

PKF PERSPECTIVES

PRESIDENT SIGNS \$350 BILLION TAX-REDUCTION PACKAGE

On May 28, 2003, President Bush signed into law one of the largest tax cuts in history. It is the third tax cut package in as many years. The Jobs and Growth Tax Relief Reconciliation Act of 2003 contains many of the President's original proposals, including dividend tax relief, an acceleration of tax rate reductions, and adds capital gains tax reduction. Also, small business will benefit from a quadrupling of the expensing deduction and a significant increase in the first year bonus depreciation. Summarized below are some of the more significant provisions of the Act.



Acceleration of Reductions in Individual Income Tax Rates

OLD RATE	NEW RATE (Effective for 2003)	RATE REDUCTION
10%	10%	
15%	15%	
27%	25%	2%
30%	28%	2%
35%	33%	2%
38.6%	35%	3.6%

Regular Tax: Prior to the **Economic Growth and Tax Relief Act of 2001** ("EGTRA"), regular income tax rates were 15, 28, 31, 36 and 39.6 percent. Under EGTRA, the tax rates were to be phased down over six years to 25, 28, 33, and 35 percent. Under the **Jobs and Growth Tax Relief Reconciliation Act of 2003** ("2003 Act") these rate reductions are accelerated. For 2003 the 27 to 35 percent rates are each reduced by two percentage points and the top rate of 38.6 percent is reduced by 3.6 percent. Therefore, for 2003 and thereafter, regular income tax rates in excess of 15 percent are 25 percent, 28 percent, 33 percent and 35 percent.

Expansion of 10 Percent Bracket

The 10-percent rate created by EGTRA applied to the first \$6,000 of taxable income for single individuals, \$10,000 for heads of households, and \$12,000 for married couples filing joint returns. In 2008, the \$6,000 amount was to increase to \$7,000 and the \$12,000 amount to \$14,000.

The new law accelerates the increase in taxable income levels for the 10-percent rate bracket to be effective in 2003 and 2004. In 2005, the taxable income levels for the 10-percent rate bracket will revert back to prior law, as enumerated above.

Here are the old and new brackets for year 2003. You will note that as part of the tax relief for married individuals, the 15 percent bracket is now double that of single taxpayers.

OLD BRACKET	OLD RATE	NEW BRACKET	NEW RATE
<i>Single</i>			
\$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%
311,951 and over	38.6%	311,951 and over	35%
<i>Married Filing Jointly</i>			
\$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%
311,951 and over	38.6%	311,951 and over	35%

Tax savings are most impressive for those falling into the highest tax bracket. For example, a married couple filing jointly with taxable income of \$400,000 in 2003 will pay \$9,496 **less** in Federal income tax (assuming that the taxpayer does not fall into the Alternative Minimum Tax provisions). Other examples follow:

Married Filing Jointly - Taxable Income	Prior Tax	Current Tax	Decreased Tax
\$ 100,000	\$ 20,707	\$ 18,620	\$ 2,087
200,000	51,535	47,445	4,050
300,000	86,532	80,445	6,087
400,000	124,701	115,205	9,496

Alternative Minimum Tax: An individual's alternative minimum tax (AMT) is the amount by which his/her tentative minimum tax (TMT) exceeds his/her regular tax. TMT is an amount equal to: (1) 26 percent of the first \$175,000 (\$87,500 for married filing separate) of alternative minimum taxable income (AMTI) in excess of a phased-out exemption amount, and (2) 28 percent of the remaining amount of AMTI.

AMTI is an individual's regular taxable income adjusted for specified preferences and adjustments. (For example, state and local income taxes and real estate taxes are allowable as deductions for regular taxable income, but **not** for AMTI.)

The exemption amounts for 2003 were: (1) \$49,000 for married individuals filing jointly, (2) \$35,750 for unmarried individuals, (3) \$24,500 for married filing separately, and (4) \$22,500 for an estate or trust. These amounts phase out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds: (1) \$150,000 for married filing jointly, (2) \$112,500 for unmarried individuals, and (3) \$75,000 for married filing separately and estates and trusts.

The new law increases the exemption amounts to \$58,000 for married filing jointly, and to \$40,250 for unmarried taxpayers for taxable years beginning in 2003 and 2004. These exemption amounts are phased out as follows:

	Maximum Exemption	Reduced by 25% of AMTI Over	Exemption Completely Eliminated at
Single or Head of Household	\$ 40,250	\$ 112,500	\$ 273,500
Married Filing Jointly or Qualifying Widow	58,000	150,000	382,000
Married Filing Separately	29,000	75,000	191,000

Effective date: The above provisions are generally effective for **taxable years beginning after December 31, 2002**. Taxpayers who have been overwithheld as a result of these changes will have to wait until they file income tax returns in order to obtain refunds of tax previously withheld in 2003. However, the Treasury has released withholding tables reflecting the new tax rates and brackets.

Most salaried taxpayers will be receiving additional money in their paychecks starting immediately.



Depreciation and Expensing Provisions

Special Depreciation Allowance for Certain Property: The **Job Creation and Worker Assistance Act of 2002** ("2002 Act") provided for an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property. Qualified property includes property with a normal recovery period of 20 years or less, and qualified leasehold improvement property. Also, the property's original use must have commenced with the taxpayer on or after September 11, 2001, the taxpayer must have purchased the property generally after September 10, 2001 and before September 11, 2004, and, finally, the property must generally be placed in service before January 1, 2005.

