Numerous Changes Lower Income and Estate Taxes

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The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, was signed on June 7, 2001, and makes some of the most significant changes to the tax code since the mid-1980s. Its 10-year budget cost for all taxpayers was estimated at $1.35 trillion. While the law does not include provisions specifically targeted to rural areas, most of the law's provisions apply to people living in rural areas as general taxpayers. About 88 percent of all individual taxpayers will benefit from one or more of the income tax reductions.

The act gradually reduces Federal income taxes in several ways over a 10-year phase-in period, with the largest cut being an across-the-board reduction in income tax rates. The law also increases income tax benefits for families with children, and addresses other issues such as the marriage penalty, education incentives, and pension and IRA provisions. Federal estate taxes will be reduced and eventually repealed, a cut that was particularly promoted to help farmers and small businesses. While some tax cuts began in 2001, many reductions are implemented gradually and some provisions do not begin until later years. Furthermore, without future action, the law will expire in 2011 and the tax code will revert to what it was before the 2001 Act.

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Federal Income Taxes

Before the new law, 23 million rural taxpayers paid $88 billion in Federal income taxes in 1998. This compares with $695 billion in such taxes paid by 101 million urban taxpayers. The average Federal income tax bill for rural tax filers was $3,800, and their average adjusted gross income (AGI) was $32,500. This compares with $6,900 in average income taxes for urban filers on an average AGI of $46,000. Thus, the average rural Federal income tax rate (12 percent) was lower than the urban rate (15 percent), reflecting the progressive tax rate system that imposes higher marginal tax rates on higher incomes.

Tax bracket reduction. Before the new law, ordinary taxable income (excluding capital gains) could be taxed in five progressive brackets—the 15-, 28-, 31-, 36- and 39.6-percent tax brackets. Higher proportions of rural than urban taxpayers are in the lower brackets. In 1998, about 23 percent of rural tax filers ended up paying no Federal income tax, compared with 18 percent of urban tax filers. About 61 percent of rural residents were in the 15-percent tax bracket, compared with 54 percent of urban residents. By contrast, 14 percent of rural residents were in the 28-percent bracket compared with 23 percent of urban taxpayers. Fewer than 2 percent of rural taxpayers paid more than a 28-percent marginal rate, compared with nearly 5 percent of urban taxpayers (fig. 1).

The new law creates a new 10-percent income tax bracket for the first $12,000 of taxable income on a joint return ($6,000 if single, $10,000 if head of household). This new bracket was carved out of the 15-percent bracket and benefits everyone with taxable income. Tax rates also are reduced for the other brackets. The reductions are gradual and become fully effective in 2006 when the rates will be 25 (from 28), 28 (from 31), 33 (from 36) and 35 (from 39.6) percent. The rate for the 15-percent bracket remains unchanged.

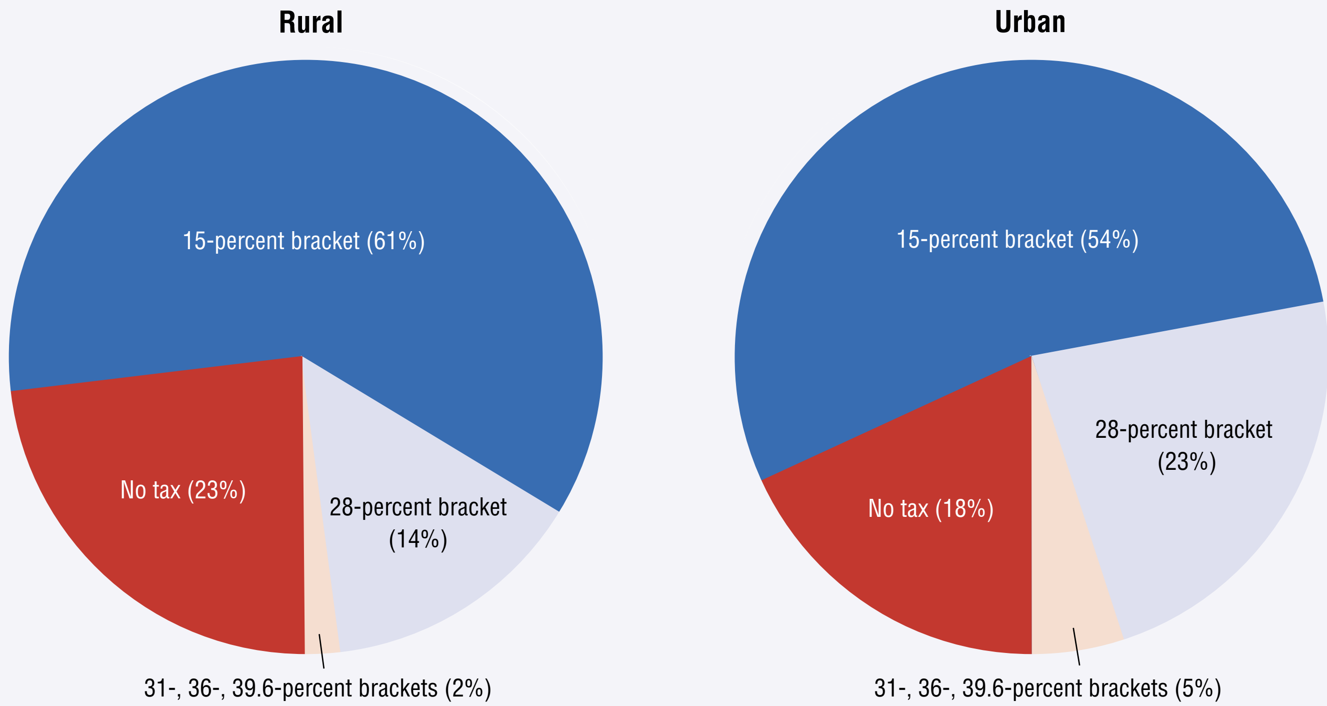
Marriage penalty relief. The so-called marriage penalty arises when the tax bill for a married couple filing a joint return is greater than if paid as two unmarried singles. This generally affects two-earner households and becomes more noticeable if the couple's income is split nearly evenly. The three most important aspects of the tax code that contribute to the marriage penalty are the standard deduction, tax rate schedules, and earned income tax credit.

