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MAKING SENSE OF THE 10% RATE SCHEME IN THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

Congress's desire to carve a 10% rate bracket for individuals out of the 15% bracket, and at the same time give taxpayers an immediate tax refund, has yielded a statutory scheme which is convoluted and confusing. The 2001 Act creates a new 10% bracket for post-2000 tax years, but then wipes it out for the 2001 year and replaces it with a rate-reduction refund based on 2000 income, and/or, in some circumstances, a rate-reduction credit for the 2001 tax year.

Here's a detailed look at the new law's 15%-to-10% rate reduction scheme and what it will mean to individuals this year and next.

NEW 10% TAX BRACKET

The 2001 Act taxes the bottom slice of an individual's taxable income (called the "initial bracket amount") at 10% instead of 15%. For tax years beginning after 2000 and before 2008, the 10% tax bracket applies to:

- ... the first \$6,000 of taxable income for single individuals and married taxpayers filing separately,
- ... the first \$10,000 for heads of household, and
- ... the first \$12,000 for married joint return filers and surviving spouses.

Thus, for 2001, the 10% rate will save a maximum of \$300 for single taxpayers and married taxpayers filing separately, \$500 for heads of household and \$600 for married joint filers.

However, the 10% rate will not appear on the 2001 tax rate tables for individuals. Instead, the benefit of the lower rate will be received through a credit/rebate mechanism in a new code section designed to put a refund check in the hands of eligible individuals before October 1st of this year. The rate-reduction refund check is not includible in income.

WHO IS ELIGIBLE FOR A RATE-REDUCTION REFUND CHECK?

The refund checks are available only to those who were "eligible individuals" for 2000. These are individuals other than:

- (1) individuals for whom a dependency deduction was allowable to another taxpayer for that year; and
- (2) nonresident aliens.

Thus, under (1), above, the refund check is not available to an individual who could have been claimed for 2000 as a dependent by someone else, even if that other person didn't actually claim the individual as a dependent.

An IRS spokesperson has indicated that a rate-reduction refund check also will be mailed for individuals who died during 2000.

HOW MUCH IS THE RATE-REDUCTION REFUND CHECK?

The refund check is computed as if for tax year 2000, a 10% rate, instead of the 15% rate, had applied to the first \$6,000 (single individuals and married taxpayers filing separately), \$10,000 (heads of household) or \$12,000 (married joint return filers and surviving spouses) of taxable income. In other words, taxpayers are treated as if they had overpaid their 2000 tax bill in the amount to be refunded.

Illustration: A single taxpayer had \$6,000 of taxable income for 2000. He wasn't entitled to any credits and paid a \$900 tax (15%). He will receive a refund check of \$300 (5% [difference between 15% and 10% rates] × \$6,000). If he had only \$4,000 of taxable income for 2000, did not claim credits, and paid \$600 in tax, he'd get a \$200 check (5% × \$4,000).

There is no rate-reduction refund check if a person didn't have taxable income in 2000. Additionally, the refund check can't exceed a taxpayer's regular and AMT income tax liability for 2000 (determined after nonrefundable credits).

Illustration: For 2000, a single taxpayer had \$3,000 of taxable income and \$450 of tax before credits, but paid only \$100 of tax after subtracting nonrefundable credits. He will get a \$100 refund check.

The IRS won't pay interest on the rate-reduction refund check.

Note, a person who is not entitled to a refund check, or receives a refund check for less than the maximum amount (\$300, \$500, or \$600, depending on filing status), may be entitled to a credit for the 2001 tax year (see discussion below).

WHEN WILL THE CHECKS COME?

IRS is to mail refund checks "to the extent practicable, before October 1, 2001." An IRS spokesperson has said taxpayers will get a letter by mid-July telling them how much their check will be and the week they will receive it. Checks are to be delivered in a ten-week period beginning July 23rd and ending in September. The Conference Report to the 2001 Act says checks will be issued in the order of the last two digits of the taxpayer identification number (usually the social security number). Those who filed an extension for the 2000 return will get their checks later, but not after December 31, 2001. The IRS spokesman suggested that taxpayers who moved since filing their 2000 return should make sure they filled out the national change of address form to assure the check is forwarded to the right address.

WHAT WILL HAPPEN WHEN THE 2001 RETURN IS FILED?

