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TYPICAL QUESTIONS ABOUT INFLATION ADJUSTMENTS TO 2004 TAX FIGURES

In the next few months, individuals will start thinking about how much tax they'll owe or get back as a refund for 2003, and how their tax picture will change in 2004. Employees soon will be receiving brochures from the benefits departments of their companies calling on them to make different choices for 2004. Some of these choices have tax implications and are impacted by inflation-adjusted tax figures for 2004.

While the IRS has not yet released the official inflation-indexed figures for 2004 and isn't required to do so until December 15th, this alert puts together a list of typical questions you may have about next year's inflation adjustments to the tax brackets and other items, and provides answers to them.

QUESTION: Do the tax rates go down in 2004?

ANSWER: No. The tax rates for individuals stay at 10%, 15%, 25%, 28%, 33% and 35% in 2004. There is some tax relief, however, in 2004 in the form of inflation adjustments to the tax brackets and other items.

QUESTION: How do the inflation adjustments work?

ANSWER: The point at which each of the top five tax brackets begins is increased for inflation. This means, in 2004, more income will be taxed at the 10%, 15%, 25%, 28% and 33% rates than in 2003. The adjustments for 2004 are based on the recently released CPI figure for August, 2003, and the figures for the 11 prior months going back to September, 2002.

QUESTION: Are other income tax items adjusted for inflation?

ANSWER: There are numerous other income tax items adjusted for inflation, including, for example, the standard deduction and the personal exemption amount. In 2003, the exemption is \$3,050. It will increase to \$3,100 in 2004. Likewise, the basic standard deduction for a married couple filing jointly is \$9,500 in 2003. It will be \$9,700 in 2004. Standard deductions for single taxpayers and other filers also generally will increase for 2004.

Observation: As a result of the inflation adjustments to the tax brackets, exemption amount and standard deduction amounts, many taxpayers can receive a modest increase in income in 2004 without being pushed into a higher tax bracket.

QUESTION: Do all of the items which qualify for adjustments get at least some increase?

ANSWER: No, that's because the technical way in which adjustments are made varies for different items. For example, different items have different rounding mechanisms. Many adjustments are rounded down, which could result in no increase for a particular year.

QUESTION: What kind of tax savings will be realized in 2004 from the adjustments?

ANSWER: Let's look at a two-wage-earner couple with two children. For 2003, they have gross income of \$120,200, \$30,000 of itemized deductions, and taxable income of \$78,000, after taking into account their four \$3,050 personal exemptions. Their tax (before any allowable credits) for 2003 comes to \$13,120. If their income stays at exactly the same level for 2004, their tax will go down to \$12,925, for a savings of \$195.

QUESTION: Do any taxpayers not benefit from inflation adjustments?

ANSWER: The AMT can rob individuals of the benefit of inflation adjustments because the AMT is not adjusted for inflation.

QUESTION: What is the AMT?

ANSWER: We actually have two income tax systems - the regular tax and the alternative minimum tax or AMT, which prevents taxpayers from paying too little tax by disallowing or reducing certain deductions and treating as income certain items which are exempt from regular tax. If an individual's AMT exceeds his regular tax, he pays the difference plus his regular tax. So let's say for 2003 an individual's regular tax is \$30,000 and his AMT also is \$30,000. He pays \$30,000 in regular tax. Now, for 2004, inflation adjustments push his regular tax down by \$300. His AMT is still \$30,000, because it's not adjusted for inflation, so he ends up still having to pay \$30,000. In other words, the AMT robs him of the \$300 benefit from the inflation adjustment.

Observation: The family of four with gross income of \$120,000 from the example above showing the benefit from the inflation adjustments could actually be subject to AMT, depending on the make-up of their itemized deductions and other factors. Some legislators are complaining that the AMT is reaching too many people and want it changed.

QUESTION: Are the monthly amounts an employee can exclude from income for transit passes and parking under a company program increased?

ANSWER: The \$100 limit for transit passes will stay at that level for 2004. However, the parking limit will go from \$190 per month in 2003 to \$195 in 2004. Employees of companies who offer these benefits can save income tax. In addition, social security taxes can be saved by employees whose wages are not over the social security wage base (\$87,000 for 2003, \$87,900 for 2004) and by employers with respect to such employees.

QUESTION: What other key adjustments are there?

ANSWER: There are some other important adjustments which affect individuals with incomes at higher levels. Many tax breaks are reduced or eliminated as income exceeds certain thresholds including, for example, itemized deductions, exemptions and education tax breaks. These thresholds generally are increased for inflation. For example, itemized deductions will be reduced if 2003 adjusted gross income is more than \$139,500 (\$69,750 for married individuals filing separately). For 2004, these figures will be \$142,700 and \$71,350. Thus, as a result of the adjustments, fewer individuals will lose some of these tax breaks and the amount that will be lost will be lessened unless they get additional income next year which pushes them over the higher levels.

QUESTION: What can be done to avoid losing tax breaks when income starts approaching the thresholds at which tax breaks are reduced or eliminated?

ANSWER: Individuals whose income is close to the threshold amount for a particular item may be able to take some steps to keep income below the threshold. A couple may know they are going to be over next year but may be able to keep below the threshold this year by taking certain steps. For example, it may be possible to reduce this year's income by pushing a bonus into next year, moving money from taxable interest bearing accounts to tax-exempt accounts, increasing 401(k) and IRA contributions and selling stock at a loss. An individual who would be over the limit this year but who might not be next year, should consider the opposite type of planning moves, i.e., accelerating income into this year and deferring above-the-line deductions until next year.

QUESTION: What do the adjustments all mean for individuals?

ANSWER: The inflation increases are low and thus the tax savings from the adjusted figures are low. Individuals can't figure on a whole lot of savings next year from the inflation adjustments. However, as a

result of recent tax law changes, there are several steps individuals can take to reduce their tax bill this year and next year, including the following:

- < Shift investments which produce ordinary income into stock or mutual funds because capital gains and qualified dividends are taxed at a maximum rate of 15%.
- < Place up to \$2,000 in a Coverdell education savings account (formerly education IRA) for a child or grandchild.
- < Take advantage of the above-the-line deduction for higher education expenses. The maximum deduction is \$3,000 in 2003 and \$4,000 for 2004. For 2003, no deduction is allowed if your modified adjusted gross income exceeds a stated threshold (e.g., \$130,000 on a joint return). Different rules apply for 2004. A \$2,000 deduction is allowed to a joint filer whose modified adjusted gross income exceeds \$130,000 but does not exceed \$160,000. No deduction is allowed if the joint filer's modified adjusted gross income exceeds \$160,000. The dollar thresholds are halved for other types of filers.
- < Make an up-to-\$3,000 annual contribution to an IRA (up to an additional \$500 can be contributed by qualifying individuals age 50 and over).
- < Make the maximum contribution which you can afford to a company 401(k) plan. The limit is \$12,000 for 2003 (\$13,000 for 2004). Employers can allow those 50 or over to contribute an additional \$2,000 for 2003 (\$3,000 for 2004).
- < Get tax-free reimbursements of over-the-counter drugs from your employer's health care flexible spending account.
- < Take advantage of the maximum lifetime learning credit, which is now \$2,000.
- < If you are a self-employed individual, you can deduct 100% of the amount you pay for medical care insurance for yourself, your spouse and your dependents.

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