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Deciphering the Code: Major Legislation in 2003 Cuts Taxes and Increases Complexity

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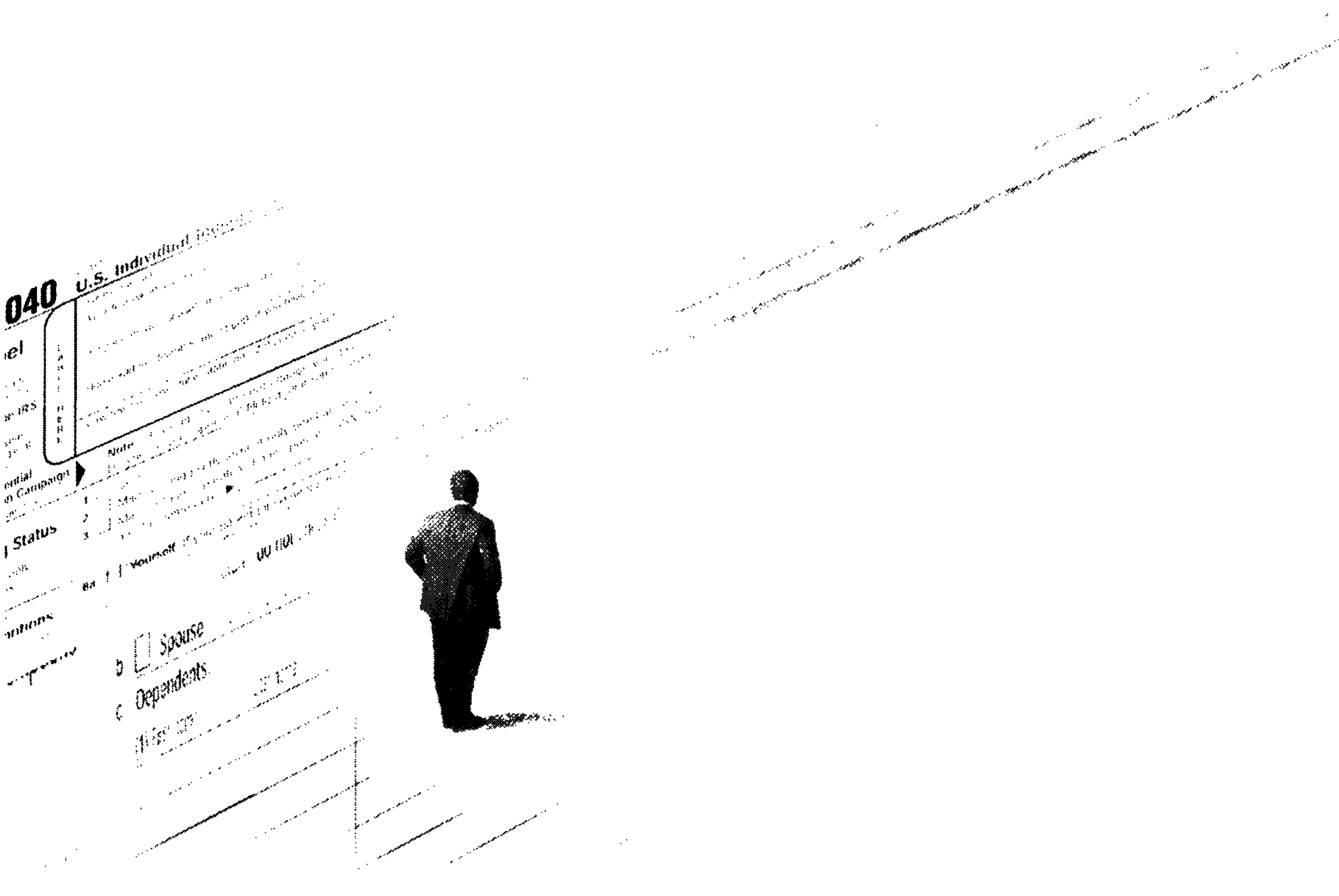

