

THE NEW TAX ACT: PLANNING OPPORTUNITIES AND PITFALLS

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Individuals with substantial investment income can expect significant tax savings over the next seven years if they take advantage of the planning opportunities. But in considering an investment strategy change, you need to keep in mind that most of the provisions are only temporary, with differing dates of expiration.

Congress passed the Jobs & Growth Tax Relief Reconciliation Act of 2003 into law on May 28, 2003, with a number of tax rate reduction provisions that will create new individual income tax planning opportunities and suggest changes in personal investment strategies.

Individuals with substantial investment income can expect significant tax savings this year, as well as over the next seven years, if they take advantage of the planning opportunities. However, in considering an investment strategy change, you should know that most of the provisions are only temporary, with differing dates of expiration.

In this article, we highlight the individual income tax planning and investment strategies suggested by the tax changes.

MARGINAL TAX RATES

Before the tax law was passed, marginal income tax rates were 10%, 15%, 27%, 30%, 35% and 38.6%.

The new tax law lowers most of these marginal rates for 2003, retroactive to January 1, 2003, to 10%, 15%, 25%, 28%, 33%, and 35%. In addition, the 10% bracket has been widened and the 10% and 15% brackets for married filing joint taxpayers are now twice that for single taxpayers.

The old and the new rates for single and married filing joint taxpayers at various income levels are listed in Table 1.

Planning Considerations:

Employers were required to implement the new reduced tax withholding tables by July 1, 2003, but were not required to make up tax savings for any retroactive period from January 1. Thus, taxpayers who want to benefit more quickly from the retroactive nature of the new reduced tax rates may wish to increase the number of exemptions claimed on their Form W-4 to reduce withholding, or reduce any remaining estimated tax payments.

In addition, it might be advantageous to switch from utilizing the 'safe harbor' method of computing quarterly estimated payments to avoid estimated tax penalties (by paying estimated taxes in an amount equal to 100% of your prior year tax liability, or 110% if your prior year adjusted gross income was at least \$150,000) to only paying in 90% of current year tax, which might increase current cash flow.

INVESTMENT TAX RATES

Capital Gains Tax Rates

Generally, the new tax law lowers the long-term capital gains tax rate from 20% to 15% for most assets sold or exchanged (excluding art and certain depreciable real estate) that have been held for at least one year. Taxpayers in the 10% and 15% brackets will pay 5% on any capital gains recognized.

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TABLE 1. INCOME TAX RATES: NEW VS. OLD

SINGLE			
Old Rates		New Rates	
2003 Taxable Income	Tax Rate	2003 Taxable Income	Tax Rate
\$0 - \$6,000	10%	\$0 - \$7,000	10%
\$6,001 - \$28,400	15%	\$7,001 - \$28,400	15%
\$28,401 - \$68,800	27%	\$28,401 - \$68,800	25%
\$68,801 - \$143,500	30%	\$68,801 - \$143,500	28%
\$143,501 - \$311,950	35%	\$143,501 - \$311,950	33%
Over \$311,950	38.6%	Over \$311,950	35%

MARRIED FILING JOINT			
Old Rates		New Rates	
2003 Taxable Income	Tax Rate	2003 Taxable Income	Tax Rate
\$0 - \$12,000	10%	\$0 - \$14,000	10%
\$12,001 - \$47,450	15%	\$14,001 - \$56,800	15%
\$47,451 - \$114,650	27%	\$56,801 - \$114,650	25%
\$114,651 - \$174,700	30%	\$114,651 - \$174,700	28%
\$174,701 - \$311,950	35%	\$174,701 - \$311,950	33%
Over \$311,950	38.6%	Over \$311,950	35%

These new rates apply to sales or exchanges occurring (and installment payments received) on or after May 6, 2003, and remain in effect for gains recognized through December 31, 2008. In 2008, taxpayers in the lowest two tax brackets (10% and 15%) will be taxed on their long-term capital gains at 0%. In 2009, long-term capital gains rates are scheduled to return to the current prevailing tax rates.

