Chapter 16: New Legislation

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Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

Just before Memorial Day, Congress approved sweeping tax legislation entitled Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003. The House passed the package on a 231-200 vote and the Senate was evenly divided, with Vice President Cheney casting the deciding vote. The President signed the legislation into law on May 28, 2003. The legislation represents the third largest tax cut in U.S. history with an estimated $350 billion price tag. However, that amount could swell to over $800 billion if Congress makes key provisions of the Act permanent instead of allowing them to expire under the terms of the enacted legislation.

The Act provides immediate tax relief for both small businesses and individuals. The majority of the tax relief provisions are retroactive to January 1, 2003, including the reduction of marginal tax rates across the board. Thus, taxpayers will have extra disposable income in 2003. The Act also lowers the tax rates on earnings from investments (including stock dividends), and provides significant tax incentives that will affect corporations, partnerships, S corporations and other entities in every business endeavor. The new lower rates for individuals, but not for corporations, tend to make partnerships and limited liability companies more attractive.

Note. All of the tax reductions under the Act are temporary. In addition, the effective dates of the new tax cuts, and their sunset dates, are intertwined with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Job Creation and Worker Assistance Act of 2002 (JCWAA).

ACCELERATED REDUCTION OF INDIVIDUAL TAX RATES

JGTRRA accelerates the reductions in individual income tax rates that were scheduled to be phased in through 2006 under EGTRRA. Effective January 1, 2003, the regular income tax rates above 15% are: 25%, 28%, 33% and 35%. The reduced rates also apply to trusts, but they are scheduled to expire effective for tax years beginning after December 31, 2010. For 2003 and 2004, the Act increases the taxable income levels that qualify for the 10% rate bracket. For 2003, the 10% bracket for unmarried persons is $7,000 (increased from $6,000) and $14,000 (increased from $12,000) for married persons filing jointly. However, the 10% bracket does not apply to trusts.

Observation. The revisions, coupled with prior-law provisions, require careful attention by tax practitioners when doing tax planning for clients. For singles, the top end of the 10% bracket will be $7,000 in 2003 and will be adjusted for inflation in 2004. It will then revert to $6,000 from 2005 through 2007, jump to $7,000 in 2008, and that amount will be adjusted for inflation for years 2009 and 2010. Beginning in 2011, the 10% bracket is repealed under the sunset provision of EGTRRA.

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The following tables illustrate the tax rate reductions under JGTRRA and the 2003 tax rates.

Individual Tax Bracket Rates - Table 1

Ordinary Income Tax Rates	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Highest	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6%
2nd Highest	35%	33%	33%	33%	33%	33%	33%	33%	33%	36%
3rd Highest	30%	28%	28%	28%	28%	28%	28%	28%	28%	31%
4th Highest	27%	25%	25%	25%	25%	25%	25%	25%	25%	28%
5th Highest	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Lowest	10%	10%	10%	10%	10%	10%	10%	10%	10%	15%

2003 Tax Rates — Table 2

Tax Rate	Married Filing Joint Return	Head of Household	Single	Married Filing Separately
10%	$ 0 – 14,000	$ 0 – 10,000	$ 0 – 7,000	$ 0 – 7,000
15%	14,001 – 56,800	10,001 – 38,050	7,001 – 28,400	7,001 – 28,400
25%	56,801 – 114,650	38,051 – 98,250	28,401 – 68,800	28,401 – 57,325
28%	114,651 – 174,700	98,251 – 159,100	68,801 – 143,500	57,326 – 87,350
33%	174,701 – 311,950	159,101 – 311,950	143,501 – 311,950	87,351 – 155,975
35%	Over 311,950	Over 311,950	Over 311,950	Over 155,975

Note. All of the income tax brackets are adjusted annually for inflation (based on the prior year's September to August average Consumer Price Index). However, the 10% bracket will be indexed for inflation beginning in 2004 instead of 2007 as was specified under EGTRRA. Revised tax withholding tables reflect all of the rate changes. The tables are accessible at www.irs.gov/pub/irs-pdf/n1036.pdf. The posted tables contain the percentage method formulas used by payroll programmers. In June, the IRS mailed printed copies of Pub. 15-T to employers with a request that the new tables be implemented as soon as possible into payroll systems. The IRS specified that, barring unforeseen circumstances, the changes were to be implemented by July 1, 2003.[1]

For 2003, the standard deduction is increased to $9,500 for married persons filing jointly, $7,000 for heads of household, $4,750 for singles and married persons filing separately. The personal exemption for 2003 is $3,050.