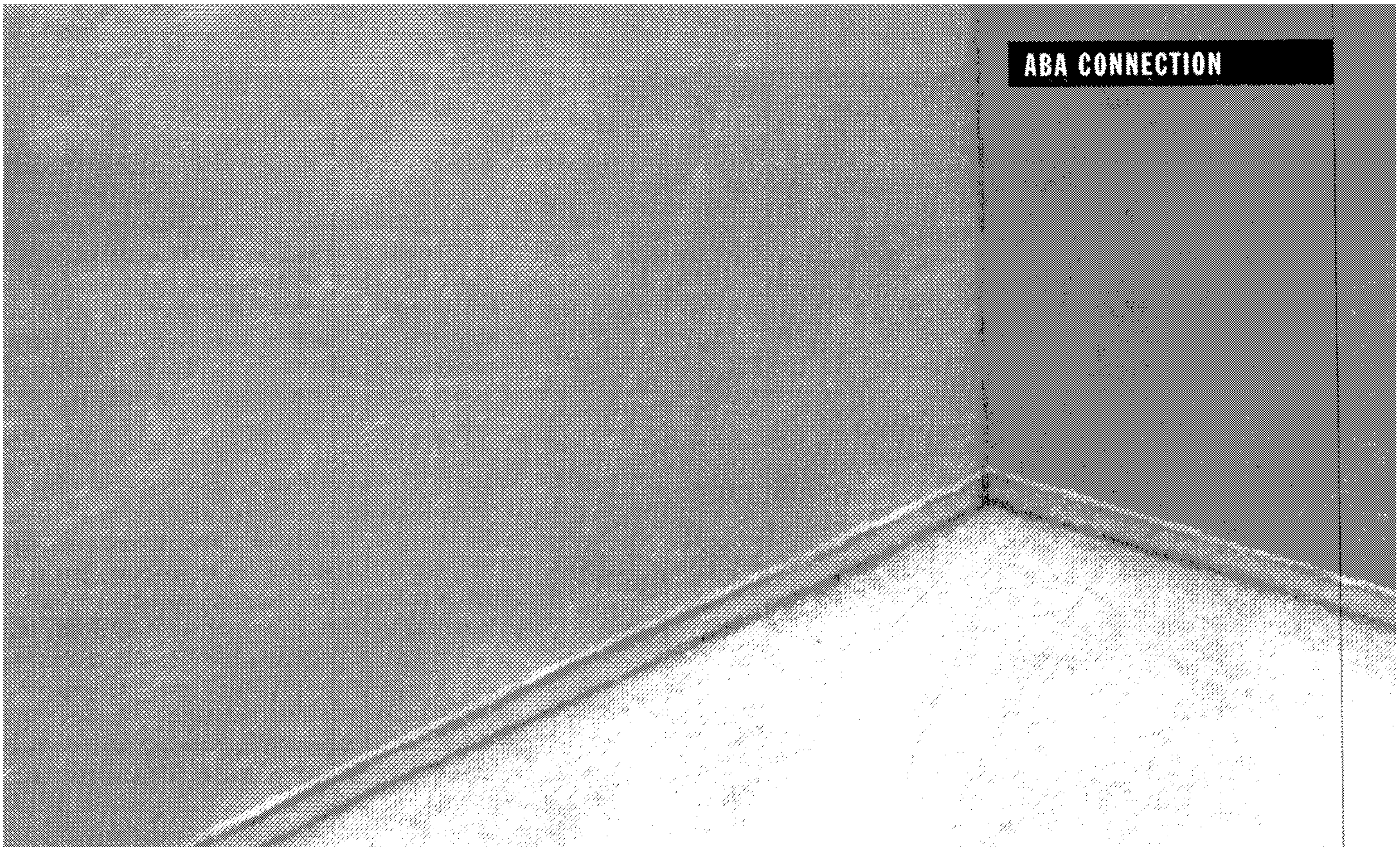

Major Legislation in 2003 Cuts Taxes and Increases Complexity

CAROL F. BURGER AND LINDA GALLER

Congress and the President have a penchant for giving tax legislation titles that convey ambitious goals. The bill that President Bush signed into law earlier this year—the Jobs and Growth Tax Relief Reconciliation Act of 2003—is no exception.

