CPA CLIENT TAXLETTER
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Sunrises and Sunsets...The New Tax Law

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) reduces individual tax rates, cuts the maximum tax rate on dividend and capital gain income, and provides significant expensing opportunities for businesses that make investments in machinery and equipment. It makes other changes as well.

While the cuts are significant, many of them are temporary. In what some commentators have wryly called a law of "sunrise, sunset," most of the reductions are scheduled to end, or "sunset," after a certain number of years. In addition, many of the reductions are only accelerations of reductions already enacted in prior tax legislation. Thus, tax planning under the new Act may be complicated.

Regardless of your tax situation, the new legislation will affect you for 2003 and the next several years. Please call our office to discuss how these provisions will affect you and what actions you should take now to take advantage of the new laws...before they change again.

Income Tax Rate Reductions for Individuals, Estates, and Trusts

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) represents the third tax reduction since 2001, although the new reductions occur by accelerating the effective date of rate cuts enacted in 2001 legislation. What changes are in store for you this time around?

In general, the tax rates in each income bracket have been reduced, in addition to the "marriage penalty" relief explained later. First, the 2003 Act increases the levels of taxable income subject to the 10% individual tax rate. For 2003, the maximum income subject to the 10% regular income tax rate rises from $6,000 to $7,000 for single individuals and married taxpayers filing separately. It also rises from $12,000 to $14,000 for married taxpayers filing jointly and qualifying widow(ers). For 2004, the ceiling for this rate bracket is indexed, and for 2005, it is

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scheduled to revert back to $6,000 and $12,000. For 2008, it increases again, to $7,000 and $14,000. Thereafter, it is indexed for inflation. There is no tax bracket increase for heads of household.

The rates for the other tax brackets are reduced as well, from 38.6% to 35%; from 35% to 33%; from 30% to 28%; and from 27% to 25%. These rates are effective for tax years beginning in 2003. In 2011, the tax rates will return to pre-Economic Growth Tax Relief and Reconciliation Act levels.

The rates for estates and trusts are also reduced: the same reduced rates of 15%, 25%, 28%, 33%, and 35% rates will apply beginning in 2003 through 2010. The 10% individual rate does not apply to estates and trusts.

Retroactive effect

The rate reductions are retroactive to January 1, 2003, and withholding tables have been adjusted for the remainder of the year.

Individual, Trust, and Estate Income Tax Rates

Prior to 2003 Act	Effective 1/1/03
10%	10%*
15%	15%
27%	25%
30%	28%
35%	33%
38.6%	35%

*n/a for income of estates and trusts

Marriage Penalty Relief

Two-earner couples have often discovered that their joint federal income tax liability becomes higher after they marry, because, for example, the sizes of the tax brackets for married couples filing jointly are not twice the tax brackets for single taxpayers. This effect is often called the "marriage penalty." After many years of discussion, Congress has finally somewhat eased this penalty. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) includes two changes.

Size of 15% bracket for couples increased

For 2003 and 2004 only, the legislation increases the upper limit of the 15% income tax bracket for married couples to twice that for a single taxpayer. For 2003, the 15% tax bracket for married couples increases from $47,450 to $56,800. Beginning in 2005, prior law is scheduled to return. The 15% bracket for joint filers will start at 1.8 times the size of the 15% bracket for single individuals, ramp up to twice the size again, and then is reduced again in 2011.

Increase in standard deduction for certain taxpayers

The basic standard deduction for married taxpayers filing joint returns and qualifying widow(er)s has increased to $9,500, twice the amount for single individuals for 2003 and 2004. Beginning in 2005, prior law is scheduled to return, which starts at 174 percent of the standard deduction for individuals, ramps up to twice the standard deduction again in 2010, and then eliminates the relief in 2011. The standard deduction for married taxpayers filing separately has increased to $4,750 for 2003 (the same as that of single taxpayers). As before, the standard deduction is adjusted annually for inflation.