Observation. The tax savings under JGTRRA will be greater for those with taxable income that includes dividends or capital gains because they are also taxed at a new lower rate. Additional tax savings will also be realized by individuals who are entitled to an enhanced child tax credit under the Act.

MARRIAGE PENALTY RELIEF

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married.

As noted in Table 2, JGTRRA increases the 15% bracket for married taxpayers filing jointly to 200% of the single bracket. This part of the marriage penalty is eliminated for 2003 and 2004. Thereafter, the end-point of the 15% bracket reverts to the EGTRRA phased-in increase. In other words, it is 180% of the single bracket for 2005, 187% for 2006 and 193% for 2007. For years 2008 through 2010, the end-point of the 15% bracket is 200% of the single bracket. The higher tax brackets are not expanded.

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EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return over a 5-year phase-in period beginning in 2005. JGTRRA, however, doubles the standard deduction for married persons filing jointly to twice the amount of the standard deduction for single taxpayers for 2003 and 2004. In 2005, the standard deduction for married taxpayers will revert to the EGTRRA provisions. That means it will fall to 174% of the standard deduction for single taxpayers in 2005, and will rise to 184% in 2006, 187% in 2007, and 190% in 2008, and then double the single amount for 2009 and 2010.

Observation. For 2003 and 2004 the increased standard deduction for married persons filing jointly will bear on the decision of whether or not to itemize deductions. Some couples will now use the standard deduction. It is noted that some states allow itemization only when itemization is chosen at the federal level. Also, the higher standard deduction may trigger application of the alternative minimum tax.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) is the amount by which a taxpayer's tentative minimum tax liability exceeds the regular income tax liability. An individual's tentative minimum tax is an amount equal to:

- 26% of the first $175,000 ($87,500 for married persons filing separately) of alternative minimum taxable income (AMTI) in excess of a phased-out exemption amount, and
- 28% of the remaining AMTI. AMTI is the individual's taxable income adjusted for specified preference and adjustment items.

Under JGTRRA, Congress modified the alternative minimum tax (AMT), but did not overhaul it. The Act raises the AMT exemption amount. The exemption for single taxpayers rises to $40,250 (up from $35,750) and the exemption for married couples filing jointly rises to $58,000 (up from $49,000), but only for tax years beginning in 2003 and 2004. The Act did not change the phaseout ranges. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds $150,000 (married filing jointly and surviving spouses), $112,500 (singles) and $75,000 (married persons filing separately, estates and trusts).

Note. While the Act raises the exemption amount, the reduction in regular income tax rates, coupled with no change in the base amount for the phaseout ranges, will have the effect of subjecting additional higher-income individuals to the AMT. Exposure to potential AMT begins for individuals with AMTI of $112,000 or more and married couples with AMTI of $150,000 or more. The AMT exemption amount is fully phased out at $273,500 (for singles) and $382,000 for married persons filing jointly.

JGTRRA provides AMT relief for those taxpayers with AMTI at the lowest end of income levels potentially subject to the AMT. For taxpayers with AMTI at higher levels, the Act does not provide relief.

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Example 1. Sam and Mary have AMTI of $400,000, including $200,000 of ordinary income, $100,000 of long-term capital gains and $100,000 of dividends. Before JGTRAA, their tax liability would have been about $104,000 and they would have paid no AMT. Under JGTRRA, Sam and Mary will have a regular tax liability of about $74,500 and an AMT liability of over $8,000. Thus, their total tax reduction will be just over $21,000.

Ordinary income	$200,000
Long-term capital gains	100,000
Dividends	100,000
AMTI	$400,000
Pre JGTRRA tax and no AMT	$103,749
Post JGTRRA tax	$ 74,311
AMT	8,189
Total post JGTRRA tax and AMT	$ 82,500
Net Tax savings	$ 21,249

Example 2. Bob and Elizabeth have AMTI of $150,000, including $35,000 of long-term capital gains and $35,000 of dividends. Under JGTRAA, their tax liability would be $20,220. After applying the AMT exemption, the minimum tax is computed to be $16,220. So, Bob and Elizabeth have no AMT liability.

