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PRESIDENT BUSH SIGNS \$350 BILLION TAX-CUT PACKAGE; IMMEDIATE RELIEF AVAILABLE

For the third time in three years, Congress has passed a major tax cut package—one designated as the third largest in U.S. history. The **Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)** - as approved on May 23rd by the House (231-200) and the Senate (51-50) - introduces a host of new rules, accelerates benefits, and creates a web of retroactive, temporary and phased-in/phased-out effective dates. President Bush officially signed the bill into law at a White House ceremony on May 28th.

The new law tracks many of President Bush's original proposals set forth in his FY 2004 Budget, including a version of his controversial and complex method of dividend tax relief. A valuable capital gains tax reduction, added to the package at the last moment, was a surprise that will significantly impact a broad segment of the population. Small business gets a tremendous push with the new law's quadrupling of the expensing deduction, almost doubling bonus first-year depreciation, and drastically lowering the amount of tax paid on taxable income through significant rate reduction for ordinary income, capital gains and dividends. "Ordinary citizens," too, will discover immediate tax benefits coming their way from the new law, not only from lower tax rates but from a highly-visible summer rebate check as a result of a retroactive increase of the child tax credit. Marriage penalty relief and a temporary respite from higher alternative minimum tax (AMT) liability are also in the new law.

Comment

JGTRRA's total impact weighs in as one of the largest tax cuts in history. Although the new law has been "scored" by the Joint Committee on Taxation as costing the Treasury an additional \$330 billion over the next 10 years (the period over which "scoring" is required), the true impact of JGTRRA is much, much greater. Estimates peg the true costs at more than \$850 billion, dwarfing President Bush's original \$726 billion tax-cut in his FY 2004 Budget. The difference in numbers is the result of a technique being used by Congress more and more on tax reconciliation bills—pass large, but temporary, tax relief provisions that last from two to five years only. Once the public becomes accustomed to these tax breaks, another Congress two to five years down the road will be forced to extend the relief.

More good news. Congress ultimately was able to pass the bill without having to include any revenue offsets (tax increases).

Reduced tax rates for capital gains. One of the major accomplishments of the new tax law is its across-the-board reduction of tax rates. In most instances, it is as simple, and complex, as plugging in the new rates— for ordinary taxable income, capital gains, and dividend income— into a taxpayer's year-end tax computation. Retroactive application of these rates, however, complicates matters since many transactions, business and personal, cannot be recast quickly. The new capital gain rates create a new variable to investment decisions, as well as headaches for

many deals that straddle the magic May 6 effective date, or that involve five-year property. Finally, the temporary nature of the cuts, especially for capital gains and dividend rate relief, makes mid- and long-term financial planning more tax driven than ever before.

CAUTION JGTRRA overlaps with the Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs Creation and Workers Assistance Act of 2002 (JCWAA). The result is a roller coaster of rate and other changes between now and 2010.

Capital Gains

Under the new law, the maximum net capital gains tax rate immediately falls five percentage points from 20 to 15 percent. The current 10-percent capital gains rate for lower-income taxpayers falls to five percent. These new rates are effective for sales and exchanges (and payments received) on or after May 6, 2003 and through December 31, 2007 (with the 15-percent rate continuing unchanged in 2008 as well). The lower rates apply for both regular tax and AMT purposes.

Zero-percent rate. In 2008, the five-percent rate for low-income taxpayers drops to zero percent...but just for one year. The 15-percent rate remains the same in 2008 for all other taxpayers. On January 1, 2009, the old, pre-JGTRRA rates of 20- and 10- percent return.

Impact *The spread between the highest tax bracket rate and the capital gains rate before JGTRRA was 18.6 percentage points (38.6 percent less 20 percent). As a result of the acceleration of the lower individual rates, the spread now increases to 20 percentage points (35 percent less 15 percent), making “gaming” to realize long-term capital gain instead of either short-term gain or ordinary income even more valuable to taxpayers in the higher brackets.*

“The result is a roller coaster of rate and other changes between now and 2010.”

Impact *Unlike the flood of revenues that followed the last cut in the capital gains rate in 1997, when the stock market was booming, there is little unrealized capital gain waiting to be freed by the 15-percent rate this time around. On the downside, losses that were “earned” during the past several years and carried over into 2003 will be adjusted to reflect the higher capital gains rate in place when they were realized. They will offset gains otherwise taxed at the new JGTRRA rates (or up to \$3,000 of ordinary income taxed at the new lower rate brackets if there is no gain to offset).*

Impact *The capital gains rate cut is not “across the board.” Long-term capital gain from some assets, such as collectibles, remains subject to a 28-percent maximum rate. Unrecaptured Code Sec. 1250 gain is subject to a 25-percent maximum rate. Deductions of capital losses against ordinary income continue to be limited to \$3,000 per year for individual taxpayers.*

Five-year property rate gone-for now. Under EGTRRA, the capital gains tax rate for gain on property held for more than five years was lowered to 18 percent (eight percent for lower income taxpayers). The lower rates started in 2001 for individuals in the 15-percent bracket, and after 2005 for individuals in higher brackets (for property held for at least five years starting after 2000). The 18/8 percent rates are not effectively repealed until 2009 when the pre-JGTRRA capital gain rates are scheduled to return. The repeal of the eight-percent rate is effective May 6, 2003. Those who would qualify for the 18-percent rate for sales in 2005-2008 will receive no additional benefit other than the new general 15-percent capital gains rates.

Impact Ending the five-year property rate for some taxpayers is problematic. Those who made a deemed sale election on their 2001 returns recognize gain as if property had been sold on January 1, 2001, but who sell that property before 2009, receive no benefit for having paid tax on pre-2001 appreciation of the asset (and at the higher 20-percent rate). A deemed sale election was necessary for pre-2001 assets since the rules for 18-percent rate specified that the asset must be acquired after 2000. Some taxpayers have been allowed through the letter ruling process to make a deemed sales election late, if they can show reasonable cause. Perhaps there will be an option for taxpayers who had previously made the election to take it back.

Impact Taxpayers with appreciated assets should think about transferring them to children over age 13 (and exempt from the “kiddie” tax). Savings in 2008 could be dramatic using this technique. Assuming the child is otherwise in the 10-percent tax bracket, a sale of appreciated assets in 2008 will, at least in part, not be taxed at all—a great way to contribute to a college or graduate school fund.

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