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August 2003

Saul Ewing Update

Highlights of the Jobs And Growth Tax Relief Reconciliation Act of 2003 ("2003 Act")

I. RELIEF FOR INDIVIDUAL TAXPAYERS

A. 15% Tax Rate on Long-Term Capital Gains. For individual taxpayers, the maximum rate of tax on most long-term capital gains has been reduced from 20% to 15%. The rate for lower income taxpayers has been reduced from 10% to 5% (and zero for 2008). The reduced rates are effective for sales and exchanges made on or after May 6, 2003 (including installment payments received after this date), but sunset in tax years beginning after December 31, 2008. The lower rates apply for both regular tax and alternative minimum tax (AMT) purposes.

As under prior law, property must be held for more than 12 months to qualify for long-term gain rates. The 2003 Act did not change the tax treatment of real estate depreciation recapture gain, which is taxed at a 25% rate, or gain from the sale of collectibles, which is taxed at a 28% rate.

The 2003 Act repealed the prior law provisions providing an 18% tax rate for certain property held at least five years. If you made a "deemed sale" election with your 2001 tax return to take advantage of this reduced rate, you may want to consider filing an amended tax return. Although the law currently provides that such a deemed sale election is irrevocable, it is anticipated that Congress may provide relief.

B. 15% Tax Rate on Qualified Dividend Income. Qualified dividend income received by individual shareholders will be taxed at the same rates that apply to long-term capital gains, and thus will be subject to a maximum tax rate of 15%. The reduced rates apply to dividends paid in taxable years beginning after December 31, 2002, and terminate for taxable years beginning after December 31, 2008. Unless the reduced rates are extended, dividends will again be subject to tax as ordinary income after 2008.

Subject to exceptions noted below, qualified dividend income is income paid by (i) a domestic corporation, (ii) a corporation incorporated in a U.S. possession, (iii) a foreign corporation that is eligible for the benefits of a U.S. income tax treaty or (iv) any other foreign corporation if the dividend is paid with respect to stock that is readily tradable on an established U.S. securities market.

The purpose of the new rate reduction is to reduce the punitive "double taxation" of income earned by taxable corporations and paid out to shareholders in the form of dividends. As a general rule, the 15% tax rate only applies in cases where a taxable corporation is distributing income that has already been subject to corporate income tax; the 15% rate is generally not available if the income being distributed was not subject to corporate income tax.

The treatment of dividends received from a mutual fund depends on the nature of the mutual fund's income. If at least 95% of the mutual fund's gross income (excluding long-term capital gains) consists of qualified dividend income received by the mutual fund, then all the dividends paid by the mutual fund should qualify for the 15% rate. If this 95% test is not met, however, then the dividends paid by the mutual fund will only qualify for the 15% tax rate to the extent that the mutual fund earned qualified dividend income or realized long-term capital gains after May 6, 2003. To the extent the mutual fund earns interest income or realizes short-term capital gains, the dividends paid by the fund will be taxed at ordinary tax rates. In general, dividends paid by money market funds, fixed income funds and bond funds will be taxed at ordinary income tax rates (up to 35%).

Dividends from a real estate investment trust (REIT) will generally be subject to tax at ordinary income tax rates, since the income of a REIT is generally not subject to corporate income tax. REIT dividends will qualify for the 15% rate, however, to the extent that the REIT recognized long-term capital gains from the sale of property, or received qualified dividend income, or had retained income on which it paid corporate income tax.

Additional types of dividends that will not qualify for the 15% tax rate include the following: (i) dividends paid by tax-exempt corporations, credit unions, mutual insurance companies, farmers' cooperatives, mutual savings banks and similar institutions; (ii) dividends paid on shares which were not held for 60 out of 120 days beginning 60 days before the ex-dividend date and ending 60 days thereafter; (iii) certain dividends paid on employer securities owned by an employee stock ownership plan; (iv) dividends paid on hybrid preferred stock (which accounts for a large proportion of recently issued preferred stock); (v) dividends paid on stock that has been hedged by a short sale or similar hedging technique; (vi) certain extraordinary dividends; and (vii) dividends paid by a foreign investment company (section 1246(b)), a passive foreign investment company (section. 1297), or a foreign personal holding company (section 552) in either the taxable year of the distribution or the preceding taxable year.

Interest on indebtedness that is allocable to stocks, bonds and other property held for investment can generally only be deducted to the extent of an individual's net investment income. To the extent that an individual taxpayer elects to take dividend income into account in computing net investment income, however, the dividends will not qualify for the 15% rate. Thus, to take advantage of the 15% tax rate, the taxpayer must not elect to take the dividend into account in computing net investment income, which may result in the loss or deferral of interest deductions.

Although qualified dividend income is taxed at long-term capital gains rates, qualified dividend income cannot be offset by long-term capital losses.

C. Acceleration of Rate Reductions. The 2003 Act accelerated tax rate reductions were originally scheduled to become effective in 2006. As a result, the top individual tax rate was reduced from 38.6% to 35%, effective for tax years beginning in 2003 through 2010. If the rate reductions are not extended, the top rate will revert to 39.6% in 2011.

D. Alternative Minimum Tax. Although the new 15% tax rate for long-term capital gains and qualified dividend income applies for both regular tax and AMT purposes, the regular tax rate reductions will cause more and more taxpayers to become subject to AMT. To try to slow down the huge projected increase in the numbers of individual taxpayers who will be subject to AMT, the 2003 Act increases the AMT exemption amount by $4,500 for single taxpayers and $9,000 for married taxpayers filing joint returns, but these reductions only apply in 2003 and 2004. The AMT is a ticking time bomb that Congress will have to revisit.