Not as simple as it looks

As indicated above, both the standard deduction and the 15% income tax bracket revert to prior law levels beginning in 2005. However, under the Economic Growth and Tax Relief Reconciliation Act of 2001, the standard deduction and the 15% income tax bracket were increased for joint filers to twice that for single filers, although those increases are phased in over a period of eight years. Due to the interaction between the 2001 legislation and this year's legislation, the standard deduction and the 15% tax bracket for married couples will fluctuate significantly over the next eight years.

Also, the legislation does not *eliminate* the marriage penalty. Because the tax brackets above 15% are not changed, high-bracket two-earner couples, with each earning about the same income, will continue to suffer under the marriage penalty.

If you are married, the 2003 Act may—or may not—affect your 2003 tax liability, and your withholding or estimated payments as well. Please call us to discuss whether your payments for the rest of the year will be appropriate.

Increased Alternative Minimum Tax Exemption for Individuals

In recent years, increasing numbers of taxpayers have become subject to the alternative minimum tax (AMT). To ease this problem, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) provides increases in the AMT exemption amounts, but only for years 2003 and 2004. The exemption amounts are increased to:

- $58,000 from $49,000 for married couples filing jointly and surviving spouses
- $40,250 from $35,750 for other unmarried individuals
- $29,000 from $24,500 for married couples filing separately

The legislation does not increase the point at which the exemption amount begins to phase out.

Even with the increased AMT exemption amounts under the new law, some higher income taxpayers and those with large AMT adjustments and preferences in 2003 may move into an "AMT position" under the new tax rate structure. The exemption amount may have changed, but the AMT remains a complicated trap for the unwary, and your tax planning should always address the possibility that the AMT may apply.

Lower Tax Rates for Dividends and Capital Gains

The centerpiece of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) is the reduction in the tax rate on both dividends and capital gain income.

For individual taxpayers the top rate on most dividends is reduced from 38.6% to 15% (the lowest since 1916) through 2008. And capital gains on most property held for more than one year (excluding art and certain depreciable real estate) will be taxed at a top rate of 15%, the lowest since 1933.

Capital gains tax reduction

The maximum tax rate on net capital gain (that is, net long-term capital gain reduced by any net short-term capital loss) has been reduced from 20% to 15%. For those in the 10% and 15% rate brackets, the capital gain rate is reduced to 5% now and to zero in 2008. The reduced rate applies for both the regular tax and the alternative minimum tax. The higher rates that apply to unrecaptured Section 1250 gain, collectibles gain, and Section 1202 gain have not changed.

The lower rates apply to sales and exchanges after May 5, 2003 (and installment payments received after that date), and before January 1, 2009.

Dividend tax reductions

For individual taxpayers, the 2003 Act provides that dividends will be taxed at the same rate as capital gains, thus 15% for most taxpayers, and 5% for those in the 10% and 15% rate brackets, with the lower income brackets enjoying tax-free dividends in 2008.

The reduced rates apply for tax years 2003 through 2008. The dividend rate applies to dividends received beginning on January 1, 2003. The reduced rates apply for regular and alternative minimum tax purposes.

Not all dividend income will qualify

To qualify for the reduced rates, the dividends must be paid by domestic corporations and certain qualified foreign corporations. There are special rules with respect to extraordinary dividends and dividends from regulated investment companies (RICs, such as mutual funds), real estate investment trusts (REITs), and certain foreign corporations. Also, dividends from certain corporations are not eligible, including tax-exempt charities, tax-exempt farmers' cooperatives, foreign personal holding companies, foreign investment companies, and passive foreign investment companies. In addition, special holding period rules apply.

Increased Child Credit for 2003 and 2004

By the time you read this issue, you may already have some extra cash in your pocket, thanks to Uncle Sam. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) raised the child tax credit to a maximum of $1,000 per child from $600 per child, beginning this year. The Act also provided for immediate tax relief by calling for an advance payment of the $400 per child increase to taxpayers this year, rather than waiting until they file their 2003 returns in early 2004.

