are at least 50 years of age may make additional contributions to a SIMPLE plan of $500 in 2002, $1,000 in 2003, $1,500 in 2004, $2,000 in 2005, $2,500 in 2006, and then indexed in $500 increments starting in 2007. No additional contributions may be made to any of these plans out of after-tax employee compensation, and no additional contributions may be made to any of these plans if any other deferral provisions apply.

Beginning in 2002, shareholders of S corporations, partnerships, and sole proprietors will be able to receive loans from qualified plans other than IRA accounts; such loans will no longer be considered to be prohibited transactions.

A new nonrefundable tax credit is available to certain taxpayers who contribute to qualified retirement plans (including IRAs and Roth IRAs.) The maximum annual contribution eligible for the credit is $2,000; this credit is in addition to any tax deduction. The credit rate phases down from 50 percent to 10 percent on the contribution, depending upon the taxpayer's AGI. This credit is available only to taxpayers with AGI below the beginning of the IRA deduction phaseout; the credit is completely phased out for joint filers with AGI exceeding $50,000, $37,500 for head-of-household, and $25,000 for single taxpayers. Students, taxpayers under age 18, and dependents may not receive this tax credit. This new tax credit will only be available for the years 2002-2006.

Briefly, here are some other new provisions relating to qualified retirement plans (most of which take effect at the beginning of 2002):

1. Small businesses will be entitled to a nonrefundable credit for administration expenses associated with certain qualified retirement plans.
2. Faster vesting of employer matching contributions will be permitted.
3. Hardship withdrawals will be easier to make.
4. Plan rollover rules will be liberalized.
5. Certain existing small plans and new plans will be exempted from many normal administrative rules.
6. The Tax Act directs the IRS to revise the life expectancy factors used to calculate minimum distributions from qualified retirement plans (the life expectancy factors that have been used before the revision are from the original regulations initiated in the mid-1980s.) The IRS recently revised its proposed regulations to minimum distributions and significantly simplified them. One of the new rules is that everybody is treated as having a joint life expectancy based on his/her own age and that of a beneficiary who is 10 years younger (even if the actual beneficiary is older than that or there is no beneficiary.) These revised rules must now be used by taxpayers beginning in 2001; an exception to the requirement of using the new rules is when a spouse is the sole beneficiary and is also more than 10 years younger than the owner of the retirement plan.

Tax Planning Tip: Tax planning will become more important in the near future for eligible taxpayers and small businesses as they take advantage of these new opportunities created by the liberalized retirement plan changes. Some of these new changes are rather complex and taxpayers are encouraged to obtain the services of a professional consultant.

CONCLUSION

This article has attempted to summarize some of the tax changes in the 2001 Tax Act. The focus has been on the changes that would directly or indirectly affect real estate investors and small businesses. The authors see no movement toward tax simplification by the U.S. Congress and the president, but the Economic Growth and Tax Relief Reconciliation Act of 2001, hopefully, will meet the objectives of improving the economy and providing some relief to taxpayers. Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act. REI

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