THE 2003 TAX RELIEF ACT

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) affects most taxpayers and investors. While some changes are phased in gradually, many take immediate effect, to provide a stimulus to the U.S. economy. Some provisions are automatic and will not require action on the part of the taxpayer (such as the marriage penalty relief and revised AMT limits) others will require the taxpayer, with appropriate counsel, to take the actions apparently anticipated by Congress.

Most individuals with young children will see an immediate benefit from the new increase in the Child Tax Credit. Nearly every working person will see a reduction in the taxes withheld from her/his paycheck due to the advancement of scheduled tax rate reductions enacted in 2001. Investors will benefit from lower rates on dividends and capital gains. Smaller businesses will be encouraged to spend more on capital equipment acquisitions by expanded write-offs for new asset purchases. The new law quadruples the expense deduction, almost doubling bonus first-year depreciation.

Personal Income Tax Issues

Tax Benefit Acceleration. In 2001, a massive tax cut law reduced individual tax rates, provided limited marriage penalty relief and increased the child tax credit. These changes, among others, were to be phased in gradually over several years. For example, tax rate reductions were scheduled to take place gradually from 2001 through 2006. Child tax credit increases were to be phased in from 2001 through 2010. The 2003 Act accelerates these changes so that they are fully in effect for the 2003 tax year.

Individual Rate Reductions. Individual taxpayers determine their federal income tax liability by applying graduated tax rates to their taxable income for the year with different income brackets applying to separate categories of taxpayers. The 2003 Act accelerates the 10% bracket increases formerly scheduled for 2008. For 2003 and 2004, the taxable income ceiling levels for the 10% tax rate bracket rise as follows:

Ceiling Level for the 10% Tax Bracket		
Filing Status	**2003-2004 (Old Law) Taxable Income up to:**	**2003-2004* (2003 Act) Taxable Income up to:**
Single Taxpayer	6,000	7,000
Head of Household	10,000	10,000
Married - Filing Jointly	12,000	14,000
Married - Filing Separate	6,000	7,000
* 2004, the 10% bracket may also be adjusted for inflation. Source: NPI		

The 2003 Act also accelerates into 2003 the scheduled reductions in the higher income tax rates. The following table shows a comparison of the old and new rates:

The Old Law Tax Rates Percentages		2003 Act Rates
2003	**2004-2005**	**2003-2010**
10%	10%	10%
15%	15%	15%
27%	26%	25%
30%	29%	28%
35%	34%	33%
38.6%	37.6%	35%
* Rates will return to the pre-2001 rates after 2010. Source: NPI		

For taxpayers in the higher brackets, these changes could have a dramatic impact on the amount of tax paid in 2003, since their top rate is reduced by at least two percent. Plus, many of those taxpayers get the benefit of the reduction in the graduated rates and also the increase in the 10% bracket amount. These changes are all subject to repeal due to the 2001 law's "sunset" provision, which calls for a return to pre-2001 rates in 2011, but there will certainly be more tax changes before then.

Marriage Penalty Relief. A married couple may file a joint tax return and be treated as one taxpayer. Joint filers pay taxes on their total taxable income. The "marriage penalty" exists when the combined tax liability of a married couple filing jointly is greater than the sum of their tax liabilities computed as though they were two unmarried filers.

The new law corrects this with two moves: (1) It increases the basic standard deduction for joint filers to twice the standard deduction for single filers, effective for 2003 and 2004; (2) The 2003 Act increases the size of the 15% bracket for joint returns to twice the size of the 15% bracket for single returns, again for 2003 and 2004. From 2005-2008 the standard deduction and tax bracket differences will drop back to less than 200%, but resume that posture in 2009.

Child Tax Credit. Eligible taxpayers may claim a tax credit (a direct offset against income tax) for each qualifying dependent child under 17. For taxpayers whose tax liabilities are not high enough to take full advantage of the credit, the law allows a refund of any unused child tax credit. The credit is refundable to the extent of 10% of the taxpayer's earned income in excess of $10,500, subject to future inflation adjustments. In 2005, the refundable percentage increases to 15% of excess earned income and a special refund rule applies to families with three or more eligible children. The child tax credit may also be claimed against the Alternative Minimum Tax.