Congressional Budget Office reports indicate that the marriage penalty affected 43 percent of mar-

Figure 1

Incidence of marginal Federal income tax brackets for rural and urban households, 1998

A greater share of rural households are taxed in the 15-percent bracket or owe no tax



Source: USDA/ERS, based on 1998 IRS data.

ried couples in 1999. Rural residents are more likely to be affected since a larger share file joint tax returns (45 percent compared with 39 percent for urban) and use the standard deduction.

Under prior law, the standard deduction and the amount taxed in various brackets for joint returns were less than twice the amounts allowed for single filers (actually about 67 percent greater than the single's amounts). The new law expands the standard deduction and the 15-percent tax bracket for married couples. Beginning in 2005, these amounts are increased gradually and eventually reach double the amount for single filers. Such increases help all married couples whether or not they previously suffered the marriage penalty. The law also increases the point at which the earned income credit begins to be phased out for joint returns.

Child tax credit. The new law increases the child tax credit from $500 to $600 in 2001, $700 in 2005, $800 in 2009, and $1,000 in 2010. The child credit begins to be phased out if household AGI exceeds $110,000 for couples or $75,000 for singles or heads of household. The new law also makes the credit refundable for more families. Under the new law, the child credit is refundable for all families in an amount up to 10 percent of their income over $10,000 (15 percent beginning in 2005). In 1998, the first year this credit was available and the only year with rural data, about 20 percent of all taxpayers claimed the child credit, with no significant difference between rural and urban households.

Retirement. Annual contribution limits for Individual Retirement Accounts (IRAs) rise under the act from their long-time level ($2,000) to $3,000 in 2002, $4,000 in 2005, and $5,000 in 2008. Contribution limits on other types of retirement accounts also increase, and greater flexibility and portability are allowed. For lower income taxpayers, the law creates a new nonrefundable tax credit for contributions to IRAs and qualified retirement plans. For example, on joint returns with adjusted gross income under $30,000, individuals will receive a 50-percent tax credit on contributions up to $2,000. Smaller 20- and 10-percent credits are available at higher incomes until the credit becomes zero (on joint returns, the credit is zero when AGI exceeds $50,000). The credit applies to tax years 2002-2006.

Education. The tax act expands benefits for education in several ways. It increases the annual contribution limit for Education Savings Accounts ("Education IRA") from $500 to $2,000 and makes the beginning of the phaseout point for joint returns ($190,000) double that of single returns. It now also allows such accounts to be used for elementary and secondary school expenses, in addition to higher education fees. Withdrawals from Education Savings Accounts are made easier when done in the same year as using the Hope Scholarship credit or Lifetime Learning credit. While contributions to Education Savings Accounts are not tax deductible, earnings in the account are tax-exempt if used for qualified expenses.