Observation. These examples illustrate that the AMT remains a problem for taxpayers with income levels near the upper end of the AMT exemption, such as married couples with an income of $382,000 and higher. Also, taxpayers with large capital gains or dividend income may be more likely to be subject to AMT.

CHILD TAX CREDIT

OLD LAW

Under EGTRRA, the child tax credit was set at:

- $600 for 2003 and 2004
- $700 for year 2005-2008
- $800 for 2009
- $1,000 for 2010

The credit was scheduled to revert to $500 in taxable years beginning after December 31, 2010, under the EGTRRA sunset provision. The credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married persons filing joint returns and $55,000 for married individuals filing separately. The length of the phaseout range depends on the number of qualifying children. For instance, the phaseout range for a single person with one qualifying child is between $75,000 and $87,000 of modified adjusted gross income. The phaseout range for a single person with two qualifying children is between $75,000 and $99,000.

Note. The amount of the child tax credit and the phaseout ranges are not adjusted annually for inflation.

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For 2003, the child tax credit is refundable to the extent of 10% of the taxpayer's earned income in excess of $10,500. The percentage is increased to 15% for taxable years 2005 and later. Families with three or more children are allowed a refundable credit equal to the amount the taxpayer's social security taxes exceeds the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,500 (for 2003).

Note. The refundable portion of the child credit does not constitute income and is not treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or any state or local program financed with federal funds. In addition, the credit is allowed against the taxpayer's regular income tax and AMT.

NEW LAW

Under JGTRRA, the amount of the child tax credit is increased to $1,000 for 2003 and 2004. After 2004, the credit will revert to the levels provided under EGTRRA. For 2003, the increased amount of the credit was paid in advance in July and August on the basis of information on the taxpayer's 2002 return filed in 2003. If a taxpayer has a child or adopts a child in 2003 (or receives the right to take the child tax credit in a divorce or separation) she may be entitled to a larger child tax credit, but the advance payment will not reflect the increased amount because it will be based on the 2002 return. In that event, the increased amount will be reported as a credit on the taxpayer's 2003 return. For these taxpayers, they may wish to lower their income tax withholding amounts immediately to take advantage of the new law.

The amount of the credit allowable on the 2003 return will be reduced by the amount of the advance payment.

Observation. The increase in the child tax credit will affect taxpayers who are required to make estimated tax payments. The IRS is expected to advise taxpayers making estimated payments for 2003 about how to adjust their payments to reflect the increased credit and required reduction for those who receive advance payments.

Example 3. Cindy and Mike have two children. Brett is age 13 and Lauren is age 9. In 2003, the family's tax liability is $17,376. In July 2003, Cindy and Mike received $800 from the IRS as an **advanced payment** of the Child Tax Credit. Their remaining 2003 Child Tax Credit is $1200. See the *2003 Child Tax Credit Worksheet – line 49* that follows.

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For Example 3

Child Tax Credit Worksheet—Line 49

Keep for Your Records

Before you begin: √ If you received (before offset) an advance payment of the child tax credit and you filed a joint return for 2002, you and your spouse are each considered to have received one-half of the payment.

CAUTION

- To be a qualifying child for the child tax credit, the child must be under age 17 at the end of 2003, and meet the other requirements listed on page 39.
- **Do not** use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 39. Instead, use Pub. 972.

1. Number of qualifying children: 2 X $1,000. Enter the result. **1** 2000

2. Enter the amount, if any, of your advance child tax credit (before offset). **2** 800

3. Is line 1 less than line 2?

☐ **Yes.** STOP You cannot take this credit. If line 2 is more than line 1, you do not have to pay back the difference.

☐ **No.** Subtract line 2 from line 1. **3** 1200

4. Enter the amount from Form 1040, line 43. **4** 17,376

5. Enter the total of the amounts from Form 1040, lines 44 through 48. **5** 0

6. Are the amounts on lines 4 and 5 the same?

☐ **Yes.** STOP You cannot take this credit because there is no tax to reduce However, you may be able to take the **additional child tax credit.** See the **TIP** below before completing the rest of your Form 1040.