Only time will tell whether all the lofty policy ambitions of the act are achieved. But although the act did not include all of President Bush's tax proposals, it does provide relief for many taxpayers.

At the same time, however, the act has added to the complexity of federal tax laws, particularly since the effective dates for each provision vary. In many cases, the tax reductions are temporary and subject to "sunset" provisions. As a result, tax liabilities are likely to jump back up to their pre-2003 levels—or even pre-2001 levels—unless Congress acts to make the changes permanent.

It is too early to predict whether Congress will take that step. In the meantime, taxpayers may get a bit queasy from the roller coaster ride that many tax rates will be on over the next few years.

The economic growth and Tax Relief Reconciliation Act

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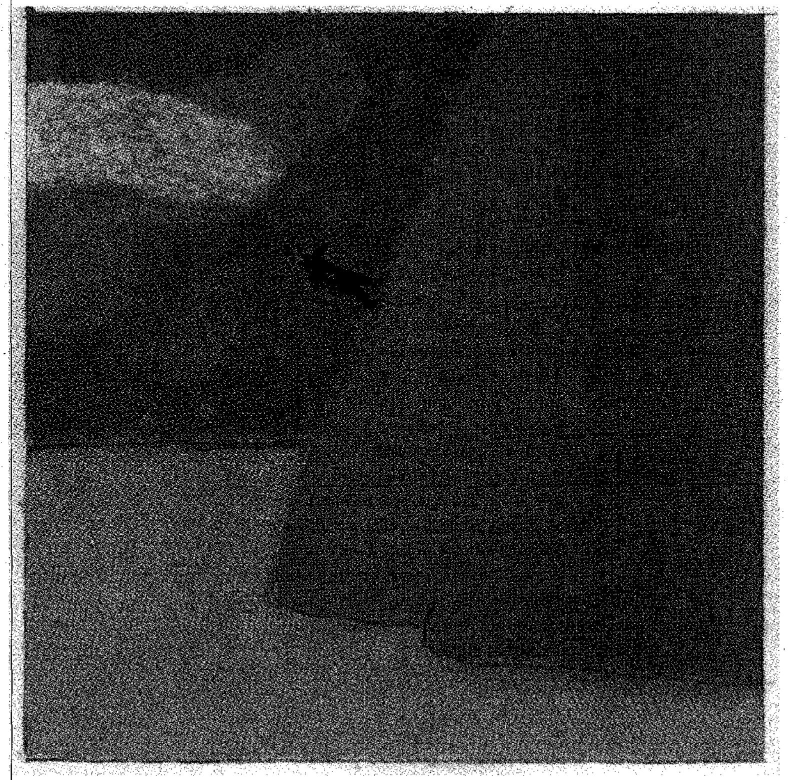
This article reflects the analyses and viewpoints of the authors on current federal tax issues.

ILLUSTRATIONS BY DAVID LESH



of 2001 (there's another one of those titles) added a new 10 percent income tax bracket to apply to a portion of personal income that previously had been taxed at a rate of 15 percent. Under the 2001 act, the amount of income taxable at the 10 percent rate would increase in 2008, but the 2003 act has accelerated the changes.

Accordingly, the new 10 percent rate will apply in 2003 and 2004 to taxable income of up to $7,000 for single filers and married couples filing separately, and $14,000 for married couples filing jointly, with an inflation adjustment in 2004.

The ceilings will drop to $6,000 for single filers and married couples filing separately, and $12,000 for married couples filing jointly in 2005, 2006 and 2007. In 2008, the ceilings will go back up to $7,000 and $14,000, with an inflation adjustment in 2009.

The 2003 act also accelerated the implementation of reduced tax rates for higher-income taxpayers that were originally scheduled under the 2001 act to go into effect in 2006. As a result, starting this year, the four highest income tax brackets will be 25 percent, 28 percent, 33 percent and 35 percent (down from 27 percent, 30 percent, 35 percent and 38.6 percent). These changes are subject to certain sunset provisions enacted in 2001 (discussed below) and are scheduled to apply only through 2010 unless Congress enacts legislation to extend them.

