

June 1, 2003

Dear Client/Friend:

Each year tax returns become increasingly more complex due to new tax legislation. New provisions are added and others expire, sometimes by means of phase-ins and phase-outs over a period of several years. In addition, many of the tax law's benefits are limited to taxpayers with adjusted gross income (AGI) below certain levels that can change every year. Some deductions are available in arriving at AGI (referred to as "above-the-line") and help to lower your AGI. By lowering AGI, you may be able to receive a greater tax benefit from other items that are calculated based on AGI. Following is a brief summary of some of the more common tax benefits that are based on AGI along with their corresponding AGI phase-out ranges for 2003.

**Student Loan Interest Deduction**

Interest on qualified education loans is an "above-the-line" deduction. The maximum deduction amount is \$2,500 and begins to phase-out when AGI reaches \$50,000 (\$100,000 for joint returns). The deduction is completely phased-out when AGI reaches \$65,000 (\$130,000 for joint returns). The deduction cannot be taken if your filing status is married filing separate.

**Tuition and Fees Deduction**

Tuition and related expenses paid to an accredited post-secondary institution can also be deducted "above-the-line". The deduction is limited to \$3,000 in 2003 and is available to taxpayers with AGI below \$65,000 (\$130,000 for joint returns). Unlike many other tax benefits, this deduction does not make use of a phase-out range. If AGI is \$1 above the AGI limit, the full deduction is disallowed. This deduction also cannot be taken if separate returns are filed.

**Hope/Lifetime Learning Credits**

These credits against tax can be taken for tuition expenses incurred in the pursuit of college or graduate degrees. The Hope credit provides a maximum \$1,500 credit for qualified tuition expenses paid for each of the first two years of post-secondary education. The lifetime learning credit allows a credit of 20% of the first \$10,000 of qualified tuition expenses for any year that the Hope credit is not claimed. The credits begin to phase-out when AGI reaches \$41,000 (\$83,000 for joint returns). The credits are completely phased-out when AGI reaches \$51,000 (\$103,000 for joint returns). The credits cannot be taken if your filing status is married filing separate.

**Medical Expenses**

Expenses paid during the year for medical care are allowed as an itemized deduction to the extent that the total exceeds 7.5% of AGI. For example, if your AGI is \$100,000 and your medical expenses were \$8,000, you would only receive a deduction of \$500.

### **Miscellaneous Deductions**

Miscellaneous deductions (e.g. unreimbursed employee business expenses, tax preparation fees, investment fees) are allowed as an itemized deduction to the extent that the total exceeds 2% of AGI. For example, if your AGI was \$120,000 and you had \$2,000 in miscellaneous deductions, you would receive no deduction.

### **Itemized Deduction Reduction**

In addition to the above itemized deduction limitations, total itemized deductions are further reduced if AGI exceeds certain levels. The amounts for 2003 are \$139,500 for single, joint, and head of household filers and \$69,750 for separate filers. Allowable itemized deductions are reduced by 3% of the amount by which AGI exceeds the threshold amount. The reduction does not apply to certain deductions (e.g. medical expenses, investment interest). The reduction is also limited to 80% of allowable deductions. For example, if allowable itemized deductions are \$15,000, the reduction amount cannot exceed \$12,000. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed this limit of itemized deductions effective for tax years after 2009. It will be gradually phased-out beginning in 2006.

### **Exemption Amount**

For 2003, the personal and dependency exemption amount is \$3,050. This deduction may be reduced or eliminated for higher-income taxpayers. If AGI exceeds the threshold amount, the deduction is reduced by 2% for each \$2,500 (\$1,250 for separate filers) or fraction thereof by which AGI exceeds the threshold amount. The threshold amounts for 2003 are \$209,250 for joint or surviving spouse filers; \$174,400 for head of household filers; \$139,500 for single filers; and \$104,625 for married persons filing separately. The exemption phase-out was also repealed by EGTRRA effective for tax years after 2009. It will be gradually phased-out beginning in 2006.

### **Child Tax Credit**

Taxpayers who have a qualifying child for whom a dependency exemption is claimed and is under 17 years old are entitled to a \$600 tax credit per child. The credit begins to phase-out when AGI reaches \$110,000 for joint filers, \$55,000 for separate filers and \$75,000 for single and head of household filers. The credit is reduced by \$50 for each \$1,000 or fraction thereof by which AGI exceeds the threshold amount.

These are a few of the most common phase-out items, but there are many more that have not been mentioned.

### **The Jobs and Growth Reconciliation Tax Act of 2003**

This Act was recently enacted and provides \$330 billion in tax cuts over the next decade. A large portion of this amount is devoted to accelerating income tax reductions enacted in the Economic Growth and Tax Reconciliation Act of 2001. Some of the key provisions are as follows:

- **Tax rates drop** – the 2001 Act reduction will become effective in 2003, retroactive to January 1. The top tax rate will fall from 38.6% to 35%. Other rates drop from 35% to 32%, from 30% to 28% and from 27% to 25%.
- **“Marriage penalty” reduced** – for married couples, the standard deduction will increase to twice that of single taxpayers. Also, the 15% tax bracket will widen for married couples filing jointly.
- **Dividend and capital gains tax lowered** – the top rate will be lowered from 38.6% on dividends and 20% on capital gains to 15% for both. The maximum rate for low-income taxpayers will be 5%.
- **Increase in child tax credit** – the credit will increase from \$600 to \$1,000 per child.
- **Alternative minimum tax narrowed** – fewer taxpayers will have to pay this tax due to increases in the exemption amounts.
- **Increase in Section 179 deduction** – the maximum annual expense amount will increase from \$25,000 to \$100,000.

As additional proof of how much more complicated tax returns have become, please refer to the copy of the U.S. income tax return from 1913 on the back of this page, in which the 16<sup>th</sup> Amendment gave Congress the power to collect income tax. We are here to assist you in complying with and benefiting from the latest tax provisions. If you have any questions, please feel free to call us.

Very truly yours,

James R. Hochwalt

JRH/fkb

Enclosure