Dividend Income Tax Rates

Dividends (so-called "qualified dividend income") received by individuals are now subject to a maximum tax rate of 15%. This tax rate change is effective retroactively from January 1, 2003, through 2008. Taxpayers in the lowest two tax brackets (10% and 15%) will be subject to a maximum tax rate of 5% on their dividend income through 2007. For 2008, those lowest-bracket taxpayers will pay 0% on dividend income before the tax rates return to their current levels in 2009.

Example: Under the old tax law, a taxpayer in the 38.6% bracket receiving \$100,000 in qualifying dividend income would pay \$38,600

in taxes. Under the new law, the same income will be taxed at 15%, resulting in a \$15,000 tax liability—a net tax reduction of \$23,600.

Not all corporate distributions are entitled to this tax-reduced dividend treatment. The law in this area gets very complicated and detailed as to what qualifies as a dividend subject to the lower tax rate. For example, the dividend must be paid by a domestic corporation or a "qualified foreign corporation." Therefore, individuals investing in standard publicly held securities will generally benefit from the reduced tax rates, but when in doubt, check the taxability status in advance.

Planning Considerations:

- Dividends received on stock that has not been held for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date or the date upon which the declared dividend goes to the seller are ineligible for the lower dividend rates.
- Although taxpayers are allowed to deduct investment interest expense on Schedule A, it is limited to the amount of current year net investment income (generally interest,

dividends, annuities and royalties). After 2002, dividends subject to the new lower tax rate are not treated as investment income for purposes of deducting investment interest expense. However, taxpayers may elect to tax dividends and long-term capital gains at ordinary tax rates to qualify that income for calculating the interest expense deduction.

CHILD TAX CREDIT

The child tax credit for dependent children younger than 17 for 2003 and 2004 was scheduled to be \$600, but under the new act the credit increases to \$1,000.

Beginning in July of 2003, the IRS will send rebate checks of \$400 per child to qualifying taxpayers who filed 2002 tax returns listing a qualifying child. If taxpayers do not receive the rebate check, then they may claim the increase in the credit on their 2003 tax return.

MARRIAGE PENALTY RELIEF

The standard deduction for married taxpayers filing joint returns is raised to twice the standard deduction for single taxpayers for 2003 and 2004. For 2003, the married filing joint standard deduction is increased from \$7,950 to \$9,500. As under prior law, the standard deduction is adjusted annually for inflation. In addition, for married filing joint taxpayers the 15% tax rate bracket increases from \$47,450 to \$56,800. However, this marriage penalty relief is scheduled to expire in 2005. In 2005, the standard deduction for married filing joint taxpayers falls to 174% of the standard deduction for single taxpayers but doubles again in 2009.

Planning Considerations:

Married filing joint taxpayers will need to calculate whether taking the increased standard deduction or itemizing deductions will generate the most tax savings overall. In

AMT: An Unpleasant Surprise

Are you subject to the alternative minimum tax? This tax comes as a surprise to many taxpayers. You may be subject to this tax, especially if any of the following criteria apply to your situation:

- You have large itemized deductions for state and local taxes;
- You have exercised incentive stock options;
- You have significant deductions for accelerated depreciation;
- You have large miscellaneous itemized deductions; and
- You have tax-exempt income from private activity bonds.

The alternative minimum tax is calculated by first determining the tentative minimum tax. The tentative minimum tax is 26% of the first \$175,000 of alternative minimum taxable income in excess of the exemption amount, plus 28% of any additional alternative minimum taxable income. However, for alternative minimum tax purposes, dividends and capital gains will be taxed under the same rules as for regular tax calculations. The alternative minimum tax is the excess of the tentative minimum tax above the regular tax calculated.

Alternative minimum taxable income adds back certain preference items to regular taxable income, including state income taxes, real estate taxes and miscellaneous itemized deductions, and can cause the alternative minimum tax to be larger than the regular tax.

