

inside business

by Michelle Pickett
and Kirk Wilson

Tax act provides short-term benefits for individuals

Editor's note: This is the second in a two-part analysis on the impact President Bush's tax cut on the economy. Friday's column explored how businesses will be affected.

Individuals and married couples both here in Santa Barbara and across the nation will benefit from the Jobs and Growth Tax Relief Reconciliation Act of 2003, signed by President Bush on Wednesday. The measure's benefits start immediately, are largely "front-loaded," and in many cases are temporary, lasting only two to five years. Unlike other major tax legislation in the past, the act adds very little new law, and instead accelerates, albeit temporarily, a number of tax cuts that were not scheduled to take effect until future years.

The major tax breaks for individual taxpayers include a reduction in the four top marginal tax rates, an expansion of the two lower tax brackets, and an increase in the size of the 10 percent bracket. Increasing the standard deduction for married couples and expanding the 15 percent tax bracket for joint filers provides marriage penalty relief. The child tax credit is also increased, with advance payment of the increased amount starting this July. The alternative minimum tax ("AMT") exemption is increased as well.

In addition, tax rates for capital gains and dividends are reduced to 15 percent for the four highest tax brackets, and to 5 percent for the two lowest brackets.

Taken as a whole, these changes add up to a significant reduction in taxes for individuals, particularly those in the higher tax brackets. The only people who will not derive some benefit from this act are single individuals in the 10 percent bracket who have no children or investments. Highlights of the act's provisions of interest to individuals are as follows:

Tax Rate Reductions: Reductions in the tax rates that were scheduled to take effect in 2006 have been accelerated to this year. This means that, effective retroactively to January 2003, the top rate of 38.6 percent drops to 35 percent, the 35 percent rate is reduced to 33 percent, the 30 percent rate drops to 28 percent, and the 27 percent rate to 25 percent. These rate reductions sunset in 2011 when the pre-act tax bracket structure will be restored.

Ten percent bracket expanded: The top end of the 10 percent bracket see-saws, increasing from \$6,000 to \$7,000 for individuals and from \$12,000 to \$14,000 for married couples filing jointly in 2003 and 2004. It then drops back to \$6,000 for single filers and \$12,000 for joint filers in 2005, 2006, and 2007; and then returns to \$7,000 for singles and \$12,000 for joint filers in 2008, 2009 and 2010. However, in 2011, this bracket expansion sunsets.

Fifteen percent bracket expanded for joint filers: The so-called "marriage penalty" is reduced by increasing the 15 percent tax bracket for joint returns to twice that for single taxpayers in 2003 and 2004. However, in 2005, 2006 and 2007, it is reduced to 180 percent, 187 percent and 193 percent, respectively, of the bracket for single taxpayers, until it again returns to 200 percent for 2008, 2009 and 2010. This bracket expansion also sunsets in 2011.

Planning note: Wage earners should see more money in their paychecks this summer. The lowering of income tax rates should be considered when making the next estimated tax payment which is due on June 16.

Standard deduction increased for joint filers: Increasing the standard deduction for married taxpayers filing joint returns to twice the amount of the basic standard deduction for single taxpayers in 2003 and 2004 further reduces the marriage penalty. In 2005, the standard deduction for joint filers falls to 174 percent of the standard deduction for single filers, and then gradually returns to 200 percent of the single taxpayer's amount for 2009 and 2010. In 2011, the increase in the standard deduction sunsets.

Child tax credit increased: Taxpayers who have a qualifying child (i.e., a dependent child under 17) may be eligible for the child tax credit. This credit is increased from \$600 to \$1,000 per child for 2003 and 2004, then falls to \$700 between 2005 and 2008, rises to \$800 in 2009, and returns to \$1,000 for 2010. Taxpayers whose 2002 returns indicate they are entitled to this credit in 2003 will receive advance payment of the increase in 2003. The increased child tax credit sunsets in 2011.

Alternative Minimum Tax exemption increased: The AMT exemption amount is increased by \$4,500 (to \$40,250) for individual taxpayers and by \$9,000 (to \$58,000) for joint filers for 2003 and 2004, and then reverts to lower amounts in 2005.

Capital Gain Tax rates reduced: For individual taxpayers, the maximum tax rate for most long-term capital gains falls from 20 percent to 15 percent through 2008. The 10 percent rate for taxpayers in the 10 percent to 15 percent tax bracket falls to 5 percent through 2007, and then drops to zero in 2008. These reduced rates are also

used to calculate AMT liability. All of these rate reductions will expire after 2008 and the previous capital gain rates (10 percent and 20 percent) will again apply.

Planning note: Taxpayers with appreciated securities may now want to consider selling some of their holdings and using the proceeds to rebalance their investment portfolio. Also, gifts of appreciated securities made to individuals in the lowest tax brackets (e.g., a child over age 13 to avoid the "kiddie tax" rates) will allow a subsequent sale by that donee with little or no tax on the capital gain (depending on the year of the sale).

Tax on Dividend Income Reduced: Corporate dividends paid to individuals have long been taxed at ordinary income tax rates. Under the act, dividend income received by an individual shareholder is taxed at a maximum rate of 15 percent through 2008, with those in the 10 percent and 15 percent tax brackets paying only 5 percent through 2007, and zero percent in 2008. The reduced rate for dividends expires in 2009.

Planning note: While dividend-paying stocks will be more attractive for the next few years, investors should still invest for maximum "total return" of both after-tax dividend income and appreciation.

Sunset provisions: As noted above, most of the act's tax reductions will expire on or before 2011, with tax rates returning to pre-act levels. This makes tax planning a problem as the rates change from year to year. It creates an analogous situation to the current phase-out of the estate and generation-skipping transfer taxes, which are scheduled to be phased out in increments, fully repealed in 2010, and then restored in 2011, making estate tax planning extremely difficult as well.

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