

A LOOK AT THE NEW TAX LAW CHANGES

"The rich aren't like us -- they pay less taxes."

Peter De Vries

By George Chamberlin

A few short weeks ago, Congress passed and the President signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Every taxpayer is likely to feel the impact of these changes and it is therefore important to review and analyze these changes and what they mean to our clients and ourselves. This article will briefly address some of the changes that will impact individual taxpayers.

One interesting aspect of the tax law changes under JGTRRA is the periodicity of the changes. As we will see in this article, many of the changes, including some of the brackets, deductions and credits implemented under the new tax law will differ from year to year, without any consistent approach. In addition, many of the changes are set to terminate in the near future with reversion to prior law.

Treatment of Dividends

An important omission from JGTRRA was the proposed exclusion of corporate dividends from income, intended to eliminate the current double taxation of dividends and to help encourage the economy. However, in what is perhaps the most impactful provision in JGTRRA, the tax rate applicable to certain dividend income was reduced to a maximum of 15% to match the new maximum rate for long-term capital gains. This change applies to dividends paid after January 1, 2003 and prior to January 1, 2009, meaning an immediate change for some taxpayers. Barring further legislation, this change will be in place for no more than six years altogether, thus limiting planning opportunities.

Most securities which pay dividends are benefited by the new treatment rules, including domestic and qualified foreign corporations, partnerships, REITs and certain mutual funds. However, the reduced rate for dividends does not apply to a wide variety of dividends, including those from money market mutual funds, employer securities owned by an ESOP, VEBAs, farm cooperatives, credit unions and mutual insurance companies. One test for applicability seems to be whether the source of the dividends is a fixed rate investment (e.g. money market funds) which is not eligible for the new treatment or if the dividend source has a variable return (e.g. common stock) which is, of course, eligible for taxation at the reduced rate. Further, if the source of the dividends is from income that is tax-exempt to the paying entity, it is unlikely that the reduced rate for dividends will apply.

Capital Gains Tax Change

A large reduction in the capital gains tax rate - from 20% to 15% - is a part of JGTRRA. Taxpayers in the lowest income tax brackets (10% and 15%) will experience a reduction from the 10% tax rate to a new low rate of only 5%. This reduction will end with 2008 absent future legislative action, meaning reinstatement of the former 20% rate at that time. The current change also eliminates the special

18% long-term capital gains rate for assets held more than five years. It is important to note, however, that the changes do not affect depreciation recapture on real estate or small business stock, which items continue to be taxed at higher rates.

As is the case with the reduction in income tax rates discussed below, the change in capital gains tax rates will make taxable return investments more attractive vis-à-vis tax deferred investments such as the IRA or a section 529 plan. In theory, at least, charitable gifts will also be less attractive because of the new lower tax rates applicable to assets that might heretofore have been transferred to a charity or charitable trust.

Reduction of Income Tax Rates

Another important feature of JGTRRA is the acceleration of the income tax cuts that were to be phased in under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Most of the cuts will take place in the next three years instead of being deferred. However, in keeping with the approach taken under EGTRRA, the tax cut provisions of JGTRRA are to sunset or terminate by 2011. This means that the changes are truly temporary and will require action to extend.

More specifically, the income tax brackets and rates originally scheduled to take effect in 2006 are being implemented in 2003, applied retroactively to the beginning of the year. The top marginal rate is now only 35% and the four highest tax brackets have each been cut by two or more percent. The six tax brackets are now 35%, 33%, 28%, 25%, 15% and 10%, respectively. (The Financeware site currently applies the new income tax rates implemented by JGTRRA.)

The immediate impact will be lower withholding and more disposable income for many taxpayers. With the lower tax rates, the choice of an IRA as an investment vehicle becomes less attractive since fewer tax dollars are shielded by this investment. Investment in municipal bonds also seems less desirable as income tax burdens decrease. These changes may encourage clients to invest more heavily in taxable investments.

“Marriage Penalty” Tax Relief

Two related changes in JGTRRA reflect Congressional concern with the disparity in income taxation of single and married persons. First, the range of the 15% bracket for married persons is increased to be exactly double that of the 15% bracket for singles. Interestingly, this treatment applies for 2003 and 2004 but is somewhat different for 2005-2007, with the range falling between 180% and 200% of the bracket for singles. The change will be significant for taxpayers who earn at or above the bracket upper limit since they may be able to save close to a thousand dollars in taxes annually.

The second change will increase the standard deduction for married (and jointly filing) taxpayers to \$9,500 annually, an amount double the standard deduction available for single taxpayers. As is the case with the 15% bracket change, this change is for 2003 and 2004 while the standard deduction for married taxpayers filing together will fall within a range between 170% and 190% of the standard deduction for singles during 2005-2008. Naturally, this change will have little impact on taxpayers who prefer to itemize their deductions and who will have sufficient income to continue itemizing.

Child Care Credit Increase

During 2003 and 2004 the child care credit will increase to a full \$1,000 annually from the prior limit of \$600. The credit will actually be reduced somewhat for the years 2005-2010, reflecting the require-

ments of EGTRRA. However, this lesser credit will still be an increase over the credit implemented prior to the enactment of JGTRRA. This change will lead to the issuance of advance payments to qualifying taxpayers during the summer of 2003. These payments will be based on the taxpayers' 2002 situation but will need to be re-determined as a part of their 2003 tax-year filing in 2004.

Alternative Minimum Tax (AMT)

The AMT exemption amounts for individuals will increase by as much as \$9,000 annually under JGTRRA. However, these increases will apply only for 2003 and 2004, leaving open the question of how AMT will be handled in future years. This promises to be an area in which many of our clients will hold continuing interest. It is to be hoped that future legislation will more thoroughly address the potential problems with AMT and reduce its impact on our clients. The current approach to AMT will be discussed in depth in a future article.

Treatment of Depreciation and Expenses

Following the events of September 11, 2001, the purchase of certain fixed assets was changed by the introduction of the concept of bonus depreciation. This concept permitted purchasers to expense up to 30% of the purchase of qualifying property in the first year while taking normal depreciation on the balance. Under JGTRRA, bonus depreciation has been increased to 50% of the purchase price and extended to the end of 2004. In addition, this depreciation has been extended to off the shelf computer software purchases in addition to other newly acquired property. In a related change, Section 179 I.R.C. expensing of business purchases has also been extended to incorporate computer software, thus benefiting individual taxpayers.

The new bonus depreciation is available only until December 31, 2004, a relatively limited period that would encourage business persons to accelerate their investment in substantial new assets for their business. Note that the federal law changes to bonus depreciation are not applicable in many states and that most states decoupled from the federal law when it was initially introduced. However, most states conform to the federal law approach to the expense election under Section 179 I.R.C.

Conclusion

Our clients will likely see an immediate impact from the tax law changes which, for the most part, will result in lower income taxes and increased disposable income for the next two years. However, these positive changes are tempered by the fact that they are temporary and that there is a great deal of uncertainty about what Congress will do in future years. As advisors, we may best help our clients through addressing how the additional disposable income may be utilized to further the clients' goals and objectives.

Leveraging the benefits to our clients of the new income tax legislation. This is the future of financial advising.