In addition, although the tax rate on capital gains and dividend income is the same for both regular tax and alternative minimum tax, the disparity in rates between the alternative minimum tax and the regular tax may result in a higher effective rate on all income, including capital gains and dividends.

doing so, they should consider whether their state law restricts the ability to itemize to only those who itemize for federal purposes. The higher deduction may also require more couples to pay alternative minimum tax (AMT).

ALTERNATIVE MINIMUM TAX

The AMT exemption amount increases from \$49,000 to \$58,000 for married filing joint (MFJ) taxpayers and from \$35,750 to \$40,250 for single taxpayers for 2003 and 2004. See the tax calculation example in Table 2. [After 2004, the exemption reverts to levels in existence before the 2001 Tax Act.]

Planning Considerations:

Since the alternative minimum tax is calculated as a separate tax and a taxpayer pays the higher of the alternative minimum tax or regular tax, anything that reduces only regular tax increases the likelihood

that alternative minimum tax may be payable. For that reason, some taxpayers with large alternative minimum tax adjustments and preferences may receive no benefit from the tax rate table adjustments, although they may get some benefit from the new maximum tax rates on capital gains and dividends, which also apply in computing the alternative minimum tax. Therefore, taxpayers should pay special attention to alternative minimum tax adjustments and preferences, such as

state tax payments and income from private activity bonds.

The provisions of the new Tax Act are presented in summary form in Figure 1.

INVESTMENT STRATEGIES

Given the retroactive nature of most of the tax cuts, along with the temporary effective dates, tax planning opportunities also give rise to investment planning opportunities. However, your goals and risk tolerance should drive your investment decisions, not just the income tax impact of an investment.

Take Advantage of Lower Marginal Rates: Under the old tax rate structure, deferring income that was taxed at higher ordinary tax rates made sense, but now under the new act, dividends and long-term capital gains are taxed at the same rate. While some investors might think it makes sense to load up on dividend paying 'value' oriented stocks to take advantage of the dividend tax reduction, 'growth' oriented stocks also have merit as they attract the same rate of income tax on their appreciation when sold.

We suggest you consider maintaining a balanced exposure to both value and growth strategies.

Sell Low Basis Stock: The new tax act presents the perfect opportunity to sell low-basis stock held for more than one year, because long-term capital gains rates may never be

TABLE 2. THE ALTERNATIVE MINIMUM TAX: OLD LAW VS. NEW

	2003 Inc. & Adj. (\$)	Old Law (MFJ) (\$)	New Law (MFJ) (\$)
Regular Taxable Income	100,000		
AMT Tax Preferences & Adjustments	30,000		
Alternative Minimum Taxable Income	130,000	130,000	130,000
Less: Alt Min Tax Income Exemption		(49,000)	(58,000)
Alt Min Tax Income Subject to AMT		81,000	72,000
Tentative Minimum Tax		21,060	18,720
Less: Regular Tax		(20,000)	(20,000)
AMT		1,060	0

TAX STRATEGIES

lower. If you have large positions in either gifted or inherited stocks, or stocks received from a sale of a business, consider using the proceeds from selling the stock to diversify your portfolio.

Consider Impact of Tax Rate

Changes on Mutual Fund Investments: Selecting tax-aware managers of mutual funds may be important to maximizing your aftertax rate of return in your taxable (i.e., not a retirement account) investment portfolio. You may choose when to sell shares of the fund, and may therefore create long-term versus short-term capital gains. But you don't control the investments within the fund. Should an equity manager fail to extend the holding period on a stock, it could cost you 20% of your gain (35% ordinary rate versus 15% capital gain rate).

Some mutual fund dividends will qualify for the 15% rate, while others will not. Dividends paid by

stocks held by the fund and passed through to the shareholder will qualify for the new dividend tax rate. However, capital distributions and bond interest will not. The Internal Revenue Service must redesign the Form 1099 so that the type of dividend can be specified.

