



Federal Tax Relief Act

DAVID A. ROSENBERG
MARK J. VUCCI
SENIOR ATTORNEYS

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001, which generally will become effective on January 1, 2002. This article discusses certain effects that the Act will have on the Commonwealth's estate tax and individual income tax.

Estate Tax

Current Law Federal

Federal estate tax laws provide taxpayers with a credit against federal estate taxes owed in the amount of state estate taxes paid, not to exceed certain maximum amounts. These maximum amounts are calculated according to a formula that increases the amounts according to the size of the taxable estate. In no event, however, can the amount of this credit exceed the amount of federal estate taxes owed.

In this regard, one of the major determinants in the amount of federal estate taxes

owed is the "unified credit," a single credit applicable to both estate and gift taxes. (For purposes of this article, the gift tax aspects will not be discussed). Currently, this credit effectively exempts the first \$675,000 of the taxable estate. In other words, no federal estate tax is owed on taxable estates worth \$675,000 or less. The amount of this unified credit (prior to the new federal law discussed below) was scheduled to gradually increase to \$1 million by 2006.

Virginia

Virginia's estate tax operates to impose a tax in an amount that equals the maximum amount of the federal credit. This state tax, referred to as a "pick-up" tax, has never increased the total taxes paid by estates, because the pick-up tax reduces, dollar for dollar, the amount of federal estate taxes due. In other words, if Virginia did not collect the tax, the federal government would.

Not surprisingly, all states, as well as the District of Columbia, impose a pick-up tax. Virginia, 37 other states, and the District of Columbia impose the pick-up tax as the **only** state death tax. The other 12 states impose the pick-up tax in addition to a separate state estate tax or inheritance tax.

Virginia's estate tax law, however, differs from almost

all of the other states' laws in one major respect. Section 58.1-901 of the Code of Virginia states that the amount of the federal credit shall not "be less than the federal credit allowable by § 2011 of the Internal Revenue Code **as it existed on January 1, 1978**" (Emphasis added). The other states (except for New York and Washington) accept the amount of the federal credit as it exists in federal law at the time of the decedent's death. (The importance of this difference is discussed in the section of this article titled "Impact on Virginia.")

In the fiscal year ending June 30, 2000, the Commonwealth collected \$150.1 million in estate taxes.

New Federal Law

The new federal Tax Relief Act alters federal estate tax law in three major respects.

1. It reduces the amount of the federal credit (i.e., pick-up tax) beginning January 1, 2002, by 25 percent each year until it no longer exists on and after January 1, 2005. Beginning January 1, 2005, the credit is replaced by a deduction that reduces the value of the estate subject to the federal estate tax in an amount equal to all state death taxes actually paid.
2. It increases the exclusion amount used to compute the unified credit to \$1 million

in 2002 and gradually increases the credit applicable to estate taxes to \$3.5 million by 2009.

3. It completely repeals federal estate taxes in 2010.

The federal Act provides that all of these changes will sunset in 2011 unless reenacted by Congress.

Impact on Virginia

The three major changes to federal estate tax laws will affect Virginia estate taxes as follows.

- Reduction of federal credit — Under **current** Virginia law, the gradual reduction of the federal credit beginning January 1, 2002, and its elimination on January 1, 2005, will **not** affect Virginia's estate tax revenues. As mentioned, § 58.1-901 of the Code of



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E.M. Miller, Jr., Director
R.J. Austin, Manager, Special Projects
K.C. Patterson, Editor

For information contact:
 Special Projects
 Division of Legislative Services
 910 Capitol Street, 2nd Floor
 Richmond, VA 23219
 (804) 786-3591
<http://dls.state.va.us/>

Virginia ties Virginia's definition of the amount of the federal credit for purposes of determining the amount of Virginia estate taxes, to the maximum amount of such credit as provided under the federal law as it existed on January 1, 1978. Accordingly, contrary to the results in most other states, reductions to the credit under the new federal law will **not** reduce the credit as currently defined by Virginia, and thus will not reduce the amount of tax imposed by the Commonwealth.

Under such circumstances, however, the Commonwealth's estate tax no longer would be a pure "pick-up" tax. That is, to the extent the amount of Virginia's estate tax exceeds the new reduced federal credit, it will constitute an amount that otherwise would not have been paid to the federal government. This situation has not occurred previously because the federal credit formula has remained the same since 1978. Thus, if the General Assembly wishes to phase out Virginia's estate tax on the same schedule as that for the federal credit, then legislative action is required.

