MONTANA LEGISLATIVE BRANCH

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TO: Legislative Finance Committee

FROM: Jim Standaert, Senior Fiscal Analyst

RE: Federal Economic Growth and Relief Reconciliation Act of 2001 – Impact on State Revenues

INTRODUCTION

The Economic Growth and Relief Reconciliation Act of 2001 – the Act, in short – was passed by Congress in Summer 2001. The Act reduces federal tax rates over the next ten years, increases the child tax credit, expands education IRA eligibility, reduces the federal marriage penalty and phases out the federal estate tax.

Each of the provisions in the Act will reduce federal tax payments, thereby reducing the amount of federal taxes claimed as a deduction against state taxable income. This indirect impact will increase state income tax revenue.

Some of the provisions in the Act will increase federal exemptions of income for certain education expenses. Since the state's definition of adjusted gross income begins with federal adjusted gross income, state exemptions for these items will also increase. This direct impact will reduce state income tax revenue.

The repeal of the estate tax will reduce state tax revenues.

The net effect of these changes is a small increase in state tax revenue over the next ten years.

This document will describe the tax changes in the Act, and will present preliminary estimates of the impact on state revenues. The estimates were provided by Larry Finch, Department of Revenue, Tax Policy and Research.

TAX RATE REDUCTIONS

New 10-Percent Bracket – A new federal ten percent tax bracket is created for a portion of taxable income that is currently taxed at 15 percent, effective for tax year beginning January 1, 2000. The 10-percent tax rate applies to the first $6,000 of taxable income for single individuals ($7,000 for 2008 and thereafter), $10,000 for heads of households, and $12,000 for married couples filing jointly ($14,000 for 2008 and thereafter).

Rate Reduction Credit for 2001 – The Act includes a rate reduction credit for 2001 to deliver the benefit of the new 10-percent income tax rate bracket during calendar year 2001. Taxpayers will be entitled to a credit in tax year 2001 of 5 percent (the difference between the 15-percent rate and the 10-percent rate) of the amount of income that would otherwise be eligible for the new 10-percent rate. Thus, the maximum credit will be $300 in the case of a single individual, $500 in the case of a head of household, and $600 in the case of a married couple filing a joint return. This credit is in lieu of the 10 percent rate bracket for 2001.

Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury. Most checks were issued before October 1, 2001 to taxpayers who timely filed their 2000 tax returns. Taxpayers who filed late or pursuant to extensions will receive their checks later in the fall.

Reduction in Individual Income Tax Rates – Beginning July 1, 2001, the present law regular income rates of 28 percent, 31 percent, 36 percent and 39.6 percent are phased down over six years to 25 percent, 28 percent, 33 percent and 35 percent.

Table 1 below shows the schedule of regular income tax rate reductions.

Table 1. Regular Income Tax Rate Reductions

Calendar Year	28% rate reduced to	31% rate reduced to	36% rate reduced to	39.6% rate reduced to
2001* - 2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35%

* Effective July 1, 2001

Phase in Repeal of Limits on Itemized Deductions – The Act phases in the repeal of limitations on itemized deductions for high income taxpayers. The limitation is reduced by one-third in tax years 2006 and 2007 and by two-thirds in tax years 2008 and 2009. In tax year 2010 and beyond, the limitation is completely eliminated.

Phase in Repeal of Limits on Personal Exemption – The Act phases in the repeal of limitations on personal exemptions for high income taxpayers. The limitation is reduced by one-third in tax years 2006 and 2007 and by two-thirds in tax years 2008 and 2009. In tax year 2010 and beyond, the limitation is completely eliminated.

PROVISIONS RELATING TO CHILDREN

Increase and Expand the Federal Child Tax Credit – The Act increases the Federal Child Tax Credit to $1,000 phased-in over ten years, effective for tax years beginning after December 31, 2000. For tax years 2001 through 2004 the child tax credit will be $600 per child; for tax years 2005 through 2008 the child tax credit will be $800; for tax year 2009, the child tax credit will be $900; and for tax years 2010 and beyond the child tax credit is $1,000 per child.

The Act makes the child credit refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,000 for calendar years 2001-2004. The percentage is increased to 15 percent for calendar years 2005 and thereafter. The $10,000 amount is indexed for inflation beginning in 2002. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the present-law rule), if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000.

Extension and Expansion of Adoption Tax Benefits – The Act permanently extends the adoption credit for children other than special needs children. The maximum credit is increased to $10,000 per eligible child, including special needs children. A $10,000 credit is provided in the year a special needs adoption is finalized regardless of whether the taxpayer has qualified adoption expenses. The beginning point of the income phase-out range is increased to $150,000 of modified adjusted gross income. Finally, the adoption credit is allowed against the alternative minimum tax permanently.