The child tax credit is phased out for individuals with income over certain thresholds. The credit is reduced by $50 for each $1,000 of modified adjusted gross income (AGI) over $75,000 for single taxpayers or heads of households, over $110,000 for married persons filing jointly, and over $55,000 for married persons filing separately.

Taxable Year	Credit Amount per Child under the Old Law	Credit Amount per Child under the 2003 Act
2003-2004	600	1,000
2005-2008	700	700
2009	800	800
2010*	1,000	1,000
* The credit is scheduled to revert to $500, beginning in 2011. Source: NPI		

Furthermore, the 2003 Act provides a major benefit for those who claimed child tax credit on their 2002 return. Under the new law, the increased amount of the 2003 child tax credit (up to $400 per child) will be paid in advance, beginning in July 2003, on the basis of information contained on each taxpayer's 2002 tax return.

Example: Mary and Ted reported adjusted gross income of $50,000 on their 2002 joint tax return and have two young children for whom they claimed a full child tax credit in 2002. In 2003, Mary and Ted will receive an advance payment of $800 ($400 for each child) as a result of the new law.

Alternative Minimum Tax Relief. The alternative minimum tax (AMT) is designed to ensure that individuals who have significant income-tax deductions or credits pay a minimum amount of tax. The law provides a minimum tax exemption to each taxpayer. The 2003 Act increased the AMT exemption amounts as follows:

Taxpayers Category	AMT Exemption under Old Law	AMT Exemption under 2003 Act
Married, filing Jointly	49,000	58,000
Head of Household and Single	35,750	40,250
Married, filing Separately	24,500	29,000

Dividends and Capital Gains. The new law contained a lot of good news for investors, especially with regard to taxing corporate dividends twice – once when profits were earned by the corporation and reported on its tax return and, again, when those profits (or a portion of them) were paid out to shareholders as dividends. These dividends were taxed as ordinary income, at up to the highest marginal rate in effect for the year (38.6% in 2003 prior to the new law's rate changes).

Capital gains taxes have also been a source of controversy over the years. When a taxpayer sells or otherwise disposes of an appreciated capital asset – an investment, for example – the difference between the sale price and what the taxpayer paid for the asset is generally considered a capital gain.

Under pre-2003 Act law, net capital gain was taxable at a maximum rate of 20%, or 10% for gain that would otherwise be taxed in the 15% or 10% tax bracket. For gain to qualify for the 20%/10% rates, the asset must have been held for more than one year. Assets held for more than five years could qualify for even lower rates – 18% and 8%, respectively. Capital losses are deductible in full against capital gains, and any net capital loss is deductible against ordinary income of up to $3,000 a year. Several exceptions and restrictions apply to these general rules.

Combined Dividend and Capital Gains Rates. Under the 2003 Act, dividends are taxable at the same rates as net capital gains. And the tax rates on those capital gains are going down – from 20% to 15% and from 10% to 5%. The capital gains rate cuts are effective for tax years ending on or after May 6, 2003, through the end of 2008. The old law's 18%/8% rates are repealed, but return after 2008 for qualifying gains.

The dividends rate cuts are effective for tax years beginning after 2002 and before 2009. For tax years beginning after 2008, both dividends and capital gains will be taxed as they were before the 2003 Act. A transitional rule applies for capital gains realized before May 6, 2003.

Ordinary Tax Bracket	Tax Rates on Dividends and Net Capital Gains*	
10% and 15%	5%**	0%
All Other Brackets	15%***	15%

* Some exceptions apply.
** After 2008, tax rates are scheduled to revert to the pre-2003 Act law.
*** Subject to transition rule for pre-May 6, 2003, capital gains. Source: NPI

Example: Robert, who is in the highest tax bracket, realizes a net long-term capital gain of $50,000 and qualified dividend income of $50,000 in 2004. Prior to the 2003 Act, Robert would have had to pay tax on his gain at a 20% rate and on his dividends at a 37.6% rate (2004). Under the new law, both his gain and his dividends will be taxed at a 15% rate. So, his tax will be approximately $15,000 on that $100,000 of income instead of approximately $28,800 under prior law - a major savings.