- Increase in unified credit — The gradual increase in the credit to \$3.5 million by 2009 will reduce Virginia's estate tax revenues more than they would have been reduced under the current schedule that would gradually have increased the credit to \$1 million by 2006. The Virginia Department of

Taxation is in the process of calculating an estimate of the amount of this reduction.

- Repeal of the federal estate tax — The triggering event for the imposition of the Virginia estate tax is the "transfer of the taxable estate." Section 58.1-901 of the Code of Virginia states that "'taxable estate' means 'taxable estate' as defined in § 2051 of the United States Internal Revenue Code of 1954, as amended or renumbered, or the successor provision of the laws of the United States." Unlike the Virginia definition of "federal credit," which has a "fixed" conformity date with federal law of 1978, the Virginia definition of "taxable estate" changes as the federal law changes ("rolling conformity"). Accordingly, when the federal estate tax is repealed in 2010 there will no longer be any "taxable estate." As a result, under current Virginia law, in 2010 there will be no "transfer of the taxable estate," and therefore no imposition and collection of the Virginia estate tax.

Of course, all of these results will be negated beginning in 2011 unless Congress repeals or extends the 2011 sunset date.

Individual Income Tax

Virginia is one of 35 states that, in one form or another, conforms its individual income tax laws to federal individual income tax laws. This means that (i) Virginia applies the federal definition of "income"

and other terms in administering its individual income tax laws; and (ii) the starting point for calculating Virginia individual income tax is the income amount (federal adjusted gross income) reported on the taxpayer's federal income tax return. Thus, any changes to federal adjusted gross income provided for under the Tax Relief Act will also impact Virginia's individual income tax revenues.

Many provisions of the Tax Relief Act operate to reduce federal adjusted gross income. Following is a discussion of several of these provisions, which are expected to significantly reduce federal individual income tax revenues. These provisions taken as a whole (or perhaps even individually) may also have a significant negative impact on Virginia's individual income tax revenues.

I. New Deduction for Qualified Higher Education Expenses

Under the Tax Relief Act, taxpayers are allowed a new deduction for qualified higher education expenses paid in a taxable year. In computing federal adjusted gross income, individuals with an adjusted gross income of \$65,000 or less (\$130,000 or less in the case of married persons) will be able to deduct up to \$3,000 in each of taxable years 2002 and 2003 for qualified higher education expenses. In each of taxable years 2004 and 2005, individuals with an adjusted gross income of \$65,000 or less (\$130,000 or less in the case of married persons) may deduct up to \$4,000 in qualified higher education expenses, and individuals with an adjusted gross income greater than \$65,000 but less than \$80,000 (greater than \$130,000 but less than \$160,000 in the case of mar-

ried persons) may deduct up to \$2,000 in qualified higher education expenses. This deduction ends in taxable year 2005.

Qualified higher education expenses include tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, and in certain cases the taxpayer's dependent for courses of instruction at an institution of higher education (an accredited post-secondary educational institution). The term does not include student activity fees, athletic fees, insurance expenses, meal expenses, room and board, and other expenses unrelated to an individual's academic course of instruction.

II. Expansion of Deduction for Interest on Education Loans

Current Federal Law

Federal income tax laws currently provide a deduction for interest paid during the taxable year on qualified education loans. In computing federal adjusted gross income, individuals with an adjusted gross income of \$55,000 or less (\$75,000 or less in the case of married persons) may deduct up to \$2,500 in interest paid on qualified education loans. A qualified education loan generally is any indebtedness incurred on behalf of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent to pay the cost of attendance at an institution of higher education (an accredited post-secondary educational institution). The deduction is allowed only during the first five years of repayment of the qualified education loan.

New Federal Law

The Tax Relief Act expands the potential use of the current deduction beginning January 1,

2002, by allowing the interest deduction for any year in which interest is paid on a qualified education loan and by changing the adjusted gross income ceiling from \$55,000 or less to \$65,000 or less (\$130,000 for married persons).

III. Expansion of the Tax-Exempt Status of Education IRAs

Current Federal Law

Education Individual Retirement Accounts (education IRAs) are tax-exempt under federal income tax law. An education IRA is a trust created exclusively to pay the qualified post-secondary educational expenses of the beneficiary of the trust designated by the person making contributions to the trust.