The Act permanently extends the exclusion from income for employer-provided adoption assistance. The maximum exclusion is increased to $10,000 per eligible child, including special needs children. In the case of a special needs adoption, the exclusion is provided regardless of whether the taxpayer has qualified adoption expenses. The beginning point of the income phase-out range is increased to $150,000 of modified adjusted gross income. These provisions are effective for tax years beginning after December 31, 2001. The provisions that extend the tax credit and exclusion from income for special needs adoptions regardless of whether the taxpayer has qualified adoption expenses are effective for tax years beginning after December 31, 2002.

Expansion of Dependent Care Tax Credit – The Act increases the maximum amount of eligible employment-related expenses from $2,400 to $3,000, if there is one qualifying individual (from $4,800 to $6,000, if there are two or more qualifying individuals) and increases the maximum credit from 30 percent to 35 percent. The Act modifies the phase-down of the credit so that it begins at $15,000 of adjusted gross income. The provision is effective for tax years beginning after December 31, 2001.

Tax Credit for Employer-Provided Child Care Facilities – The Act creates a new tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per tax year. The provision is effective for tax years beginning after December 31, 2001.

MARRIAGE PENALTY RELIEF

Standard Deduction Marriage Penalty Relief - The Act increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. This increase is phased-in over five years beginning in 2005 and would be fully phased-in for 2009 and thereafter. Table 2 below shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

Table 2. Phase-in of Increase in Standard Deduction for Married Couples Filing Jointly

Calendar Year	Standard Deduction for Joint Returns as Percentage of Standard Deduction for Single Returns
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

Expansion of the 15-Percent Rate Bracket For Married Couples Filing Joint Returns – The Act increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased-in over four years, beginning in 2005. Table 3, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 3. Increase in Size of 15-Percent Rate Bracket for Married Couples Filing Jointly

Calendar Year	End point of 15-percent rate bracket for married couples filing jointly as percentage of end point of 15-percent rate bracket for unmarried individuals
2005	180%
2006	187%
2007	193%
2008 and later	200%

EDUCATION INCENTIVES

Modifications to Education IRAs – The Act increases the annual limit on contributions to education IRAs from $500 to $2,000. The Act expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include elementary and secondary

school expenses. The Act increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified adjusted gross income. The Act provides that various age limitations do not apply to special needs beneficiaries.

The Act clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

The Act allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

The Act repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any tax year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary.

The provisions modifying education IRAs are effective for tax years beginning after December 31, 2001.

Private Prepaid Tuition Programs; Exclusion From Gross Income of Education Distributions From Qualified Tuition Programs – The Act expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529. The Act modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. An exclusion from gross income is provided for distributions from qualified tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. The provisions are effective for taxable years beginning after December 31, 2001.

Exclusion for Employer-Provided Educational Assistance – The Act extends the exclusion for employer-provided educational assistance to graduate education and makes the exclusion (as applied to both undergraduate and graduate education) permanent, effective with respect to courses beginning after December 31, 2001.

Modifications to Student Loan Interest Deduction – The Act increases the income phase-out ranges for eligibility for the student loan interest deduction to $50,000 to $65,000 for single taxpayers and to $100,000 to $130,000 for married taxpayers filing joint returns. These income phase-out ranges are adjusted annually for inflation after 2002. The Act repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible. The provision is effective for interest paid on qualified education loans after December 31, 2001.

Tax Benefits for Certain Types of Bonds for Educational Facilities and Activities - The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from $5 million to $10 million. Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures. The provisions are effective for bonds issued after December 31, 2001.

Deduction for Qualified Higher Education Expenses – The Act permits taxpayers an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses are defined in the same manner as for purposes of the HOPE credit.

In 2002 and 2003, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of $3,000 per year. Taxpayers with adjusted gross income above these thresholds would not be entitled to a deduction. In 2004 and 2005, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $4,000 and taxpayers with adjusted gross income that does not exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $2,000. The provision is effective for taxable years beginning after December 31, 2001.

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

Phase-out and Repeal of Estate and Generation-Skipping Transfer Taxes; Increase in Gift Tax Unified Credit Effective Exemption – In calendar 2002, estate tax rates in excess of 50 percent are repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to $1 million. In 2003, the estate and gift tax rates in excess of 49 percent are repealed. In 2004, the estate and gift tax rates in excess of 48 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $1.5 million. (The unified credit effective exemption amount for gift tax purposes remains at $1 million as increased in 2002.) In addition, in 2004, the family-owned business deduction is repealed. In 2005, the estate and gift tax rates in excess of 47 percent are repealed. In 2006, the estate and gift tax rates in excess of 46 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $2 million. In 2007, the estate and gift tax rates in excess of 45 percent are repealed. In 2009, the unified credit effective exemption amount is increased to $3.5 million. In 2010, the estate and generation-skipping transfer taxes are repealed.

From 2002 through 2009, the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes are as shown in Table 4, below.