E. Relief for Low to Moderate Income Taxpayers. The 2003 Act accelerated a number of previously enacted tax benefits for low and moderate income taxpayers, effective for 2003 and 2004. These provisions (i) increase the income cut-off for the 10% tax bracket by a small amount, (ii) increase the 15% tax bracket and the standard deduction available to married taxpayers who file joint returns and (iii) increase the child tax credit from $600 to $1,000. These benefits are eliminated or cut back after 2004, and are then phased back in over the next several years, but only through 2010, when the 2003 Act sunsets.

II. GROWTH INCENTIVES FOR BUSINESS

A. <u>50% Bonus Depreciation Allowance.</u> The Job Creation and Worker Assistance Act of 2002 provided for a 30% bonus depreciation allowance for qualified depreciable property acquired and placed in service within certain time periods. The 2003 Act builds on this concept by permitting taxpayers to elect to claim an additional first year depreciation deduction equal to 50% of the adjusted basis of qualified property that is acquired after May 5, 2003, and that is placed in service before January 1, 2005 (or January 1, 2006, in the case of certain property with an extended production period). The remaining 50% of adjusted basis is recovered over the normal recovery period for the property. Taxpayers who qualify for the 50% bonus depreciation deduction can elect to claim either 50% bonus depreciation, or 30% bonus depreciation or zero bonus depreciation.

To qualify for 50% bonus depreciation, the taxpayer must be the original user of the property and there must have been no written binding contract for the acquisition of the property in effect prior to May 6, 2003. The following types of property will generally qualify for bonus depreciation, assuming they are acquired and placed in service within the appropriate time periods: (i) tangible property with a recovery period of 20 years or less; (ii) leasehold improvements made by a lessor or lessee to the interior portion of nonresidential real property, with certain exclusions for structural improvements; (iii) depreciable computer software other than software amortizable under section 197 of the Internal Revenue Code; and (iv) certain water utility property. The impact of bonus depreciation is particularly dramatic in the case of leasehold improvements, which otherwise must be depreciated on a straight-line basis over 39 years.

In order to reflect the bonus depreciation changes, Congress increased the "luxury auto limits," which restrict the total annual depreciation that can be claimed on autos and light trucks, from $4,600 to $7,650.

B. <u>Increase in Section 179 Expense Deduction.</u> Section 179 of the Code permits a taxpayer to deduct the cost of qualifying tangible personal property that is placed in service in a year, subject to certain dollar limitations and phase-outs. Effective for taxable years beginning in 2003, 2004 and 2005, the 2003 Act (i) increases the maximum dollar amount that may be deducted under section 179 from $25,000 to $100,000 (indexed for inflation), (ii) increases the level of qualifying section 179 expenditures which cause the section 179 deduction to be phased out from $200,000 to $400,000 and (iii) includes off-the-shelf computer software as qualified property for the section 179 deduction. All these rules are due to sunset in tax years beginning after 2005.

C. <u>Miscellaneous</u>. The 2003 Act reduces the tax rate for the accumulated earnings tax and personal holding company tax to 15%. The obsolete collapsible corporation rules have finally been repealed. Unfortunately, all these provisions are due to expire in 2009.

The 2003 Act did not address the tax treatment of S corporations that sell assets subject to the built-in gains tax. Such gains may be subject to both corporate income tax and individual tax rates of up to 35% (e.g., in the case of depreciation recapture), and thus may be subject to a greater level of tax than if a regular, taxable corporation had sold an asset and distributed the after-tax proceeds as a dividend. It remains to be seen whether any relief will be granted in this situation.

The 2003 Act also did not include certain provisions passed by the Senate that would attack corporate "inversions" and corporate tax shelters.

There is a good chance that these provisions will be enacted later this year.

III. TAX PLANNING IDEAS

- Since money taken out of an IRA or 401K account will be taxed at ordinary income tax rates, if you hold part of your portfolio directly and part through your IRA or 401K, it makes sense to hold taxable fixed income assets in the IRA or 401K and to hold stocks that generate dividend income and capital gains directly.

- Highly appreciated assets (like real estate) are often stuck in C corporations. Making an S election may not be possible because of retained corporate earnings and profits. Now that the tax on dividends has been reduced by 15%, it becomes more feasible to pay out a dividend to eliminate old earnings and profits, then make an S election. As noted above, however, if assets are sold within 10 years the built-in gains tax can be a problem.

- Individuals that made a deemed sale election to take advantage of the 18% tax rate for property held for more than five years may want to consider filing amended returns, but it appears legislative relief will be needed to claim a refund of the taxes paid when the election was made.

- Preferred stocks have become attractive, but most outstanding preferred stock is probably hybrid preferred and will not qualify for the 15% tax rate.

- The tax treatment of mutual fund dividends depends on the assets held by the fund and whether the fund holds stocks for at least 12 months before selling. A fund that holds assets at least 12 months will be able to pay out dividends taxable at the 15% rate, whereas dividends paid out of short-term gains will be taxed at up to 35%. It is possible that some funds will start specializing in stocks that pay out qualified dividend income.

- Although dividends paid by REITs will generally not qualify for the 15% rate, REITs typically pay much higher dividends than other corporations, since (i) the REIT must distribute its income to eliminate corporate income tax and (ii) the income of the REIT is consequently paid out on a pre-tax basis, not an after-tax basis.

- Giving appreciated capital assets to charity is still a tax effective device, because the donor avoids tax on built-in capital gains, but the tax savings have been reduced due to the reduction of the capital gains tax.

- The 15% tax on dividends has substantially reduced the tax cost of operating a business or holding assets through a taxable C corporation, but this is generally still a poor choice of entity for most new businesses. The double tax has not been eliminated and it is uncertain whether the 15% tax will be extended.

- An increasing number of taxpayers have to be concerned about AMT.

For additional information about the subject discussed in this Update, please contact any of the attorneys listed below:

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