☐ **No.** Subtract line 5 from line 4. **6** 17,376

7. Is the amount on line 3 more than the amount on line 6?

☐ **Yes.** Enter the amount from line 6. Also, you may be able to take the **additional child tax credit.** See the **TIP** below.

☐ **No.** Enter the amount from line 3.

This is your child tax credit. **7** 1200

Enter this amount on Form 1040, line 49.

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 65, if you answered "Yes" on line 6 **or** line 7 above.

- First, complete your Form 1040 through line 64.
- Then, use Form 8812 to figure any additional child tax credit.

Proof as of July 11, 2003 (subject to change)

If the taxpayer received an advanced payment in excess of the allowable credit, the excess will **not** be required to be repaid to the IRS.[2]

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Example 4. Tina and Rickie divorce in 1996. In 2002, Tina was entitled to claim the exemption for their 12-year-old son. Tina and Rickie alternate years for claiming the dependency exemption via Form 8332.

Tina received the advanced payment of $400 in August 2003, based on her 2002 tax return. Rickie will claim the exemption in 2003. Assuming he otherwise qualifies, he can claim the full child tax credit of $1,000.

Observation. This is an unexpected windfall for divorced couples in similar situations.

DEPRECIATION PROVISIONS

Note. In-depth analyses of the changes in depreciation and IRC §179 are covered in Chapter 13, Depreciation. On September 5, 2003, the IRS released final and temporary regulations on the "bonus" depreciation. This also includes the "bonus" depreciation on the unrecovered cost of a like-kind exchange or involuntary conversion. This can result in **substantial additional deductions** for some taxpayers.

BONUS DEPRECIATION

The JCWAA of 2002 provided for an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property. The provision was covered extensively in the *2002 University of Illinois Income Tax Workbook*. The 30% "bonus depreciation" is not affected by a short taxable year and is allowed for both regular tax and AMT purposes for the tax year in which the property is placed in service. The legislation defines eligible property as MACRS property with a recovery period of 20 years or less, computer software, water utility property and qualified leasehold property. Also, eligible property must be new property (the original use must commence with the taxpayer after September 10, 2001, and before September 11, 2004) that the taxpayer places in service before January 1, 2005. The provision also specifies that passenger automobiles subject to the annual depreciation limits are eligible for an increase of $4,600 during the first year of the recovery period. That amount was not indexed for inflation.

Under JGTRRA, the first-year "bonus depreciation" amount increases to 50% for tax years ending after May 5, 2003. The provision is effective for property acquired after May 5, 2003, and before January 1, 2005. Property does not qualify for 50% bonus depreciation if a binding written sales contract was in effect before May 6, 2003. If there was a binding contract in effect before May 6, 2003, but not before September 11, 2001, the property remains qualified for the 30% allowance previously available.

Note. The property must be placed in service under the new provision before January 1, 2005, except for property described in IRC §168(k)(2)(B) (property having longer production periods), before January 1, 2006.

A taxpayer may elect out of the enhanced bonus depreciation under the same rules as applied to the 30% bonus amount. If an election out is not made, the taxpayer is considered to have taken the 50% amount. Also, taxpayers may elect on a class-by-class basis to claim the 30% bonus amount instead of the 50% bonus first-year depreciation for qualifying property, or elect not to claim bonus first-year depreciation at all.

For property that qualifies only for the 30% bonus first-year depreciation allowance, the taxpayer may elect not to claim bonus first-year depreciation at all. The election out may be made for any class of property for any tax year, and does not affect qualified property in that class that is eligible for the 50% bonus amount (unless the taxpayer elects out for that property as well). However, a taxpayer who elects out of additional first-year depreciation for a specific class of property will be subject to the AMT depreciation adjustment for property in that class. Thus, AMT depreciation is computed using the 150% declining balance method (switching to straight-line), except that straight line must be used for property for which straight-line depreciation must be used for regular tax purposes. The recovery period is the same for AMT and regular tax purposes. **By contrast, there is no AMT adjustment for the entire recovery period of qualified property written off under IRC §168(k), which provides for the 50% and 30% bonus depreciation allowances.**