An "eligible individual" for 2001 will complete a worksheet when he files his 2001 return. This worksheet will calculate the reduction in tax for 2001 that would

apply if a 10% rate instead of a 15% rate applied to the first \$6,000 (single individuals and married taxpayers filing separately), \$10,000 (heads of household) or \$12,000 (married joint return filers and surviving spouses) of 2001 taxable income. This reduction in tax is referred to in the Code as a "credit against tax" for 2001.

Eligible individuals would then subtract from this rate-reduction credit the amount of the rate-reduction refund check they receive during 2001. There are three possible results:

- (1) The rate-reduction credit and the rate-reduction refund are exactly the same. In this case, the rate reduction will not affect 2001 taxes. That's because the individual will have received the benefit of the 5% rate reduction in the form of a rebate check.

Illustration: A married couple filing jointly had \$45,000 of taxable income for 2000 and receive a \$600 rate reduction rebate check during 2001. They have \$50,000 of taxable income for 2001. If a 10% rate instead of a 15% rate applied to the first \$12,000 of their 2001 taxable income, they would pay \$600 less in tax (or, in the 2001 Act's phrasing, they would be entitled to a \$600 credit against tax).

Result: They don't claim a rate-reduction credit and the rate-reduction refund has no effect on their 2001 tax return.

- (2) The rate-reduction credit exceeds the rate-reduction refund. Here, the excess of the credit over the refund amount is claimed as a credit against 2001 tax liability. The excess is treated for estimated tax purposes as if it were a nonrefundable credit. In other words, the rate reduction credit acts as a dollar-for-dollar reduction in the amount of tax that must be prepaid via estimated taxes in order to avoid a penalty.

The amount claimed as a credit in lieu of a rate reduction—namely, the excess of the rate-reduction credit over the rate-reduction refund amount—can't be more than a taxpayer's regular and AMT income tax liability for 2001 (determined after nonrefundable credits).

Illustration: For 2000, a single taxpayer had \$4,000 of taxable income and paid \$600 in tax. In 2001, she receives a rate-reduction refund check for \$200 (5% of \$4,000). For 2001, the taxpayer has \$20,000 of taxable income. She will be entitled to a \$100 credit on her 2001 return (5% of the first \$6,000 of income for 2001, less \$200 rate-reduction refund credit). However, if the individual had only \$5,000 of 2001 taxable income, she would only get a \$50 credit on her 2001 return (5% of \$5,000 less \$200 refund check).

A rate-reduction credit also will be available where:

- ... an individual could have been claimed as a dependent on another's return for 2000, but can't be so claimed for 2001. This would apply, for

example, to a child who finished college in 2000 and entered the labor force in 2001.

... an individual was a nonresident alien in 2000, but becomes a resident alien for 2001.

In either situation, the individual was not an "eligible taxpayer" in 2000 (and thus didn't receive a rate-reduction refund), but will be entitled to a rate reduction credit for 2001.

- (3) The rate-reduction credit is less than the rate-reduction refund or is zero. The Committee Report to the 2001 Act unambiguously says that where subtracting the rate-reduction refund from the rate-reduction credit yields a negative number (i.e., where the refund exceeds the credit), the taxpayer won't have to repay the amount to IRS.

Illustration: A married couple filing jointly had \$12,000 or more of taxable income for 2000 and during 2001 receive a rate-reduction refund check for \$600 (5% of \$12,000). For 2001, they have only \$10,000 of taxable income and would be entitled to a rate-reduction credit of only \$500. They don't have to repay \$100 to IRS (excess of \$600 rate-reduction refund over \$500 rate reduction credit). None of the \$600 rate-reduction refund will be taxable income to the couple and it will have no effect on their 2001 return.

There will be instances where a rate-reduction refund check may have been paid based on 2000 taxable income, but the rate-reduction credit will be zero. This can occur, for example where:

- ... an individual owes no tax for 2001, but paid tax for 2000;
- ... an individual can be claimed as a dependent on someone else's return for 2001 (and thus isn't an "eligible individual" for that year), paid tax for 2000, but wasn't eligible to be claimed as a dependent on someone else's return for 2000; or
- ... an individual died early in 2001 and had low or no taxable income for 2001.

In all of these cases, the taxpayer will be entitled to keep the entire rate-reduction refund check received on the basis of 2000 taxable income.

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