Table 4 - Estate and Gift Tax Rates and Unified Credit Exemption Amount

Calendar Year	Estate and GST Tax Deathtime Transfer Exemption	Highest Estate and Gift Tax Rates
2002		50%
2003		49%
2004		48%
2005		47%
2006		46%
2007		45%
2008		45%
2009		45%
2010	Taxes Repealed	GT - top individual rate

In 2010, the estate and generation-skipping transfer taxes are repealed. Also beginning in 2010, the top gift tax rate will be the top individual income tax rate as provided under the bill.

After repeal of the estate and generation-skipping transfer taxes, the present-law rules providing for a fair market value (i.e., stepped-up) basis for property acquired from a decedent are repealed. A modified carryover basis regime generally takes effect, which provides that recipients of property transferred at the decedent's death will receive a basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death.

From 2002 through 2004, the state death tax credit allowable under present law is reduced as follows: in 2002, the state death tax credit is reduced by 25 percent (from present law amounts); in 2003, the state death tax credit is reduced by 50 percent (from present law amounts); and in 2004, the state death tax credit is reduced by 75 percent (from present law amounts). In 2005, the state death tax credit is repealed, after which there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent. Such state taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount, and reductions in and repeal of the state death tax credit are phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers after December 31, 2001.

Pension and Individual Retirement Arrangement Provisions - The Act makes extensive changes to the rules relating to individual retirement arrangements ("IRAs") and qualified pension plans. Among the changes included in the Act are the following provisions:

(1) Increased contribution limits and catch-up contributions to IRAs;

(2) Provisions for expanding coverage, including increased contribution and benefit limits for qualified plans, increases in elective deferral limits, and a credit for certain elective deferrals and IRA contributions;

(3) Provisions to enhance fairness for women, including additional catch-up contributions for individuals over age 50;

(4) Provisions for increasing portability for plan participants;

(5) Provisions for strengthening pension security and enforcement; and

(6) Provisions for reducing regulatory burdens.

AMT Relief – The Act increases the individual alternative minimum tax exemption amount by $2,000 (for single taxpayers) and $4,000 for married taxpayers filing joint returns for 2001 through 2004.

IMPACT ON STATE REVENUES

Table 5 shows preliminary estimates of the impact of the Act on state income and estate tax revenues. The estimates were provided by Larry Finch, Tax Policy and Research, Department of Revenue and were presented to the Revenue and Transportation Committee on September 14, 2001.

As shown in the table, increased state tax revenues from Federal income tax reform is partially offset by reductions due to repeal of the Federal estate tax provisions. The estimated net increase in state revenues is $5.7 million in fiscal 2002 and $7.6 million in fiscal 2003, or a total of $13.3 million for the 2003 biennium. This impact was not included in the revenue estimates adopted by the 2001 legislature in HJR 2. The estimated impact on fiscal years 2004 through 2010 is an average $4.0 million per year.

The estimates are preliminary. Further analysis of the Act will be made in the fall of 2002 when calendar 2001 state income tax returns are available.

Table 5

Preliminary Impact of Federal Tax Reform on Montana Revenue
State Fiscal Years 2001 - 2010; Millions of Dollars

	State Fiscal Year									
Federal Act Provision (Individual Income Tax)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Create new 10 % bracket (rebate in 1st year)	-	5.490	5.521	5.536	5.518	5.518	5.499	5.960	6.226	6.318
Phase-in reduction in tax rates	-	0.275	2.896	2.917	3.987	4.498	6.989	8.150	8.290	8.462
Phase-in repeal of itemized deduction limitation	-						(0.434)	(0.880)	(1.374)	(1.858)
Phase-in repeal of personal exemption limitation	-						0.065	0.131	0.190	0.246
Increase child tax credit	-		0.071	1.275	1.362	1.455	1.755	2.514	2.608	2.664
Marriage penalty provisions	-						0.672	1.120	1.254	1.187
Education provisions	-			(1.146)	(1.618)	(2.002)	(2.208)	(1.297)	(1.070)	(1.186)
Pension and IRA provisions	-			(0.883)	(1.907)	(2.114)	(2.466)	(2.714)	(2.500)	(2.429)
Miscellaneous provisions	-			0.014	0.088	0.112	0.117	0.120	0.124	0.125
Total - all federal Income Tax Provisions	**-**	**5.765**	**8.488**	**7.713**	**7.430**	**7.467**	**9.989**	**13.104**	**13.748**	**13.529**
Estate Tax Provisions	-	**(0.013)**	**(0.913)**	**(3.403)**	**(4.941)**	**(6.226)**	**(7.250)**	**(7.563)**	**(7.804)**	**(8.021)**
Net Impact - All Provisions	-	**5.752**	**7.575**	**4.310**	**2.489**	**1.241**	**2.739**	**5.541**	**5.944**	**5.508**

Estimates provided by TPR,DOR

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