Contributions to the trust are invested. Unlike the trust itself, earnings from investment of the contributions are generally included in federal adjusted gross income at the time they are distributed (this is similar to the tax treatment for other earnings, such as interest on bank savings accounts). However, earnings of an education IRA are excluded from federal adjusted gross income if, in the year of distribution, the total amount distributed from the education IRA (contributions plus earnings) is less than the post-secondary educational expenses of the beneficiary.

Qualified educational expenses for which an education IRA may be established include tuition, fees, books, supplies, equipment, and room and board. The maximum amount that can be contributed on behalf of each beneficiary is limited to \$500 per year, and contributions may not be made on behalf of persons 18

and older. Furthermore, only individuals with an adjusted gross income of \$110,000 or less (\$160,000 or less in the case of married persons) can contribute to an education IRA.

New Federal Law

Under the Tax Relief Act, along with qualified post-secondary educational expenses, qualified elementary and secondary school expenses may also be paid using tax-free distributions from an education IRA. Qualified elementary and secondary school expenses include tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (grades kindergarten through 12). The term also includes computer technology, computer equipment, and Internet access and related services to be used by the beneficiary during any of the years the beneficiary is in school.

The Tax Relief Act also increases the maximum amount that can be contributed on behalf of each beneficiary from \$500 per year to \$2,000 per year. Finally, the adjusted gross income ceiling applicable to married persons is increased from \$160,000 or less to \$220,000 or less.

The practical effect of these changes, which are effective beginning January 1, 2002, is to expand the use of education IRAs in paying for certain educational expenses. An

increase in the usage of education IRAs means that more earnings on IRA contributions will be permanently excluded from federal adjusted gross income and therefore from the Virginia individual income tax base.

IV. Extension of the Exclusion for Educational Assistance Provided by Employers

Current Federal Law

Under present law, the first \$5,250 of educational assistance provided to an employee by his employer (generally, payment of the employee's tuition, fees, books, supplies, and equipment for a course of instruction) is excluded from the employee's federal adjusted gross income. The educational assistance must be related to a written plan of the employer that provides educational assistance to his employees. The \$5,250 exclusion does not apply to educational assistance for graduate level courses. Moreover, the exclusion is set to expire on December 31, 2001.

New Federal Law

The Tax Relief Act makes the exclusion permanent and applicable to educational assistance for both graduate level and undergraduate courses. This will allow employees a permanent and expanded exclusion for educational assistance provided by their employers, which is otherwise taxable income.

V. Increase in Allowable Contributions to Traditional Individual Retirement Accounts and Tax-Deferred Retirement Plans

Current Federal Law

Federal income tax laws provide certain tax preferences to encourage taxpayers to contribute to individual retirement savings plans such as IRAs and tax-deferred retirement savings plans. These preferences include allowable deductions for contributions (in computing federal adjusted gross income) and the deferral of income tax on certain salary and other compensation that is contributed to a retirement savings plan.

Individuals may contribute up to \$2,000 a year to a traditional (excluding Roth and education IRAs) IRA. The annual contribution limit is \$4,000 for married persons. The amount contributed to a traditional IRA may be deducted by the taxpayer in computing federal adjusted gross income.

In addition, taxpayers may defer federal income tax on salary and other compensation that is used to make contributions to § 401 (k) plans (employer matching contribution plans) or § 457 plans (state and local government deferred compensation plans). In these cases, the federal income tax is deferred until the time the contributions and earnings are withdrawn from these retirement savings plans. Both the contributions and any earnings are subject to federal income taxes when withdrawn. The deferral of federal income tax on

such compensation also results in a deferral of Virginia individual income tax, as such compensation is generally included in federal adjusted gross income at the time of withdrawal (i. e., when the taxpayer is ready to retire).

The maximum that a taxpayer may contribute per year to a § 457 plan is the lesser of \$8,500 or 33.3 percent of his compensation. The maximum annual contribution allowed to a § 401 (k) plan is \$10,500.

New Federal Law

The Tax Relief Act increases the maximum yearly contribution to a traditional IRA and allows a higher maximum contribution for persons 50 and older, as shown in Table 1.

These new limits increase the amount that may be deducted for traditional IRA contributions in computing federal adjusted gross income. As discussed above, any

decrease in the amount of income reported as federal adjusted gross income will result in a decrease in Virginia individual income tax revenues.