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Example 4. John, in April of 2003, bought a new Suburban SUV for use in his business for $35,000. He also bought a new computer for business use in April. He paid $15,000 for the computer equipment. These assets will qualify for the 30% bonus first-year depreciation allowance, but not the 50% amount since they were purchased before May 6, 2003. In July, John bought an Astro passenger van for business purposes for $25,000. This vehicle will qualify for the 50% first-year bonus depreciation allowance. All of the assets are 5-year property for MACRS purposes and are placed in service in 2003. Assume John does not want to take any IRC §179 depreciation on these assets, and that John uses the 200% declining balance method for 5-year property under the half-year convention.

Note. Both vehicles that John bought were over 6,000 pounds GVW.

What are his depreciation options for 2003?

- **Option 1.** John could elect out of any bonus first-year depreciation for all the property. This would yield a first-year depreciation allowance of $15,000.

  $75,000 × .20 regular first-year depreciation allowance

- **Option 2.** John could elect out of the 30% bonus provision for the vehicle purchased in April and for the computer equipment. He could choose to claim a 30% bonus first-year amount for the vehicle purchased in July. That would give John a first year depreciation allowance of $21,000.

  $10,000 ($50,000 × .2) plus $7,500 ($25,000 × .30) plus $3,500 (($25,000 – $7,500) × .20)) for a total of $21,000.

- **Option 3.** John could claim the 30% first-year bonus depreciation on the computer equipment and the vehicle purchased in April, and elect out of the additional 50% first-year depreciation on the vehicle he purchased in July. That would yield a first-year depreciation allowance of $27,000.

  $15,000 ($50,000 × .30) plus $7,000 (($50,000 – $15,000) × .20) plus $5,000 ($25,000 × .20)) for a total of $27,000.

- **Option 4.** John could elect out of the additional 30% bonus depreciation for the assets purchased in April and claim the additional 50% bonus depreciation for the vehicle purchased in July. That would result in a first-year depreciation allowance of $25,000.

  $10,000 ($50,000 × .20) plus $12,500 ($25,000 × .50) plus $2,500 (($25,000 – $12,500) × .20)) for a total of $25,000.

- **Option 5.** John could claim the additional 30% bonus depreciation for all of the property. This method applies automatically for the assets purchased in April and on an elective basis for the asset purchased in July (instead of 50%). Doing so would result in a first-year depreciation allowance of $33,000.

  $22,500 ($75,000 × .30) plus $10,500 (($75,000 – $22,500) × .20)) for a total of $33,000.

- **Option 6.** John could claim the bonus 30% first-year depreciation allowance for the assets purchased in April and claim the bonus 50% amount for the asset purchased in July. That would yield a first-year depreciation allowance of $37,000.

  $15,000 ($50,000 × .30) plus $7,000 (($50,000 – $15,000) × .20)) plus $12,500 ($25,000 × .50) plus $2,500 (($25,000 – $12,500) × .20)) for a total of $37,000.

Observation. A taxpayer is likely to consider making an election to claim smaller bonus first-year depreciation (or to elect out of it entirely) when the taxpayer has net operating losses that are about to expire or anticipates being in higher tax brackets in future years.

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> **Note.** Claiming the bonus depreciation allowance has no effect on the taxpayer's choice of depreciation method.[3] In general, assets with shorter class lives (10-year MACRS property or less) that are normally depreciated by using the 200% declining balance method may, at the taxpayer's election, be depreciated using the 150% declining balance method or by straight-line. The election to use a slower depreciation method is made for all property within a recovery class placed in service within the year.[4] Thus, electing to use a slower MACRS depreciation method with bonus first-year depreciation can reduce the first-year depreciation amount to the desired level without losing the AMT benefit that comes with depreciating qualified property under the bonus depreciation rules of IRC §168(k).

For passenger automobiles which are subject to inflation-adjusted depreciation limits, the increase in the first-year allowance for new vehicles under the bonus depreciation rules is boosted from $4,600 to an additional $7,650 with the same effective dates as for the increase from 30% to 50% of the income tax basis of eligible property. Thus, for new passenger automobiles that are depreciable, the allowable depreciation is $3,060 plus $7,650 or $10,710 if acquired **after** May 5, 2003. For new passenger automobiles acquired **before** May 6, 2003, the limit is $3,060 plus $4,600 or $7,660. The first-year limit for used passenger automobiles remains at $3,060.

