

## Big, Big Postcard

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The Congressional leadership that crafted the Taxpayer Relief Act of 1997 wants the tax system to be so simple that taxpayers can fill out a tax form on a postcard. Judging by some of the choices they made in the new law (with lots of help from the President), they had in mind a postcard the size of a billboard.

For example, they cut capital gains taxes, which was no surprise. What was a surprise is that they invented a whole new tax system to do it. They say they want a flat tax system—that is, one tax rate on all income—but they've created six new rates on capital gains alone, in addition to all the rates that applied under old law. There's an 8-percent rate for gains on assets held five years or more and sold after 2000 by taxpayers in the 15-percent bracket, and a 10-percent rate for the same taxpayers on their assets held from 1 to 4 years, or sold before 2001. The 15-percent rate applies to assets held 12 months or less.

Taxpayers in the 28-, 31-, 36-, and 39.6 percent brackets pay tax at those rates on short-term gains, but long-term gains on assets held for less than 12 months are taxed at a 28-percent rate. Assets held 1 to 4 years or 5 years or more, but purchased before 2001, face a 20-percent rate. Gains on assets held 5 years or more and purchased after 2000 will be taxed at an 18-percent rate. Taxpayers whose gains alone elevate them from the 15-percent bracket to higher tax brackets might face almost all of these different tax rates on different portions of their gains. (See new Schedules D2 through D13 and allocation worksheet.)

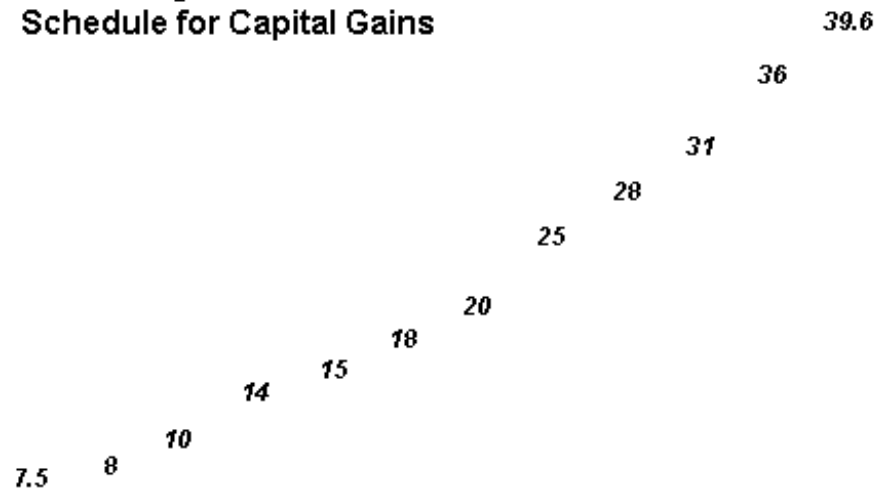
Under the new law, the gain on a single real estate investment by a high-income taxpayer could be taxed at three different rates! Recaptured depreciation would be taxed at 39.6 (or 36 or 31) percent, the nonrecaptured depreciation at 25 percent, and any additional gain at 20 percent. (See Pub. 1984, *So, you want to sell your apartment building, eh?*) And qualifying small business stock is taxed at either the 14 or 7.5 percent rates.

Does that sound like fun? Well, a lot of taxpayers will have to do all the calculations twice, because those special rates apply under the alternative minimum tax (AMT) too—another completely separate tax schedule that was on the Congressional agenda for elimination until mark-up began. The AMT used to just apply to rich people with overzealous accountants, but now lots of people will get to experience it because of...

The child credit. That was another campaign promise—to provide tax relief for families. We'll no doubt appreciate the cut in our tax bills, but will it be enough to pay the accountant? The child credit eventually will provide \$500 per child under 17 in tax reductions for many families, unless their incomes are too low or too high. Low-income families can only claim tax credits up to the amount of their income tax liability...

Unless they have three or more children, in which case they qualify for a "partially refundable credit." In that case the credit is limited to their income tax before credits plus the employee's share of payroll taxes minus earned income credits. These taxpayers will have to compute their child credit both ways to see which one results in a bigger credit. Of course, any low-income person who can actually do these calculations should be earning a lot more than the minimum wage, so the IRS will probably audit them to look for unreported income.

## Redefining Flatness: New Tax Schedule for Capital Gains



What about higher income people with kids? If your income is over \$90,000, you start losing child credits. (See worksheet.) This phase-out creates yet another set of income tax rates. When you earn a dollar of capital gains (or other income) in the phase-out range, you lose 5 cents in tax credits. Thus, if your capital gains tax rate is supposed to be 20 percent, it's really 25 percent. (The new law creates lots of other complicated phase-outs that also raise marginal tax rates for certain taxpayers. Consult your rocket-scientist to see if they apply to you.)

Which brings me back to the AMT. It is pretty awful to make people figure their taxes two different ways—one way is unpleasant enough—but the AMT used to primarily affect higher income people who could afford to pay for help with their taxes. Not any more. People are subject to the AMT if they take advantage of tax preferences (such as personal exemptions and the deduction for state and local taxes) to reduce their ordinary income tax. The child credit is a tax preference. It will cause the ordinary income tax liability of some moderate income people with big families to fall below the AMT, in which case the AMT applies.

Well, not technically. Congress saw this coming so they designed the child credit so that it would not cause anybody to become an alternative minimum taxpayer. But you may want to hold off on the thank you letter. The new law instructs taxpayers to reduce their child credit by the difference between ordinary income tax liability and AMT. Technically, you're not subject to AMT, but there's no way to calculate this limitation without calculating your AMT liability. (Complete Schedule AMT-NOT and child credit limitation worksheet.)

I could try to explain to you about the new Roth IRA (your tax benefits will vary depending upon your income and the tax laws in effect when you retire; consult your seer), and the potpourri of new tax incentives for education: Hope Credit, education IRAs, Lifetime Learning Credits, exemption for state tuition programs, partial deduction for student loan interest, and penalty-free withdrawals of IRAs for education expense, but it's too complicated.

But, even with all of these new incentives, one is missing: the Hope to Learn how to do your Taxes Credit.

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