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2003 TAX LAW SUMMARY

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Accelerated tax rate cuts. Marriage penalty relief. An increased child tax credit. Dividend and capital gains tax reductions. Growth incentives for businesses. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “2003 Act”) promises to provide federal income tax relief to nearly every individual and business taxpayer.

Economic stimulus and growth are the stated objectives of the 2003 Act. And, while the new law was the result of sometimes contentious negotiations (and, in fact, passed by only the narrowest of margins in the Senate), it will almost immediately put more money in the pockets of most individual taxpayers.

Most individuals with young children will see an immediate benefit in the form of a payment from the government, reflecting the new law’s increase in the child tax credit. And nearly every working person will see a reduction in the taxes withheld from her/his paycheck due to the speeding up of tax rate reductions enacted in 2001.

Investors and business taxpayers will benefit this year, as well. New lower rates on dividends and capital gains should be welcomed by investors battered by the stormy markets of recent years. And expanded write-offs for new asset purchases will favor businesses that spend on capital equipment acquisitions.

This publication summarizes the new tax law and how its provisions might apply to your situation. Many of the new rules are complex, and most of the changes are temporary. We urge you to seek professional assistance before acting on anything you read in this summary. The new law presents numerous planning opportunities, and a professional can help you best take advantage of them.

Acceleration of Tax Benefits

In 2001, a massive tax cut law reduced individual tax rates, provided 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. And 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. The IRS’s regular tax rate schedules are divided into several ranges of income (“brackets”), and the tax rate increases as income rises. Different income brackets apply to separate categories of taxpayers (single, head of household, married filing jointly and surviving spouses, and married filing separately).

In 2001, the tax rates were overhauled. To the then-existing rates of 15%, 28%, 31%, 36%, and 39.6%, the 2001 law added a new 10% rate. The upper ends of the 10% bracket were scheduled to remain constant until 2008, when they would increase for all but head of household filers. Also included in the 2001 law were gradual reductions in the tax rates above the 15% level to 25%, 28%, 33%, and 35%. These rate reductions were scheduled to be phased in from 2001 through 2006.

The 2003 Act accelerates the 10% bracket increases formerly scheduled for 2008. So, for 2003 and 2004, the taxable income levels for the 10% tax rate bracket rise as follows:

<i>Filing Status</i>	<i>For 2003-2004 (Old Law), Taxable Income up to:</i>	<i>For 2003-2004* (2003 Act), Taxable Income up to:</i>
	Single	\$6,000
Head of Household	\$10,000	\$10,000
Married — Joint	\$12,000	\$14,000
Married — Separate	\$6,000	\$7,000

* For 2004, the 10% bracket will be adjusted for inflation.
Source: NPI

After 2004, the taxable income levels for the 10% rate bracket will return to the levels allowed under previous law. So, for 2005, 2006, and 2007, the 10% bracket will apply to taxable income up to \$6,000 for single filers and married persons filing separately, \$10,000 for heads of households, and \$12,000 for joint filers. In 2008, the income levels for the 10% bracket will return to those now applicable in 2003-2004 due to the 2003 Act.

The 2003 Act also accelerates to 2003 (and after) the scheduled reductions in the higher tax rates. The table that follows shows a comparison of the old and new rates.

	<i>Old Law</i>	<i>2003 Act</i>
<i>2003</i>	<i>2004-2005</i>	<i>2003 and after*</i>
10%	10%	10%
15%	15%	15%
27%	26%	25%
30%	29%	28%
35%	34%	33%
38.6%	37.6%	35%

* Rates will return to 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. The 2003 Act reduces their top rate by at least two percentage points. Plus, many of those taxpayers get the benefit of the reduction in the graduated rates *and* the increase in the 10% bracket amount.

Keep in mind, though, that these changes are all subject to repeal due to the 2001 law's "sunset" provision, which calls for a return to pre-2001 rates after 2010.

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 (Although a couple may file separate returns, this usually results in higher taxes than filing jointly.) A “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 2001 tax legislation introduced two changes designed to gradually alleviate this marriage penalty, but they were not scheduled to begin taking effect until 2005. The first provision called for raising the joint filer standard deduction (a deduction allowed to individual taxpayers who do not itemize deductions on their tax returns). The second change increased the size of the 15% income tax bracket for joint filers. The 2003 Act accelerates this tax relief.

First, the new law increases the basic standard deduction for joint filers to twice the standard deduction for single filers, effective for 2003 and 2004. Second, 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. After 2004, the basic standard deduction and the 15% tax bracket for joint filers will go back to what they would have been under the 2001 law.