Last issue's *CPA Client Tax Letter* explained the details of the increased credit. However, you should remember that, if you received an advance payment this summer, be sure to keep the IRS notice of the advance payment amount to properly complete your 2003 tax return. You must remember to reduce the amount of the child tax credit you claim on your 2003 return by the amount of the advance payment.

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Individuals May Need to Adjust Estimated Tax Payments

Some taxpayers will benefit from the tax cuts in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) without any action on their part, such as the advance payments of the child tax credit increase and the reduced withholding rates. However, if you are self-employed or have significant income from capital gains or dividends, the way to get the tax benefits this year may be to adjust your remaining 2003 estimated tax payments.

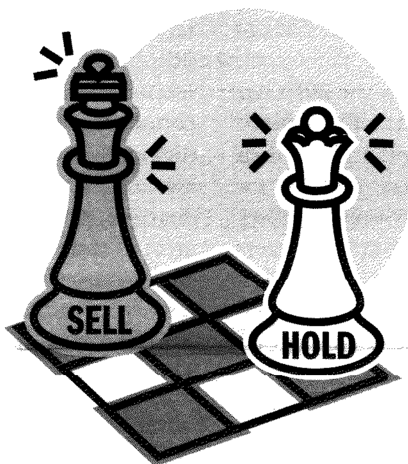
If you are a business owner, you may also need to consider changes due to the increased first-year bonus depreciation allowance and the higher Section 179 expensing deduction.

In some cases, it may be much more advantageous to pay estimated taxes based on your estimate of current-year tax liability rather than based on the prior-year safe harbor, even though this may require a projection of your income.

You don't have to wait until your 2003 return to benefit from the tax cuts. Please contact us to help you act now to take advantage of the new tax breaks as soon as possible.

Time to Rethink Your Investment Strategies?

Until now, a generally tax-wise investment strategy has been to invest for capital gains, to take advantage of the deferral of income taxes and the preferential rates for capital gain income. However, because the new Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) taxes both dividends and capital gains at the same (lower) rate, deferral becomes a less compelling goal. What might the tax rate changes mean for your investment strategy?



As always, a prudent investment strategy considers many objectives, such as your overall financial situation, goals, needs, and tolerance for risk. However, because of the rate changes, you may need to reconsider, for instance, what types of assets belong in your taxable accounts and which belong in tax-deferred accounts such as your IRA or other retirement accounts. Here are just a few of the possible actions that individual investors will now need to think about:

- Consider selling some highly appreciated securities that have been held for a long time to take advantage of lower rates.
- Remember the one-year holding period to take advantage of the lower long-term capital gain rate on sales and exchanges after May 5, 2003.
- Rethink efforts to shelter long-term investments from tax within a retirement account, because distributions from those accounts may be taxed at ordinary rates upon distribution.
- Income investments should perhaps be weighted more toward dividends instead of interest.
- Investments in tax-exempt bonds may be less attractive as after-tax yields on taxable investments increase. However, they may still be good investments for taxpayers who are subject to high state and local taxes.

Keep your eye on the big picture

Always consider the total return on your investment, not just the tax impact. In addition, your decisions will be complicated by the fact that rates are already scheduled to change back after 2008. Perhaps the only certainty is that you should have professional advice in hand before you change your investment strategy. Please call us to discuss how the new rules may affect your investment planning, both this year and beyond.

If You Are an Employer...

New wage withholding tables reflecting the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) went into effect no later than July 1, 2003. In addition to wage withholding, the 2003 Act changes the withholding rate on supplemental wage payments, such as bonuses, and the backup withholding rate on income such as interest and dividends paid to foreign persons. Accordingly, many types of payors will need to change their payment systems to reflect the appropriate rates of withholding.