The 2001 act contained provisions aimed at reducing, if not eliminating, the "marriage penalty" starting in 2005. That penalty results in many married couples paying higher taxes together than they would have if they had remained unmarried and filed separate returns.

The 2001 act called for the maximum taxable income in the 15 percent bracket for married couples filing jointly to gradually increase so that by 2008, it will equal twice the maximum taxable income in the 15 percent bracket for single people. The 2003 act has accelerated those rates, but only temporarily.

Again, the roller coaster effect is at work. The 15 percent bracket ceilings that were originally scheduled to take effect in 2008 will apply for 2003 and 2004. But starting in 2005, the ceilings will return to their pre-2003 levels, and the original phase-in schedule will start in 2005 as originally set forth in the 2001 act, becoming fully effective in 2008.

Under the 2003 act, the standard deduction for married couples filing jointly has been increased to twice that of single filers, effective for 2003 and 2004.

The standard deduction will return to its pre-2003 level in 2005. Between 2005 and 2009, the standard deduction for married couples filing jointly will increase each year until it equals twice that of single filers in 2009.

Under sunset provisions in the 2001 act, all marriage penalty relief will end in 2010, unless Congress takes further action to extend it.

CHILD TAX CREDIT, CAPITAL GAINS

THE 2003 ACT INCREASED THE AMOUNT OF THE CHILD TAX credit in 2003 and 2004 from $600 to $1,000 for each qualifying child. In 2005, the credit will go down to $700.

Under rules in effect prior to 2003, the child tax credit phases out once the taxpayer claiming the credit reaches a certain level of income, but it will now phase out more gradually for most affected taxpayers.

The phaseout begins at $110,000 of modified adjusted gross income for married couples filing jointly, for instance, and is reduced by $50 for each $1,000, or fraction thereof, above that threshold. Married taxpayers whose incomes equal or exceed $130,000 would not be eligible for the credit at all.

On the other end of the income scale, taxpayers with incomes too low to pay taxes will not receive the credit. As a result of an agreement reached in the final hours of negotiating the 2003 act, millions of low-income working families who do pay taxes also are excluded from receiving the credit. Those with incomes between $10,500 and $26,625 received no advance checks from the IRS this summer and will receive no tax benefit from the child credit legislation. Efforts in Congress to rectify the situation by expanding the credit failed.

Before this year, long-term capital gains were taxed at rates of 20 percent or 10 percent, depending on the taxpayer's income tax bracket. Those rates, in turn, were lowered when the capital asset that was sold had been owned for at least five years. The 2003 act reduces both rates and eliminates the five-year rule altogether.

Thus, 15 percent is now the maximum rate of tax on capital gains. Individuals in the 10 percent or 15 percent tax brackets are taxed on capital gains at only 5 percent. That lower rate, however, will drop to zero for taxable years beginning after Dec. 31, 2007.

All of the new rates are set to expire in taxable years beginning after 2008, when the pre-2003 rates of 20 percent and 10 percent will apply once again.

(The 2003 act does not change any of the rules that apply to capital losses.)

Congress did not adopt the centerpiece of President Bush's tax proposals: elimination of double taxation of dividends by letting individuals deduct corporate dividends from their incomes.

Congress did, however, lower taxes on dividends by reducing the rate of the applicable tax. Where all dividends previously were taxed at the same rates as other types of ordinary income, including wages, some dividends are now taxed at the same rates as capital gains. Dividends received from domestic corporations are eligible for the lower rates.

Also eligible are dividends from certain qualified foreign corporations—generally, those whose stock is traded on an established U.S. securities market and corporations organized in countries that have a comprehensive income tax treaty with the United States.

The new rates apply to dividends received in taxable years beginning after 2002, and will expire for taxable years beginning after 2008.

CAPITAL COST RECOVERY

THE 2003 ACT CHANGED A NUMBER OF capital cost recovery rules to lower the cost of capital and to encourage capital investment, particularly for small businesses.