<i>Calendar Year</i>	<i>Joint Return Standard Deduction as a % of Single Return Standard Deduction under 2003 Act</i>	<i>Top of 15% Joint Bracket as a % of Top of 15% Single Bracket under 2003 Act</i>
2003-2004	200%	200%
2005	174%	180%
2006	184%	187%
2007	187%	193%
2008	190%	200%
2009 and after*	200%	200%

* The increases in the basic standard deduction and in the 15% tax bracket for joint filers are scheduled to expire after 2010.
Source: NPI

Child Tax Credit

Eligible taxpayers may claim a tax credit (that is, a direct offset against income tax) for each qualifying dependent child under age 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 (in 2003; subject to future inflation adjustments). In 2005, the refundable percentage increases to 15% of excess earned income. (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 (or fraction thereof) 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.

Under the old law, an individual could claim a child tax credit of up to \$600 per child for 2003 and 2004, with the credit increasing in steps to \$1,000 in 2010. The 2003 Act makes the \$1,000 credit effective for 2003 and 2004. After 2004, the credit amount for each year will follow the old schedule, as shown in the table.

<i>Taxable Year</i>	<i>Credit Amount per Child under Old Law</i>	<i>Credit Amount per Child under 2003 Act</i>
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

The 2003 Act provides a major benefit for those who claimed the child tax credit on 2002's tax return. Under the new law, the increased amount of the 2003 child tax credit (that is, 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 (filed in 2003).

Example: Maria and Robert, who reported adjusted gross income of \$50,000 on their 2002 joint tax return, have two children (ages 5 and 7) for whom they claimed a full child tax credit for 2002. In 2003, Maria and Robert will receive an advance payment of \$800 — \$400 for each child — as a result of the new law.

Dividends and Capital Gains

Some of the toughest wrangling over the 2003 Act's provisions involved cutting taxes on corporate dividends paid to individuals. When all was said and done, however, the new law contained a lot of good news for investors.

Background

For years, many experts have discussed the unfairness of 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. More unfair, said the critics, was the fact that 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 capital gain.

Under pre-2003 Act law, net capital gain was taxable at a maximum rate of 20% (10% for gain that would otherwise be taxed in the 15% or 10% tax bracket if it were ordinary income). 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% (with a holding period starting after 2000) 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.

New Rates

While the new law does not eliminate the double tax on dividends, it does provide tax relief to those individual taxpayers who receive corporate dividends. 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 5% rate will be 0% in 2008. (In effect, then, the new capital gains rates will apply to sales and exchanges and payments received on or after May 6, 2003, and before January 1, 2009.) The holding period to qualify for the new 15%/5% rates is more than one year. The old law's 18%/8% rates are repealed, but return after 2008 for qualifying gains.

The dividend 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.

<i>Ordinary Tax Bracket</i>	<i>Tax Rates on Dividends and Net Capital Gains*</i>	
	<i>2003-2007</i>	<i>2008**</i>
10% and 15%	5% ***	0%
All Others	15% ***	15%

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

Example: Ross, who is in the highest tax bracket, realizes net long-term capital gain of \$150,000 and qualified dividend income of \$50,000 in 2004. Prior to the 2003 Act, Ross would have had to pay tax on his gain at a 20% rate and on his dividends at a 37.6% rate. Under the new law, both his gain and his dividends will be taxed at a 15% rate. So, his tax will be approximately \$30,000 on that income instead of approximately \$48,800 under prior law.

The new dividend rates apply to dividends received by an individual shareholder from a domestic or “qualified foreign” corporation (one whose stock is traded on an established U.S. securities market or meets certain criteria).

If a shareholder does not hold a stock for more than 60 days during the 120-day period beginning 60 days before the stock’s ex-dividend date, dividends on that stock will not qualify for the reduced rates. Among the other special rules that apply:

- ? Amounts treated as ordinary income on the disposition of certain preferred stock are treated as dividends eligible for the reduced rates.
- ? For purposes of the investment interest deduction (which is generally limited to the amount of net investment income realized during the year), a dividend will qualify as investment income only if the taxpayer elects not to use the reduced rates for the dividend.
- ? The reduced rates are not available for dividends to the extent a shareholder is obligated (through a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.
- ? The amounts of qualifying dividends that may be paid by a real estate investment trust or regulated investment company are limited in some cases.
- ? The reduced rate doesn’t apply to dividends received from an organization exempt from tax under Section 501 of the tax code or that was a tax exempt farmers’ cooperative in either the taxable year of the distribution or the previous taxable year.
- ? Neither does the reduced rate apply to dividends received from a mutual savings bank that received a deduction for dividends paid on deposits nor to deductible dividends on employer securities held by a qualified Employee Stock Ownership Plan (where the dividends are distributed to plan participants).

The Impact?