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Higher Depreciation Deductions for Businesses

Two of the most significant benefits of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) are the increases in the first-year "bonus" depreciation allowance and the Section 179 expensing deduction for businesses.

Increase and extension of bonus first-year depreciation

The Job Creation and Workers Assistance Act of 2002 created a special first-year bonus depreciation allowance of 30% of the adjusted basis of qualified property. Qualified property included equipment, machinery, furniture, cars and trucks, and off-the-shelf computer software placed into service during a specified time period.

Under the 2003 Act, the first-year "bonus" depreciation allowance has been increased from 30% to 50%. The new rule generally applies for qualified property acquired after May 5, 2003, and placed into service before January 1, 2005 (January 1, 2006, for long-term production property). It does not apply to property acquired pursuant to a binding written contract in effect before May 6, 2003.

Instead of claiming the 50% allowance, you may elect to claim the 30% allowance or elect not to claim any special allowance.

Special rules for vehicles

The "luxury auto" rules limit the annual depreciation deduction that a taxpayer can claim for a business auto. For an auto first placed in service during 2002 and used more than 50% in business, the first-year limit was $3,060 (an amount that is adjusted annually for inflation) *plus* an additional 30% first-year bonus amount of $4,600, for a total possible first-year depreciation in 2002 of $7,660.

The 2003 Act provides that the additional first-year bonus depreciation for qualifying autos placed in service in 2003 will be $7,650 rather than $4,600. Thus, the 2003 allowable depreciation limit for an auto placed in service during 2003 will be $10,710 ($3,060 plus $7,650), or possibly more if the $3,060 is indexed for inflation (the 2003 figure has not yet been announced.)

Under special rules, a significantly larger deduction may be available for certain "purpose-built" passenger automobiles, such as certain electric automobiles, and for certain SUVs, vans, and pickups.

Increased Section 179 deduction

A taxpayer, other than an estate, trust, and certain noncorporate lessors, may elect under Code Section 179 to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of certain personal property placed in service during the tax year. Under prior law, the maximum amount that could be expensed annually was $25,000 for tax years beginning in 2003 or later. The annual expense limit was reduced (but not to go below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeded $200,000. Under the 2003 Act, the maximum qualifying Section 179 amount has been dramatically increased from $25,000 to $100,000 ($135,000 for qualified zone property, qualified renewal property, or qualified New York Liberty Zone property) for property placed in service in 2003, 2004, and 2005. This amount will be indexed for inflation after 2003. The amount of property placed in service before Section 179 begins to phase out is increased from $200,000 to $400,000.

Also, the definition of Section 179 property has been expanded to include off-the-shelf computer software.

The election to expense may be revoked by the taxpayer on an amended return without advance permission from the Internal Revenue Service. However, once the election is revoked, the taxpayer cannot change back again.

Planning notes

You may be able to combine the 50% first-year bonus depreciation and the Section 179 deduction. For certain vehicles, you may be entitled to "regular" depreciation as well. Generally, you first take the Section 179 deduction, then bonus depreciation on the remaining cost, and finally regular depreciation on any qualifying remaining cost.

As a result of the dramatically increased deductions, now may be the time to consider making a machinery or equipment purchase for your business, and to reconsider a decision about leasing as compared to purchasing an asset. If you are considering buying or leasing any type of vehicle for your business in 2003, you may wish to call us to discuss your particular situation.

Other Corporate Changes

The Jobs and Growth Tax Relief Reconciliation Act of 2003 has reduced the rates for both the accumulated earnings tax and personal holding company tax rates. Both have been reduced to 15% from 38.6%, effective for tax years beginning after December 31, 2002. However, the reduced rates will not apply to tax years beginning after December 31, 2008. Additionally, the collapsible corporation rules have been temporarily repealed, effective for tax years beginning after December 31, 2002 and through 2008.

The CPA. Never Underestimate The Value.