The Tax Relief Act also increases the maximum yearly contribution to § 401 (k) and § 457 plans, as shown in Table 2.

Thus, taxpayers will be allowed to defer federal income taxes on more of their salary and compensation. This also means that the Virginia individual income tax would be deferred to a later date on such salary and compensation.

VI. Increase in the Maximum Amount of Itemized Deductions

Current Federal Law

Federal income tax laws provide for deductions from federal adjusted gross income for an individual's unreimbursed expenses, including unreimbursed medical expenses, mortgage interest, state and local taxes, charitable contributions, and certain employee expenses. These deductions are

**TABLE 2
Maximum Annual Contribution to § 401 (k) and § 457 Plans***

Tax Year	Maximum Annual Contribution
2002	\$11,000
2003	\$12,000
2004	\$13,000
2005	\$14,000
2006	\$15,000
2007 and beyond	\$15,000**

*These are general maximum limits for each individual
** The \$15,000 is indexed in \$500 increments for inflation.

known as itemized deductions and are subtracted from federal adjusted gross income. Itemized deductions reduce the amount of an individual's income that is subject to federal income taxes.

While itemized deductions do not factor into federal adjusted gross income (the starting point in determining Virginia individual income tax), the Commonwealth's income tax laws allow Virginia citizens an income tax deduction equal to either a standard amount or the amount reported as itemized deductions on the individual's federal income tax return. (The standard deduction for Virginia individual income tax purposes is \$3,000 for individuals and \$5,000 for married persons.) Thus, any change in federal law affecting itemized deductions will also impact Virginia's individual income tax revenues.

New Federal Law

The Tax Relief Act allows certain taxpayers an increase

**TABLE 1
Maximum Annual Contribution for Traditional IRAs***

Tax Year	Under Age 50	50 and older
2002	\$3,000	\$3,500
2003	\$3,000	\$3,500
2004	\$3,000	\$3,500
2005	\$4,000	\$4,500
2006	\$4,000	\$5,000
2007	\$4,000	\$5,000
2008	\$5,000	\$6,000
2009 and beyond	\$5,000**	\$6,000***

*These are general maximum limits for each individual
** The \$5,000 is indexed in \$500 increments for inflation.
*** The \$6,000 is indexed in \$500 increments for inflation.

in the amount of itemized deductions that they currently can claim on their federal income tax return. This is accomplished by repealing the current overall limitation on the amount of itemized deductions that may be claimed on a federal income tax return. Current federal law provides that the amount of otherwise allowable itemized deductions is reduced by three percent of the amount of an individual's federal adjusted gross income in excess of \$66,475 (\$132,950 in the case of married persons). The Tax Relief Act repeals this required reduction over a five year-period beginning in 2006, as shown in Table 3.

Repealing the overall limitation on itemized deductions will allow certain taxpayers to claim more in itemized deductions on both their federal and Virginia individual income tax returns. This will tend to decrease both federal and Virginia individual income tax revenues.

TABLE 3
Reductions in Allowable
Itemized Deductions

Tax Year	Required Reduction
2001 - 2005	3%*
2006 & 2007	2%
2008 & 2009	1%
2010 and beyond	Repealed

*No change from current law.

Summary

The Economic Growth and Tax Relief Reconciliation Act of 2001 contains several provisions that could significantly impact Virginia's estate and individual income tax rev-

enues. The Department of Taxation will be developing a fiscal impact statement on the specific state revenue implications resulting from the new federal tax legislation. This information will be reported as soon as it is available.

Summary of Fiscal Impacts on Virginia Economic Growth and Tax Relief Reconciliation Act of 2001

2000-02 (Current) Biennium: Small – \$1.4 million
2002-04 (Next) Biennium: Larger – \$83.3 million

Fiscal Impact (\$millions)

Item	2002	2003	2004	2005	2006
Eliminate limit on itemized deduction	0	0	0	0	-7.4
Benefits for children	0	-0.1	-2.5	-2.5	-2.6
Education provisions	0	-14.7	-21.7	-27.5	-37.8
Estate tax	0	-8.6	-11.5	-16.1	-15.0
Pension and IRA	-1.4	-8.7	-15.5	-20.7	-27.5
Total	-1.4	-32.1	-51.2	-66.8	-90.3

Source: Virginia Department of Taxation