Reconsider Taxable vs. Tax-Free

Bonds: Due to reduced tax rates, the aftertax yield on taxable bond investments may increase for certain taxpayers. Therefore, investments in tax-free bonds may be less attractive. Additionally, private activity bonds (a type of tax-free bond) could increase your exposure to the alternative minimum tax since their interest income is taxable for purposes of the alternative minimum tax. You should review your bond and money market accounts to make sure that you are earning the highest aftertax return. Don't forget to consider state tax implications of switching from tax-free to taxable

bonds before making any final portfolio decisions.

Consider Increasing Retirement

Savings: You may want to use the additional cash flow from decreased estimated tax payments to increase the amount invested in an IRA or 401(k) plan. In this way, you might "double-up" on the tax-relief by using the tax cut to create an additional deduction. The main advantage of retirement accounts—tax deferral—continues to make them a good investment vehicle.

Consider Change in Retirement

Investments: The spread between capital gains and ordinary income rates may now suggest altering your investment strategy by adjusting the asset allocation between taxable and tax-deferred (retirement) accounts. For example, retirees often hold stocks in their tax-deferred accounts and bonds in their personal portfolios in order to have access to the

FIGURE 1. AN OVERVIEW OF TAX ACT PHASE-INS AND PHASE-OUTS

Provision	2003	2004	2005	2006	2007	2008	2009	2010	2011	
Marginal Income Tax Rates					35%					39.6%
					33%					36%
					28%					31%
					25%					28%
					15%					15%
					10%					
Top of 10% Bracket										
Single	\$7,000		\$6,000		\$7,000, then indexed				N/A	
Married Filing Jointly	\$14,000		\$12,000		\$14,000, then indexed				N/A	
Child Credit	\$1,000		\$700		\$800		\$1,000	\$500		
Marriage Penalty Relief										
Standard Deduction	Twice Singles		Gradual Increase to Twice Singles			Twice Singles		N/A		
15% Tax Bracket	Twice Singles		Gradual Increase to Twice Singles			Twice Singles		N/A		
			Singles							
Capital Gains & Dividend Rate (High Brackets/Low Brackets)	15%/5%				15%/0%		Capital Gains - 20%/10% Dividends - Ordinary Income Rates			
AMT Exemption										
Single	\$40,250				\$33,750					
MFJ	\$58,000				\$45,000					

cash flow. From a tax perspective this could be expensive, because gains resulting from stocks held in tax-deferred plans such as IRAs or 401(k) plans will be taxed at ordinary rates when taken as a distribution. By reversing that structure, taxable bonds and other tax-inefficient assets will be shielded from tax in the deferred accounts while equities will enjoy the reduced rates for dividends and capital gains in personal accounts. Tax-free municipal bonds should, of course, remain outside of retirement accounts. Individuals should also consider the cost of commissions and taxes, as well as current cash flow needs, before making any investment moves between taxable

and tax-deferred accounts.

Make Gifts to Your Children: If you have children/grandchildren over the age of 13 (whose income is not automatically taxed at their parents' rate), consider gifting appreciated assets to them. If the child is in the two lowest income tax brackets in 2008, then no tax will be paid on some (possibly all) of the long-term capital gain generated from the sale of the appreciated asset. This may be a great way for you and your child to fund education expenses.

CONCLUSION

While the new tax act does present tax and investment planning oppor-

tunities, it is important to remember that taxes are not the key to investment planning. The retroactive effective dates and the temporary duration of many of its provisions should motivate individuals to reconsider existing strategies.

There is one thing for sure: This won't be the last change in the tax code. Congress will have to address these issues again, as many of the current provisions expire over the next few years. Although many taxpayers can expect tax savings in the near future—especially high-wealth individuals with substantial investment income—everyone should consider how the changes directly affect their overall tax and investment strategies. ♦