

The “Simple” 2003 Tax Act

By Grace Allison, Tax Counsel, and
James Teufel, Tax Counsel

In broad outline, the Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerates income tax cuts into 2003, gives small business generous expensing and depreciation incentives, and reduces the maximum income tax rate on long-term capital gains and “qualified dividend income” to 15%. The Act’s alternative minimum tax (AMT) relief is short-lived and minimal: a small increase in the AMT exemption for 2003 and 2004.

The drop in the maximum long-term capital gains rate from 20% to 15% — effective May 6, 2003, through December 31, 2008 — was a late addition to the Act. In contrast, the even more significant rate cut (from 38.6% to 15%) for qualified dividend income — effective January 1, 2003, through December 31, 2008 — represents resolution of a lengthy policy debate over the double taxation of corporate income.

From a national budget perspective, the Act’s most expensive provision is the retroactive reduction of the four highest income tax rates for individuals, trusts, and estates, effective January 1, 2003, through December 31, 2010. The top income tax rate is now 35%, down from 38.6%.

The Act provides a limited expansion of the 10% bracket, which — under our graduated income tax system — applies to low-income and high-income individual taxpayers alike. In 2003 and 2004, that bracket widens by \$2,000 for married couples filing jointly and by \$1,000 for singles, and the maximum child tax credit, which phases out for higher-income taxpayers, is increased from \$600 to \$1,000. Also in 2003 and 2004, the Act provides limited relief from the “marriage penalty”: both the 15% bracket and the standard deduction for married couples are equal to double the amount for singles.

The IRS has already issued new withholding tables (see www.irs.gov) reflecting these rate and bracket

changes, which employers must implement by July 1, 2003.

Although the reduced tax rates for qualified dividend income and capital gains seem to encourage equity investing, the Act’s investment implications for individuals and trustees are not that simple. Most obviously, asset allocation is driven not only by after-tax yield but also by perceived risk-reward, volatility, issuer fundamentals, and state income-tax rates. For example, investment-grade municipal bonds exempt from federal and state tax likely will continue to be attractive to risk-averse, tax-shy investors.

For tax planners, the Act creates uncertainty with many new effective-date and anti-abuse provisions. Typical of this are the Act’s tax-bracket adjustments. The Act first expands the 10% and 15% income tax brackets (so that more income is taxed at lower rates in 2003 and 2004). It then contracts them (so that less income is taxed at lower rates from 2005 through 2007). Finally, the Act reinstates the favorable 2003 brackets in 2008, creating an accordion-like effect.

In addition, to prevent investors from “gaming” the new maximum 15% income tax rate on dividends, the Act adds yet another defined term — qualified dividend income — to the cluttered tax law. The U.S. Treasury has already commented that it will need to draft many new regulations clarifying this new term.

Dividends paid by domestic corporations and “qualified foreign corporations” (including dividends on foreign stock traded on a U.S. exchange) will be qualified dividend income. Only a portion of ordinary income dividends distributed by mutual funds will be qualified dividend income. To the extent that these dividends come from other sources of income, such as short-term capital gains or interest, they will continue to be taxed at ordinary income tax rates. For example, because money market funds and bond funds typically earn interest income, their dividends will not generally qualify for the 15% rate.

If a stock has not been held for more than 60 days during a designated period, then the corresponding dividends will not be qualified dividend income.



Northern Trust

continued on reverse ➤

The “Simple” 2003 Tax Act

Continued from front

“Payments in lieu of dividends” paid or received by short sellers and securities lenders will definitely not qualify. If a partnership or common fund receives qualified dividend income, the partners and common fund holders will be taxed at the 15% rate on their allocable share of that income.

Under current law, investment interest expense is deductible only to the extent of investment income. The 2003 Act gives investors the choice of losing a portion of their investment interest deduction or having otherwise qualified dividend income taxed at 35%.

The effect of all these tax changes should not be exaggerated. For example, despite the likelihood that most real estate investment trust (REIT) dividends will not be eligible for the 15% rate, we do not expect REITs, which give investors exposure to the real estate market, to disappear. Even if most REIT dividends now will be taxed at 35%, that same rate would apply to rental income received directly by the investor. Hedge funds likely also will remain a viable alternative investment, despite their pattern of short-term holding periods and short sales.

For the typical individual investor or irrevocable trust with stocks, bonds, and mutual funds, the 2003 Act is not a sea change. Rather, it is an opportunity to fine-tune investment allocation. As always, running projections with your personal income-tax planner and investment manager is a necessary prelude to action. The following checklist may serve as a good starting point:

- **If you have a concentration of appreciated stock, the federal income-tax cost of diversification has just decreased by 25%. After considering transaction costs, is an outright sale now more attractive than an exchange fund or options strategy?**
- **If you have significant assets in retirement plans, does it now make even more sense to hold taxable bonds in these tax-deferred vehicles and equities in your other accounts? Consider the new after-tax yield on each asset class (outlined in the following chart), remembering that capital gains in an IRA or 401(k) plan eventually will be taxed at ordinary income tax rates.**

Sample After-Tax Yields for Individuals, Trusts, and Estates*

	Before-Tax Yield	Top Tax Rate	After-Tax Yield	Ratio to Taxable Bond
OLD LAW	%	%	%	
➤ Money Market Dividend	1.00	38.60	0.61	0.27
➤ Stock Dividends (S&P 500 avg.)	1.74	38.60	1.07	0.47
➤ 10-Year AAA Municipal Bond Interest	3.07	0.00	3.07	1.33
➤ 10-Year AAA Corporate Bond Interest	3.75	38.60	2.30	1.00
NEW LAW	%	%	%	
➤ Money Market Dividend	1.00	35.00	0.65	0.27
➤ Qualified Dividend Income (S&P 500 avg.)	1.74	15.00	1.48	0.61
➤ 10-Year AAA Municipal Bond Interest	3.07	0.00	3.07	1.26
➤ 10-Year AAA Corporate Bond Interest	3.75	35.00	2.44	1.00

* Chart reflects federal income tax only

- **Taking into account both state and federal tax rates, consider the new after-tax yields on different asset classes. Does the 15% rate on dividends make dividend-paying stocks relatively more attractive? (Note: the chart above takes into account federal income tax rates only.)**

Finally, we strongly recommend taking the Act’s effective dates and sunset provisions at face value. Predicting the actions of a future Congress — or a future market — is risky at best. Current pundits who write “once a tax cut, always a tax cut” may find themselves wishing that they had focused more sharply on exactly what planning opportunities were available to them in 2003.

This article does not attempt to discuss all of the 2003 Act’s provisions or the investment implications and opportunities it presents. We will explore the Act in more detail in the June issue of Market Signals, which you should receive mid-month. If you have any questions about how these changes may affect your portfolio, please contact your Relationship Manager.