The 2003 Act provides for an additional first-year depreciation deduction for qualified property, equal to **50 percent** of the adjusted basis of the property. Qualified property is defined the same as provided under the 2002 Act as mentioned above, except that the applicable time period for acquisition of the property is modified. In order to qualify, the property must be acquired after May 5, 2003 and before January 1, 2005.

The law clarifies that the adjusted basis of qualified property acquired by a taxpayer in a like kind exchange or an involuntary conversion is eligible for the additional first-year depreciation deduction.

The law also increases the limitation on the amount of depreciation deductions allowed with respect to passenger automobiles in the first year, by \$7,650 (in lieu of \$4,600 provided under the prior tax act) for automobiles that qualify (and do not elect out the increased first year deduction). This provision applies to taxable years ending after May 5, 2003 (generally calendar year 2003).

Increased Section 179 Expensing:

Prior law provided that, in lieu of depreciation, a taxpayer could generally elect to deduct up to \$25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service during the tax year. In general, qualifying property is depreciable tangible personal property used in a trade or business. This election was binding and generally could not be revoked. This \$25,000 cap was reduced by the amount by which the cost of qualifying property placed in service during the year exceeded \$200,000 — dollar-for-dollar. Thus, if a taxpayer placed \$225,000 of qualifying property in service during a year, Section 179 depreciation was not available. In general, taxpayers could not elect to expense off-the-shelf computer software.



The new law increases the cap from \$25,000 to \$100,000 for property placed in service in taxable years beginning in 2003, 2004 and 2005. In addition, the \$200,000 amount is increased to \$400,000. Dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2006. In addition, the new law includes off-the-shelf computer software placed in service in a taxable year beginning in 2003, 2004, and 2005 as qualifying property. Also, the 2003 Act provides that for taxable years beginning after 2002 and before 2006, a taxpayer may revoke an expensing election without IRS approval.

Assume that on July 15, 2003 a company purchases and places in service computer equipment of \$300,000. Under the new provision, the taxpayer is first allowed a \$100,000 Section 179 deduction. Next, 50 percent of the remaining basis could be taken as bonus depreciation and finally, the remaining basis would be depreciated under the normal MACRS depreciation rules. Thus the total “depreciation” deduction for 2003 would be \$220,000 (\$100,000 Section 179 plus \$100,000 bonus depreciation and \$20,000 first year MACRS deduction).

Capital Gains and Dividends Provisions

Reduced Individual Capital Gains Rates: Under prior law, the maximum rate of tax on the adjusted net capital gain was 20 percent. In general, net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than a year. Taxpayers in lower tax brackets were subject to a reduced capital gain rate of 10 percent.

The 2003 Act reduces the 10 and 20 percent rates to 5 and 15 percent, respectively. In addition, the 5 percent rate drops to zero for taxable years beginning after December 31, 2007.

These lower rates apply for both regular tax and alternative minimum tax purposes. The reduced tax rates apply to taxable years ending on or after May 6, 2003 and beginning before January 1, 2013. For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. In the case of gain and loss taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule. These rules have the effect of applying the lower rates to capital assets sold or exchanged on or after May 6, 2003.

Keep in Mind: The 5 percent drop in the capital gains rates under the 2003 Act is more than the 3.6 percent drop in the top individual rate under 2003 Act and the 2 percent drop in other individual rates. Thus, the advantage of long-term capital gains over other types of taxable income is even greater for high earners than it was before.

Treatment of Dividend Income of Individuals: Under the new law, dividends received by an individual from domestic corporations and from qualified foreign corporations, are taxed at the same rates that apply to net capital gains (generally, 5 and 15 percent). The rate applies to both regular tax and alternative minimum tax. Prior law taxed dividends at ordinary income tax rates.

In order to obtain the lower tax rate, a shareholder must hold a share of stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date. For example, if the ex-dividend date is June 30, the taxpayer must hold the stock for 60 days during the period between 60 days before June 30 and 60 days after this date [120-day window]. Also, reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property. Certain dividends are not eligible for the reduced 15 percent rate; generally, those include REITs.

Keep in Mind: As a result of this rate reduction for dividends, an investor may want to reallocate his investment portfolio, investing more heavily in stocks paying dividends, which will be taxed at the favorable capital gains rate, rather than investing in non-tax-exempt bonds, the interest on which will continue to be taxable at the high ordinary rates. **Reduced rates will not apply after 2008.** While these reduced rates for capital gains and dividends can result in considerable tax savings, in devising a long-term investment strategy it is important to remember that these rates are not permanent. They are scheduled to “sunset” (i.e. no longer apply) after 2008.

Foreign Corporations: The term “qualified foreign corporation” includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the U.S. and which includes an exchange of information program. The Treasury Department is expected to issue guidance regarding a determination as to which treaty partners qualify for this purpose. Until then, all treaty countries except Barbados should qualify.

In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid if such stock is readily tradable on an established securities market in the U.S.

Dividends received from a foreign corporation that was a foreign investment company, a passive foreign investment company or a foreign personal holding company in either the taxable year of the distribution or the preceding taxable year will not qualify for the reduced rate.

In the Words of ...

The ancient Egyptians built elaborate fortresses and tunnels, even posted guards at tombs to stop grave robbers ... today ... we call that estate planning.

Bill Archer
(Retired U.S. Congressman from Texas)

Items in this publication should not be considered official statements of position, nor advice for individuals or organizations without consulting a tax advisor. For more information, please contact Howard Pell or Leo Parmegiani at:

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