Before the 2003 act, a maximum of $25,000 of qualifying property placed in service in a given year could be currently expensed under Internal Revenue Code § 179, and this amount was reduced dollar-for-dollar if more than $200,000 of qualifying property was placed in service during the year.

For example, if $210,000 of qualifying property was placed in service in 2002, only $15,000 could be currently expensed. The balance would be depreciated under the usual rules.

Being able to expense the cost of new property rather than depreciate the cost over time accelerates the tax savings, thereby lowering the true cost of additional capital investment. By reducing the amount that may be expensed when a significant amount of new property is placed in service in a given year, the law limits the benefits of this provision to fairly small businesses, for which the extra savings are more likely to encourage capital investment that otherwise would not have been made.

Under the 2003 act, the $25,000 maximum has been increased to $100,000 for property placed in service in 2003, 2004 or 2005. The $200,000 phase-out threshold has been increased to $400,000. In addition, off-the-shelf computer software will be considered qualifying property if placed in service between 2003 and 2005.

In 2002, Congress enacted a special 30 percent first-year bonus depreciation deduction for certain qualified property either acquired after Sept. 10, 2001, and before Sept. 11, 2004, or acquired pursuant to a written binding contract entered into during that period and (with certain exceptions) placed in service before 2005.

The 2003 act increases the first-year bonus depreciation deduction to 50 percent, effective for property acquired after May 5, 2003, (and not subject to a binding contract on that date) and before 2005, and (with certain exceptions) placed in service before 2005. Before calculating the bonus depreciation, the adjusted basis of property must be reduced by any amount expensed under IRC § 179. Adjusted basis is then further reduced by the bonus depreciation before regular depreciation is calculated.

Previously, the limit for automobiles eligible for 30 percent bonus depreciation was $4,600. The first-year depreciation limit for automobiles eligible for the 50 percent bonus depreciation has been increased by $7,650.

Adding to the complexity of tax planning and reporting in this area is the fact that a number of states with income tax systems that generally conform to the federal tax system do not allow bonus depreciation for state income tax purposes, or allow it only in part.

THINGS AREN'T PERFECT

WHILE MANY CERTAINLY WELCOME TAX RELIEF, IT IS CLEAR that the 2003 act did not simplify the tax law. (Notably, the act's title did not refer to that goal.) Coupled with inconsistent enforcement and the usual panoply of unanswered questions, complexity remains a vexing problem for the federal tax system.

Even the Treasury Department appears to agree with that concern. In remarks to the Tax Executives Institute last December, Pamela Olson, the assistant treasury secretary for tax policy, said the tax system is "held together by chewing gum and chicken wire" that is "applied in haste, not strategically."

Olson said the Treasury Department is developing recommendations to overhaul the tax system to make it easy to understand, with reasonable filing and record-keeping requirements, and nonintrusive tax administration. She said the department's goal is for the system to be fiscally sound and more efficient. Other goals are to increase competitiveness of U.S. businesses and workers, and to avoid constant tinkering and perceptions of unfairness.