How will the new rates on dividends and capital gains affect investors? Almost certainly, dividend-paying stocks will become more attractive to higher-income investors. And investors may put more pressure on publicly traded corporations to pay tax-advantaged dividends. 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.

From a capital gains perspective, the lower rates may discourage investors from short-term trading, since the differential between the tax rates on long- and short-term gains has grown.

See your professional advisor for more information on how you can take advantage of the new dividend and capital gains rates.

Business Incentives

To stir economic activity, the 2003 Act also provides growth incentives for businesses.

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. Deductions must 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). To figure the deduction for a particular item, one must know not only the property's cost, but also the recovery period, depreciation method, and placed-in-service convention applicable to that type of property under MACRS. Various IRS regulations and procedures spell out the rules.

Example: Company X buys a delivery truck for \$50,000 in 2004. Under MACRS, general purpose trucks belong in the five-year recovery class. Using the 200% declining balance method and half-year convention, Company X's first-year depreciation is 20% (200% divided by 5 divided by 2) of \$50,000 — or \$10,000.

In 2002, a new law gave businesses an opportunity to significantly increase their first-year depreciation deductions. The goal was to provide businesses with tax savings that might be used to help finance the purchases of the assets themselves or to meet other business objectives.

The 2002 law introduced, for a limited time, an additional first-year depreciation “bonus” equal to 20% of the adjusted basis (essentially, cost) of qualified property. To qualify under the 2002 law, the property must generally be new property acquired after September 10, 2001, and before September 11, 2004, and that is placed in service before January 1, 2005. In addition, the property must be:

- ? Subject to MACRS and have a recovery period of 20 years or less,
- ? Water utility property,
- ? Eligible computer software, or
- ? Qualified leasehold improvement property.

Other requirements and exceptions apply.

The bonus depreciation is available for both regular and alternative minimum tax purposes, is not mandatory, and doesn't preclude the regular deduction for first-year depreciation. However, the

bonus depreciation is subtracted from the property's adjusted basis when figuring the regular deduction.

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: Returning to our earlier example, assume Company X qualifies for the additional 50% first-year depreciation deduction for the \$50,000 truck. Instead of claiming the regular depreciation deduction of \$10,000, Company X 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).

Other related provisions of the 2003 Act include:

- ? A \$7,650 increase in the limitation on the amount of depreciation deductions allowed with respect to certain 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 additional first-year depreciation.
- ? For 30% additional first-year depreciation purposes, a provision allowing qualifying property to be acquired before the end of 2005 (the old law required acquisition before September 11, 2004).

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, and 2005. In addition, for phaseout purposes, the \$200,000 annual investment limit described above rises to \$400,000 for property placed in service during those years. The dollar limits will be indexed for annual inflation for tax years beginning after 2003 and before 2006. And off-the-shelf computer software qualifies for the Section 179 election, for tax years beginning in 2003, 2004, and 2005. After tax years that begin in 2005, the expensing election rules go back to the way they were prior to the 2003 Act.

	<i>Pre-2003 Act</i>	<i>2003 Act (2003-2005)</i>	<i>Post-2003 Act</i>
Limit on Expensed Property*	\$25,000	\$100,000**	\$25,000
Annual Phaseout Limit	\$200,000	\$400,000**	\$200,000

* An additional \$35,000 "Liberty Zone" expensing election is available for property placed in service in the area of New York City damaged by the September 11, 2001, terrorist attacks.
 ** To be adjusted for inflation for 2004 and 2005.
 Source: NPI

Example: In 2003, Corporation A has taxable income of \$150,000 (without considering Section 179). For the year, Corporation A makes asset purchases consisting of \$50,000 in computer hardware, \$10,000 in off-the-shelf computer software, \$10,000 in office furniture, and \$30,000 for a delivery van. Under the old law, Corporation A could have made a Section 179 election for only \$25,000 of the purchases, with the \$75,000 remainder subject to regular depreciation rules (with bonus first-year depreciation available for those assets that qualified). After the 2003 Act, Corporation A may expense all of the asset purchases in the current year, since the limit is now \$100,000 and the company's taxable income exceeds that figure.

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.

Corporate Estimated Taxes

In general, corporations are required to make quarterly estimated tax payments of their federal income tax liability. For a corporation whose taxable year is the calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Part of the political battle over the 2003 Act was caused by the desire of some in Congress to limit the “cost” of the law to \$350 billion. In order to fit the 2003 Act into that framework, the new law takes 25% of the corporate estimated tax payment payable by September 15, 2003 (which falls in the 2003 U.S. government fiscal year) and makes it payable by October 1, 2003 (which falls in the 2004 U.S. government fiscal year).

Can We Help?

We would be happy to help you with your tax and financial planning, and with a variety of other related services that our firm offers. Let our professionals be of assistance to you.

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