The new dividend rates apply to dividends received by an individual shareholder from a domestic or "qualified foreign" corporation (stock is traded on an established U.S. securities market or meeting certain criteria). There are seven circumstances under which the new rates do not apply, so you will want to give careful consideration to any moves.

Investment Market Impact. The new tax structure will likely make capital gains and dividend paying stocks more attractive to higher income investors. Investors may put more pressure on publicly traded corporations to pay dividends now that they receive such favorable treatment. Note also that dividends from closely held corporations are eligible for the reduced rates. So, business owners who are stockholder-employees of a private C corporation will have to analyze the relative merits of taking dividends versus compensation of salary or bonus.

The capital gains rate cut is not “across the board” for all holdings. Long-term capital gain from some assets, such as collectibles, remains subject to a 28% maximum rate.

From a capital gains perspective, the lower rates may discourage investors form short-term trading, since the differential between the tax rates on long– and short-term gains has grown. This may have a somewhat stabilizing effect on the market. Investors will now be paying much closer attention to the dividend payment history and the current profit posture of corporations as they consider making purchases.

Finally, the temporary nature of the cuts, especially for capital gains and dividend rate relief, makes mid and long term financial planning more tax driven than ever before. Since the double tax still exists, taxpayers should explore new planning opportunities. Taxpayers may, under existing law, borrow money to purchase stocks and take deductions on the interest paid. Because the dividend tax rate falls to 15 percent, the interest rate deduction will partially insulate dividend income from taxation, reducing the effective tax rate even further.

Accumulated Earnings and PHC Tax Rates. The accumulated earnings tax is imposed on regular C corporations that accumulate unreasonable amounts of earnings and profits to avoid paying taxable dividends to their shareholders. For tax years beginning after 2002 and before 2009, the accumulated earnings tax rate and Personal Holding Company (PHC) tax rate are reduced to 15%.

The PHC tax is a penalty tax payable by certain C corporations on income that isn’t distributed to shareholders. To be subject to the tax, a corporation must: (a) at any time during the last half of the year, have more than 50% of its stock owned by five or fewer individuals and (b) derive at least 60% of its income from dividends, interest, annuities, rents, royalties, etc.

Tax Return Preparation Complications. The May 6, 2003 effective date is sure to add complexity and the IRS anticipates a large number of errors on 2003 returns. The IRS reported that eight lines will have to be added to Schedule D, the Schedule D Tax Worksheet, Form 6251 (AMT), and Form 8801 (Credit for Prior Year Tax). In addition, taxpayers whose only capital gains are capital gain distributions will not be able to use the shorter worksheet for Forms 1040 and 1040A. They will have to attach Schedule D to Form 1040. The IRS predicted that up to six million taxpayers could be impacted.

Incentives for Business

To stir economic activity, the 2003 Act also provides growth incentives for businesses. Whether this stimulates employment or accelerates stock market prices has yet to be determined.

Extension of Bonus First-Year Depreciation. In most cases, taxpayers must recover the cost of assets used in a trade or business or for the production of income through annual depreciation deductions on their tax returns. This causes the deductions to be spread out whether the taxpayer pays cash or finances the purchase.

The amount of the annual depreciation deduction is usually determined using a series of rules called the modified accelerated cost recovery system (MACRS). The 2003 Act expands and modifies the bonus depreciation provisions. Under the new law, taxpayers can elect additional first-year depreciation of 50% for qualified property. Qualified property is defined in the same manner as under the 2002 law except the time period for acquisition is different. The original use of the property must commence with the taxpayer after May 5, 2003, and the property must be acquired by the taxpayer after May 5, 2003, and before January 1, 2005, and be placed in service before that latter date. Again, other requirements and exceptions apply.

Example: Assume a company qualifies for the additional 50% first-year depreciation deduction for a $50,000 truck. Instead of claiming the regular depreciation deduction of $10,000 the company may claim three times that amount in 2004 - $30,000. That amount consists of $25,000 of additional first-year depreciation (50% times $50,000 plus $5,000 of regular MACRS depreciation 20% of $25,000, the truck's remaining basis after subtracting the $25,000 of bonus depreciation).