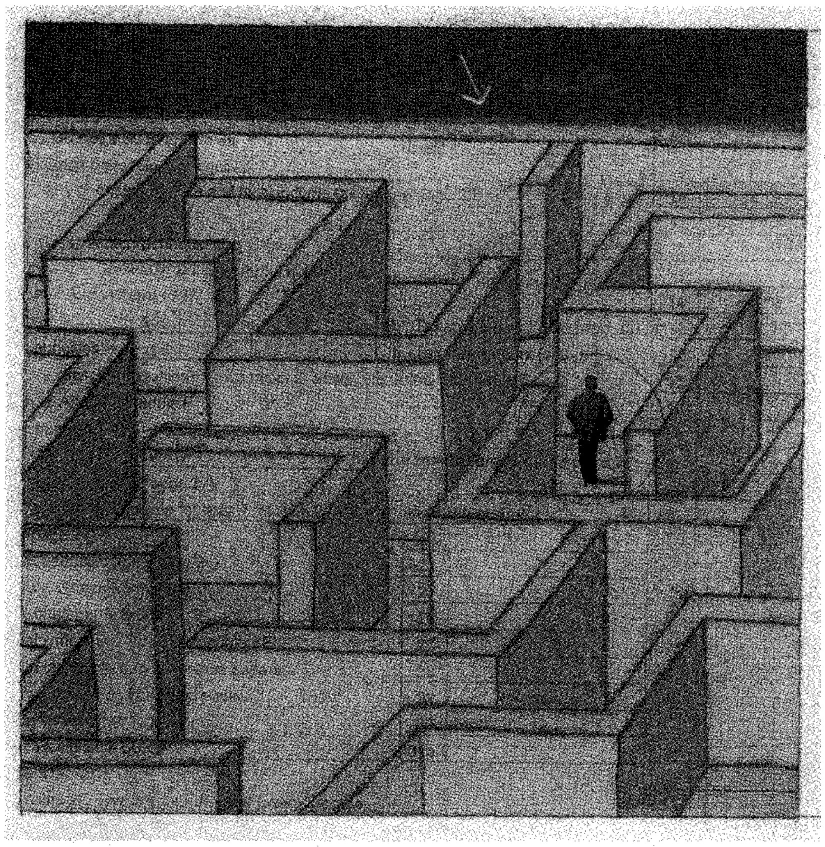
These are some of the areas in which the federal tax system falls short of those goals:

Definition of "Child." The IRC contains five different definitions of "child": one each for the dependency exemption, the child tax credit, the earned income tax credit, the dependent care credit and head-of-household filing status.

The Senate version of the 2003 act would have adopted a uniform definition of who is a qualifying child for each of these areas, but the provision was dropped in the conference agreement with the House of Representatives. The outlook is unclear on whether the provision will be included in any other legislation enacted in the near future.

The Internal Revenue Service has at least developed a uniform method for determining a child's age. In Rev. Rul. 2003-72, 2003-33, IRB 1, the IRS ruled that for four of the five provisions cited above (the exception being head-of-household filing status, which does not contain an age provision), a child will be treated as attaining a given age on the anniversary of the date on which the child was born. The rule also will apply to the adoption credit, the dependent care assistance exclusion, the foster care exclusion and the adoption assistance exclusion.

Sunset Provisions. Constant tinkering increases the complexity of the IRC. Frequent and constant revisions require taxpayers and their advisers to spend countless hours learning and relearning the law. The expectation of future changes also creates planning uncertainty for both individual and business taxpayers.



Nowhere is this uncertainty more evident than in the "sunset" of the entire package of 2001 tax legislation on Dec. 31, 2010—just after the act's provisions are fully phased in.

Some provisions of the 2001 act can be applied on a year-by-year basis without regard to the sunset. If, for example, an increased Individual Retirement Account deduction is allowable for certain years, the fact that it might not be available indefinitely does not create insurmountable planning difficulties.

The temporary nature of other provisions might create problems for a limited number of people. It is possible, for example, that some taxpayers might not want to get married unless they are certain that marriage penalty relief will be permanent.

The temporary nature of yet other provisions, however, creates huge headaches for very many people.

A glaring example is the repeal of the estate tax. Under the 2001 act, the amount exempt from estate tax gradually increases from 2002 through 2009, followed by full repeal of the tax for taxpayers dying on or after Jan. 1, 2010. But if the law sunsets on Dec. 31, 2010, as scheduled, the estate tax will be reinstated for taxpayers dying on or after Jan. 1, 2011.

Taxpayers attempting to implement testamentary plans and estimate life insurance needs are having great difficulty. For example, a taxpayer buying life insurance for the sole purpose of using the proceeds to pay his or her estate tax liability might buy term insurance if it were at least reasonably clear that the tax would be repealed in 2010 and thereafter. Given the uncertainty, however, an adviser would be hard-pressed to recommend such action.

Similarly, a taxpayer deciding whether to make a lifetime gift that would incur a gift tax does not know if making the gift will reduce the taxpayer's ultimate estate tax liability or will merely be a wasted payment of tax. And an older taxpayer's decision whether to sell an asset during his or her lifetime may be influenced by the expectation of a stepped-up basis for assets held until death.

Uncertainty regarding the repeal of the estate tax is not the only area cre-

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