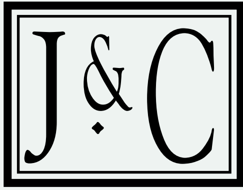

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Attorneys and Counsellors at Law

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Trusts & Estates Law Alert

TAX ACT OF 2003 REDUCES INDIVIDUAL TAX RATES AND ENCOURAGES SOME TYPES OF INVESTMENTS

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Billed as one of the largest tax cuts in U.S. history, the Jobs and Growth Tax Relief Reconciliation Act of 2003 reduces federal income tax rates for all individuals. The 2003 Act also provides some new incentives to invest in dividend-paying stocks, other capital assets, and certain business property.

MAJOR CHANGES SUMMARIZED

Taxation of Individuals

Reduces marginal income tax rates across the board beginning in 2003; for example, the top tax rate has been reduced from 38.6% to 35%.

Reduces tax rates on capital gains and dividends to 15% (5% for taxpayers in lower tax brackets).

Mitigates the "marriage penalty" on married couples filing joint income tax returns compared to single taxpayers having the same income.

Increases the child tax credit from $600 to $1,000.

Increases amounts of taxable income exempt from the alternative minimum tax ("AMT").

Taxation of Corporations

Repeals the "collapsible corporation" rules.

Reduces from 38.6% to 15% the tax rates on excess accumulated earnings and excess personal holding company income.

Depreciation of Business Equipment

Increases "Section 179" expensing from $25,000 to $100,000 per year.

Increases "bonus" (first-year) depreciation from 30% to 50%.

Caution about Effective Dates

Many of the changes are scheduled to expire ("sunset") later in the 2000s. For example, the reduced tax rates on capital gains and dividends are scheduled to expire after 2008. Other changes will sunset even sooner. In planning under any of these changes, taxpayers and their advisors should note the effective date and sunset date of the particular provision involved.

CHANGES NOT MADE

Estate, Gift, and Generation-Skipping Transfer Taxes

The 2003 Act does not repeal or amend the federal estate, gift, or generation-skipping transfer taxes. Absent future legislation, the rates at which those taxes are imposed will continue to decline between 2002 and 2009. The annual gift tax exclusion remains at $11,000 and the unified credit at $1.0 million. The estate tax will be repealed in 2010 but will be reinstated to $1.0 million in 2011 as it existed before its amendments by the 2001 Act.

Capital Losses

Capital losses of individuals will continue to be deductible only to the extent of capital gains plus $3,000.00 per year.

The information contained in this newsletter does not constitute legal advice. Consult a legal professional to discuss the specific facts relevant to your situation. The accompanying analysis highlights the changes by the 2003 Tax Act that we believe readers will find most significant. To determine how all the changes may affect their situations, taxpayers should consult their own tax advisors.

2003 TAX ACT AUTOMATICALLY CUTS SOME TAXES AND CREATES NEW OPPORTUNITIES TO REDUCE OTHERS

Michael J. Grace, Esquire

Billed as one of the largest tax cuts in U.S. history, the Jobs and Growth Tax Relief Reconciliation Act of 2003 reduces income tax rates for all individuals and provides new opportunities to reduce the tax costs of owning some types of property. Some of the new tax reductions occur automatically beginning this year. Other benefits can be obtained by entering into particular transactions or modifying particular strategies.

Many of the new tax reductions are scheduled to expire ("sunset") later in the 2000s. Politics and the size of future projected deficits in the federal budget, exacerbated by these tax reductions, will dictate whether and how long (if at all) the new rules are extended. This Alert highlights the changes that we consider most significant for our clients. To determine how all the new changes may affect their tax situations, taxpayers should consult their own tax advisors.

AUTOMATIC TAX REDUCTIONS

Reduced individual income tax rates. Two years ago, the Economic Growth and Tax Relief Reconciliation Act of 2001 reduced individual income tax rates for 2002 and further reduced them beginning in 2006. The 2003 Act accelerates those reductions to 2003. For example, the highest stated rate in 2002 (38.6%) has been reduced to 35% beginning this year. To reflect these rate reductions, the IRS has revised its wage withholding tables. As a result, individuals will begin to benefit from the reductions even before they file their 2003 tax returns. Without future legislation, individual tax rates will revert to their pre-2002 levels beginning in 2011.

Increased AMT exemptions. The alternative minimum tax ("AMT"), originally enacted to discourage individuals from investing in tax shelters, continues to ensnare increasing numbers of taxpayers. The 2003 Act attempts to slow this trend by increasing temporarily the amount of taxable income exempt from the AMT. For 2003 and 2004, the exemption increases by $9,000 (from $49,000-$58,000) for married taxpayers filing joint returns and by $4,500 (from $35,750-$40,250) for other individuals. After 2004, however, the exempt amounts are scheduled to revert to their previous levels.

PLANNING FOR ADDITIONAL TAX REDUCTIONS

The 2003 Act encourages individuals to invest in stocks paying dividends compared to other categories of investments.

Reduced rates on dividends. Before the 2003 Act, dividends were taxable as ordinary income at marginal rates ranging up to 38.6%. The 2003 Act reduces the maximum rate on dividends to 15%. For taxpayers in the 10% and 15% marginal rate brackets, dividends will be taxable at only 5%. These reduced rates apply under both the regular tax and the AMT to dividends from domestic corporations and most foreign corporations. The 15% rate will apply from 2003 through 2008 and the 5% rate through 2007. In 2008, taxpayers in the 10% and 15% marginal rate brackets will pay no tax on dividends.