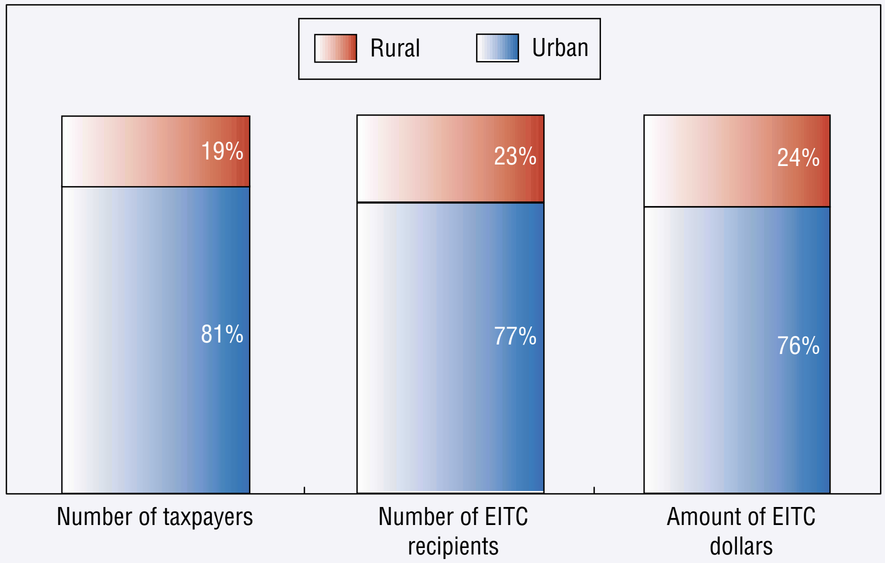
The ability to deduct student loan interest grows by removing the restriction that limited the deduction to only the first 5 years of loan repayments. The phaseout ranges for student loan interest deductions were raised and now begin when AGI exceeds $50,000 for singles and $100,000 for couples.

A new above-the-line deduction for higher educational expenses is available, but it expires after 2005. Beginning in 2002, up to $3,000 of education expenses may be deducted if AGI is less than $130,000 for couples ($65,000 for singles). Expenses used for this deduction cannot be used for other education tax incentives. While education tax credits have fixed values ($1,500 for Hope Scholarship credit, $1,000 for Lifetime Learning credit) and separate income limits, the value of the new deduction will depend on the taxpayer's marginal tax rate.

Figure 2

Distribution of earned income tax credit (EITC) for rural and urban households, 1998

Compared with the base population, the share of EITC benefits is greater in rural areas



Source: USDA, Economic Research Service, based on 1998 IRS data.

Only about 4 percent of all taxpayers used the education credits and 3 percent used the student loan interest deduction in the first year that they were available in 1998, with little difference between rural and urban areas.

Earned Income Tax Credit. The earned income tax credit (EITC) is the Federal Government's largest program designed to aid working poor families. In 1998, the program provided 19.7 million low-income taxpayers and their families with over $31.6 billion in refundable tax credits. One out of every 5 rural taxpayers or about 4.5 million received a credit, which averaged $1,674. A smaller share of urban residents, about 15 percent, received the EITC. Thus, compared with the overall ratio of rural to urban taxpayers, EITC benefits are slightly skewed toward rural areas (fig. 2). While a small portion of the credit is used to offset Federal income and other taxes, most of the credit is refunded to taxpayers when they file their Federal income tax return.

The EITC is available to working families that generally earn less than 200 percent of the poverty level. While regular tax liability rises with increasing income, EITC recipients are eligible for an increased tax credit as earned income increases up to a maximum dollar amount. The maximum credit is available over a $2,000-to-$3,000 range of income but then is phased out as earned income increases beyond this amount. The EITC reduces their net income tax liability and may even provide a cash refund since the credit increases at a faster rate than regular income tax liability before the maximum credit is reached.

The 2001 Tax Act modified the EITC benefit formula for married couples, instituting a separate benefit schedule for them. This is accomplished by extending the beginning point of the phaseout range by $1,000 in 2002-2004, $2,000 in 2005-2007, and $3,000 in 2008 and thereafter. This will increase both the number of low-income married couples eligible for the credit and the average amount of the credit for all eligible married couples with earned income above the point at which benefits begin to be phased out ($13,090 in 2001). Once the changes are fully phased in, the EITC amount will increase by over $600 for those married couples in the phaseout range for the credit.

Federal Estate Tax

While only about 2 percent of all estates end up owing any Federal estate taxes, a larger share of farmers and other rural business owners do. Over the next decade, the law makes a number of changes that will greatly reduce the number of estates affected by the Federal estate tax. These changes include an increase in the amount of property exempted from tax by the unified credit (from $675,000 in 2001 to $3.5 million by 2009) and a reduction in the top estate tax rates from 55 to 45 percent. The estate tax is completely repealed in 2010.

While these changes will reduce the amount of Federal estate taxes owed, the most dramatic effect during the phaseout period will be the sharp drop in the number of estates required to file a return. Thus, as the phaseout progresses, more estates will be exempted from the administrative costs as well as the tax obligation associated with the Federal estate tax. RA