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Action May Be Needed for Split-Dollar Life Insurance Arrangements

In a common arrangement, corporations take out a life insurance policy on the life of an employee involving the buildup of cash surrender value. In certain cases, the employee gets little or no economic benefit from the arrangement. However, in other situations, called "equity" split-dollar arrangements, some or all of the cash surrender value belongs to the employee. Until recently, rules provided that, if such an arrangement was terminated and the policy transferred to the employee, there was no current tax to the employee on the cash value buildup as long as the policy remained in force.

New guidance issued

However, the IRS has issued new guidance on the taxation of split-dollar life insurance arrangements. For arrangements entered into before January 28, 2002, if an existing equity arrangement is terminated after December 31, 2003, the cash surrender value transferred to the employee will be taxable income to that employee upon termination of the arrangement.

The IRS guidance contains two safe harbors that may allow you to avoid the taxation of such a future transfer upon termination:

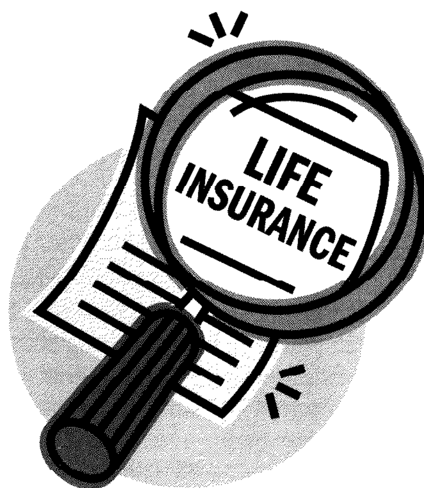
1. If the arrangement is terminated (the policy is "rolled out" to the employee) before January 1, 2004.
2. If, beginning January 1, 2004, all premium payments, including those before 2004, are treated as loans.

What to do now

If you are insured by your employer under a split-dollar cash-value equity arrangement that was entered into before January 28, 2002, you have the opportunity to take action before December 31, 2003. Action now will prevent the future taxation of the cash value buildup if, in the future, the arrangement is terminated and the policy is transferred to you.

Whether or not you should take advantage of one of these safe harbors depends on several factors, including how much current cash value exists.

If you have one of these policies with your employer, or are unsure about a policy, please call us to be sure you do not overlook this planning opportunity.



The New Health Coverage Tax Credit—Does It Apply to You?

The federal Health Coverage Tax Credit (HCTC) was created by the Trade Act of 2002 to help certain displaced workers and certain retirees pay for health insurance. For those who qualify, the credit can provide substantial assistance towards the payment of health insurance premiums.

Who Qualifies?

Those eligible to claim the credit fall into one of two categories:

1. Certain workers who have lost their jobs due to increased imports or a shift in production to another country and are classified as Trade Adjustment Assistance (TAA) or Alternative Trade Adjustment Assistance (ATAA) eligible.
2. Individuals whose pensions are being paid by the Pension Benefit Guaranty Corporation (PBGC), are at least 55 years of age and not entitled to Medicare.

How the Credit Works

For eligible and registered individuals and qualified family members, the credit acts as a 65 percent subsidy, or "advance credit," towards the payment of health insurance premiums. Once a covered individual has registered, he or she then remits 35 percent of the eligible health plan premium to the HCTC program, and the HCTC program will then add the remaining 65 percent and submit the full 100 percent to the recipient's health plan on behalf of the individual.

Until the HCTC program begins making payments to the insurance plan, individuals must continue to pay 100 percent of their health insurance coverage and claim the 65 percent credit by filing Form 8885 with their federal income tax return.

How to register

Certain individuals may have already received registration materials by mail. If not, you may call the HCTC Customer Contact Center to check eligibility (1-866-628-4282 or TDD/TTY 1-866-626-4282). If you think you may be eligible for the credit and have not been contacted by the HCTC, please call us to help you determine if you qualify.