Provisions of the 2003 Act Include: A $7,650 increase in the limitation on the amount of depreciation deduction allowed with respect to certain "luxury" passenger automobiles in the first year (versus the $4,600 increase allowed under the 2002 law).

Clarification by Congress that the adjusted basis of qualified property acquired in a like-kind exchange or an involuntary conversion is eligible for the addition first-year depreciation.

Corporate vs. Partnerships. With corporate rates no longer a bargain compared with individual rates, operating as a pass-through entity or as a sole proprietorship may make more sense under JGTRRA.

Example: The effective corporate tax rate in 2003 for taxable income within the $75,000 - $100,000 level is 34%; within the $100,000 - $335,000 level, 39%; and within the $335,000 – $1 million level 35%. Personal service corporations are subject to a flat 35% rate on all income.

Increase in Section 179 Expensing. Small businesses can take advantage of the election under Section 179 of the tax code to expense the cost of depreciable assets in the year of acquisition, within tax law limits.

Under Section 179, a taxpayer may elect to deduct up to a dollar limit ($25,000, under pre-2003 Act law), the cost of qualifying property placed in service during the tax year. The dollar amount is phased out dollar-for-dollar as the taxpayer's cost of qualifying property for the year exceeds $200,000. The amount that can be expensed each year cannot exceed the taxpayer's taxable income derived from the active conduct of a trade or business for the year (without taking into account the effect of Section 179). Thus, the expensing election is most beneficial to profitable smaller businesses with sufficiently small annual capital investments.

Property qualifying for the election must generally be tangible personal property, like equipment, vehicles, machinery, etc. Under pre-2003 Act law, off-the-shelf computer software did not qualify. The 2003 Act increases the maximum dollar amount that may be deducted under Section 179 to $100,000 for property placed in service in tax years beginning in 2003, 2004, 2005. In addition, for phase-out purposes, the $200,000 annual investment limit described above rises to $400,000 for property place in service during those years.

The increased Section 179 election and the newly expanded additional first-year depreciation bonus can be a powerful combination when it comes to writing off new asset purchases, especially given the significantly higher Section 179 annual asset investment limit. The rules can be tricky, however, so the advice of a professional tax advisor is recommended.

Retirement Planning. This Tax Act does not benefit non-deductible IRA plans, employee after-tax contributions to 401(K) plans and variable annuities. There are two reasons:

- **No step-up in basis.** When the assets within each plan are liquidated they receive no special step-up in basis or capital gains benefits, since the plan structure avoids this.

- **No dividend special treatment.** All dividends are received by the plan without tax, but are fully taxed later when the proceeds are withdrawn.

Had the same funds been placed in a non-qualified investment account and invested in the same securities, there would be favorable capital gains tax rates, and very favorable tax on dividends received – plus the remaining appreciated assets would receive a step-up in basis upon death. Does this mean you should surrender those investments? No, but it does indicate that the tax advantage is now tilted toward non-deductible investments outside of those plans, rather than inside the plans that have higher taxes upon withdrawal.

Education and Estate Planning. Taxpayers with appreciated assets should think about transferring them to children over age 13 (and exempt from the "kiddie" tax). Savings in 2008 could be dramatic using this technique. Assuming the child is otherwise in the 10-percent tax bracket, a sale of appreciated assets in 2008 will, at least in part, not be taxed at all – a great way to contribute to a college or graduate school fund.

How Can We Help? This tax law has many features, and was enacted with the stated purpose of stimulating economic growth by encouraging taxpayer investments.

What should you do to take advantage of the 2003 Act? Obviously, this will vary for each family and personal situation, but you might consider talking further with us about:

- **Reinvesting the Child Care Refund Checks.** This should be received later this summer. Don't spend this – put it to better long term use.

- **Increasing your investments.** If the lower income taxes produce more spendable income, why not strengthen your long-term position by increasing you contribution to (a) deductible retirement plans or (b) non-deductible investments.

- **Altering existing investments.** Take advantage of the favorable dividend and capital gains treatment.

- **Re-evaluate your insurance.** Perhaps you have been postponing the purchase of additional life insurance or long-term care coverage – and the tax savings could stimulate you to take action.

Please give us a call if you would like additional information or a personal assessment as to taking action on any provisions.