Reduced rates on long-term capital gains. Before the 2003 Act, long-term capital gains (from selling property held more than 12 months) were taxable at a maximum rate of 20% (10% for taxpayers subject to marginal rates below 25%). The Act reduces the 20% rate to 15% and the 10% rate to 5%. These

reduced rates apply under both the regular tax and the AMT to gains from selling assets after May 5, 2003. The reduced rates are scheduled to sunset at the same time as the reduced rates on dividends (generally, after 2008).

The 2003 Act does not reduce the 25% tax rate on gain representing depreciation on commercial real property. Assume, for example, that an individual sells a building on which depreciation has been taken. The taxpayer will have to pay tax equaling 25% of the portion of the gain representing prior depreciation deductions and 15% (or 5%) of the remaining gain.

Planning and choices. The reduced rates on dividends create incentives to invest in equities compared to other investments paying returns taxable as ordinary income. For example, interest on corporate bonds will continue to be taxable as ordinary income at rates up to 35%.

Not all amounts colloquially known as "dividends" qualify to be taxed at the newly reduced rates. For example, "dividends" from mutual funds generally qualify only to the extent that the fund receives dividends on stocks. Mutual fund dividends representing interest on taxable debt instruments held in the fund are taxable as ordinary income. In their tax reporting to shareholders, mutual funds will have to identify the components of their "dividends." Dividends from real estate investment trusts generally qualify only to the extent that they represent either income previously taxed to the REIT (a rarity) or capital gains received by the REIT. REITs, however, tend to pay significant dividends and, unlike regular corporations, generally are subject to only one level of tax.

In view of the reduced rates on dividends and capital gains, individuals should rethink (but not necessarily change) their retirement planning. Conventional wisdom suggests that individuals should hold stocks paying significant dividends in tax-deferred accounts such as 401(k) plans, traditional IRAs, and Keoghs. Dividends paid into such plans are not taxable currently, but all amounts eventually distributed from the plans are taxable as ordinary income regardless of their source. The 2003 Act does not change that result. However, dividends on stocks held in taxable accounts now are taxable at only 15% (or 5%, as the case may be). Reacting to this change, some individuals may choose to own more dividend paying stocks directly. These individuals will have to pay tax on the dividends when received at the reduced rates. However, they would not have to pay tax at ordinary income rates when the dividends instead were distributed from a tax-deferred retirement plan. In deciding how to hold investments, individuals should consider all factors including the anticipated number of years remaining until they retire and the projected rates at which future distributions would be taxed. Because tax rates can change at any time, taxpayers rely on projections at their peril. This choice between current and deferred taxation need not be made for Roth IRAs, the distributions from which are not subject to tax.

Disincentives for short-term trading. The 2003 Act discourages short-term trading of stocks in two ways. First, only dividends on stock held for a minimum period of time qualify to be taxed at 15% (or 5%). The stock must be held for at least 60 days during the 120-day period straddling the stock's "ex-dividend" date. Second, the reduced rates on capital gains apply only to gains from selling capital assets held for more than 12 months. Short-term capital gains remain taxable as ordinary income.

INCENTIVES TO INVEST IN BUSINESS PROPERTY

The 2003 Act enhances two incentives to invest in property used in business.

50% "bonus" depreciation. Unless they elect otherwise, taxpayers now may deduct 50% of the cost of certain new property in the year acquired. The remaining basis in the property is depreciated over time under the regular depreciation rules. Qualified property includes property depreciable over 20 years or less, certain computer software, and qualified leasehold improvements. The property generally must be acquired and placed in service after May 5, 2003 and before 2005 (2006 for certain self-

constructed property).

In lieu of the 50% bonus depreciation, a taxpayer may elect either 30% or 0%. The less bonus depreciation taken, the larger the regular depreciation deductions allowable over the asset's recovery period (useful life).

Increased Section 179 expensing. The Act also expands temporarily the tax benefits of investing in "Section 179 property." Section 179 property generally means any tangible personal property or computer software acquired for use in an active trade or business. Subject to some limitations, taxpayers may elect to deduct the cost of Section 179 property in the year acquired. The Act increases the allowable deduction from $25,000 to $100,000 per year. This $100,000 limit must be reduced by the amount by which all Section 179 property acquired during the year exceeds $400,000 (increased from $200,000 under prior law). These increased limitations apply to Section 179 property placed in service after 2002 and before 2006. After 2003 (and before 2006), the $100,000 and $400,000 limitations will be indexed for inflation.

CONCLUSIONS

In deciding whether or when to purchase, hold, or sell property, taxpayers should not base their decisions solely on tax rates and other tax considerations. For example, individuals should not increase their exposure to stocks solely because tax rates on dividends have been reduced. They also should not sell capital assets by 2008 (when the reduced rates on long-term capital gains are scheduled to expire) if non-tax factors dictate holding the property longer. Businesses should not invest in unneeded equipment solely to obtain bonus depreciation or Section 179 expensing. If, however, considerations besides taxes suggest entering into particular transactions, then the 2003 Act provides some powerful tax incentives, at least through the scheduled sunset dates.

MICHAEL J. GRACE, offering expertise in tax planning, transactions, and controversies, recently joined Jackson & Campbell, P.C., as a Director. Recently, his "Practical Analyses" of the Jobs and Growth Tax Relief Reconciliation Act of 2003 appeared in "Law, Explanation and Analysis" of the Act published by CCH Incorporated.

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