

Memo

To: All MDE Clients
From: Andrea Nodoro, CPA, MBA
Date: May 30, 2003
Re: Recap of 2003 Tax Law Changes

On Wednesday, May 28, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003. As a follow-up to my recent memo explaining the new law, this memo will give you a better understanding of how the changes will affect you.

For most individuals, the most significant provisions of the Act are the accelerated reductions in tax rates previously scheduled to be phased-in over a number of years. Effective retroactively to January 1, 2003, the top four marginal income tax rates of 27%, 30%, 35% and 38.6% are lowered to 25%, 28%, 33%, and 35%. In addition, the recently established 10% tax bracket is increased from \$12,000 to \$14,000, and the 15% tax bracket has been expanded upward from \$47,450 to \$56,800, which is now double the \$28,400 threshold level applicable to single individuals. This increase in the 15% income tax bracket applicable to those claiming Married Filing Jointly status is intended to eliminate the so-called "marriage penalty." To completely level the playing field, the Act also increases the standard deduction from \$7,950 to \$9,500, so that it, too, is exactly double the \$4,750 standard deduction allowed for single individuals.

A new provision that should also be very beneficial to our clients allows dividends from US corporations and qualified foreign corporations to be taxed at the same preferential tax rates applicable to long-term capital gains. Furthermore, for sales made on or after May 6, 2003, this preferential tax rate is lowered from 20% to 15% if taxable income already exceeds the 15% income tax bracket threshold of \$56,800. To the extent that one's taxable income, including dividends and capital gains, is less than \$56,800, the preferential tax rate is lowered from 10% to 5%.

These tax law changes alone are likely to provide significant income tax savings to our clients at all income levels. For example, for a married couple filing jointly, assuming that 10% of their taxable income is comprised of dividends, the tax savings from just these changes would be as follows:

<u>Taxable Income (Including Divs.)</u>	<u>Tax Under Old Law</u>	<u>Tax Under New Law</u>	<u>Potential Tax Savings</u>
\$ 100,000	\$ 20,706	\$ 17,620	\$ 3,086
\$ 250,000	\$ 69,032	\$ 59,446	\$ 9,586
\$ 500,000	\$163,031	\$140,207	\$23,095
\$1,000,000	\$356,301	\$305,207	\$51,095

In addition, for tax years 2003 and 2004 only, individuals with a "modified adjusted gross income" of \$110,000 or less can also look forward to a child credit of \$1,000 per child, versus \$600 per child under the old law. For 2003, the increased amount of the credit will be paid out in advance, starting in July, based

on information reported on 2002 income tax returns. However, since this credit is phased out between AGI levels of \$110,000 and \$130,000 (or \$75,000 and \$95,000 if filing single), many of our clients will derive little direct benefit from this particular tax law provision. However, individuals with taxable incomes in excess of \$311,950 can take solace in the fact that the top marginal income tax rate was reduced by a full 3.6%, while the tax rates for each of the next three income tax brackets applicable to taxable incomes between \$56,800 and \$311,950 fell by only 2%.

From an investment planning perspective, the change that deserves the greatest amount of attention is the reduced tax rate applicable to dividends. Although both long-term capital gains and corporate dividends are eligible for a preferential tax rate of 15%, or even 5% if taxable income is less than \$56,800, these downwardly revised preferential tax rates are more likely to have the greatest near-term impact on holders of dividend-paying stocks, since there generally is no shortage of capital loss carryforwards available to offset capital gains. Fortunately, for independent reasons, beginning last year we tilted our clients' investment portfolios toward value-oriented stocks with above average dividend yields, so boosting the after-tax returns of these stocks by lowering the tax rate applicable to their dividends should provide an even more meaningful benefit to our clients. For example, if we also assume a 5% state income tax rate, under the old law, a 5% dividend yielded about 2.86% after-taxes to an individual in the top marginal income tax bracket. Under the new law, this same dividend would now yield about 4.04% after-taxes.

Unfortunately, the slower economy has forced many states and localities to hike their taxes on individual income and property, among other things. Since state and local income taxes and property taxes are deductible for regular income tax purposes, but are not allowable deductions for purposes of calculating the Alternative Minimum Tax, these higher state and local taxes can increase the risk that certain individuals will be snared by the AMT. Reducing the regular income tax rates while maintaining the existing 26% and 28% AMT rates also serves to heighten this risk. As if to address this concern, the new federal tax law increases the AMT exemption from \$49,000 to \$58,000 (or \$35,750 to \$40,250 if filing single). This exemption is allowed in lieu of certain deductions that may be claimed only for regular income tax purposes. However, the exemption is phased-out between AMT income levels of \$150,000 to \$382,000 (or \$112,500 to \$273,500 if filing single), so individuals with AMT income within or slightly above these applicable bands may be especially prone to the AMT, which some fear to be an encroaching flat tax that has been lurking behind the scenes for a number of years.

If you have any questions concerning how these changes might affect your personal situation, please feel free to contact me.