Under the 2003 Act, an election related to any class of property for purposes of bonus depreciation **does not apply** to all property in the class that is eligible for the 50% bonus amount and is placed in service during the tax year. **But**, as under prior law, there is no AMT depreciation adjustment for the entire recovery period of qualified property recovered under the bonus first-year depreciation rules (50% or 30%).

> **Observation.** The bonus depreciation provision is treated as a depreciation deduction. Thus, any bonus amount is subject to the depreciation recapture rules as ordinary income under IRC §1245 upon sale of property at a gain before the end of the property's recovery period. Thus, for those nearing retirement who anticipate a sale of qualified assets, taking the additional depreciation amount (as well as any IRC §179 deduction) may not be prudent planning.

The enhanced bonus depreciation provision means that taxpayers will have to separately calculate the bonus depreciation for the first year and then calculate the regular MACRS depreciation on the asset's remaining basis.

IRC §179 DEPRECIATION

The IRC §179 deduction has been increased from $25,000 to $100,000 effective for taxable years beginning after 2002 and before 2006. The increase is effective for 2003, 2004 and 2005. Thereafter, the limit returns to $25,000 unless there is further legislation to change the amount.

> **Note.** Under IRC §179, "qualifying property" is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Business vehicles weighing more than 6,000 pounds are eligible for the provision and so are **business vehicles** weighing less than 6000 pounds. For those weighing less, the limits for "passenger automobiles" have ordinarily precluded the use of IRC §179 depreciation because regular depreciation exceeds the amount of the first year allowance. With the dramatic increase in the first year depreciation for passenger automobiles under the bonus depreciation rules, the first year amount claimed for passenger automobiles is as much as $10,710. The provision may encourage the purchase of less fuel-efficient vehicles and could lead to additional legislation for vehicles that weigh 6,000 pounds or less as well as heavier vehicles.

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Under JGTRAA, the $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000 (up from $200,000). The $100,000 dollar limitation and the phaseout threshold amount ($400,000) are indexed for inflation for taxable years beginning after 2003 and before 2006. The inflation adjustment is in $1,000 increments for the $100,000 amount and $10,000 increments for the $400,000 amount.

Note. An election to utilize IRC §179 depreciation is generally made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with the consent of the IRS. JGTRRA provides that for taxable years beginning after 2002 and before 2006, taxpayers may revoke an election on an amended return without consent from the IRS. However, once the revocation is made, it is irrevocable.

Note. The Conference Committee Report permits taxpayers for such years to make or revoke expensing elections for those years on amended return without the IRS's consent.

The 2003 legislation excludes air conditioning and heating units from eligibility for IRC §179 depreciation. Also excluded from eligibility is property described in IRC §50(b) (property used outside the United States, property used for lodging, property used by certain tax-exempt organizations and property used by governmental units or foreign persons or entities). However, the Act includes off-the-shelf computer software placed in service in a taxable year beginning after 2002 and before 2006 as qualifying property.

Planning Pointer. Because the election may be applied against the entire cost or a portion of the cost of one or more items of qualifying property, it may be a good strategy to allocate the IRC §179 allowance to property with the longest recovery period. That will allow the cost of all property placed in service to be recovered in the shortest possible period of time. Likewise, because JGTRRA does not change the deductibility rules under IRC §162 or capitalization under IRC §§263 and 263A, it is still a sound strategy to deduct an expense as an ordinary business expense (when the facts support the deduction) so as to deduct the entire purchase price in the year of purchase and preserve the $100,000 limitation.

COMBINING BONUS DEPRECIATION WITH IRC §179 DEDUCTION

The 50% first-year bonus depreciation is not in addition to the 30% bonus depreciation under the 2002 legislation. However, a taxpayer can combine the new $100,000 IRC §179 deduction with the increased 50% bonus amount. In that event, the IRC §179 deduction is taken first, and then the bonus 50% amount applies to the remaining basis in the first year the asset is placed in service. However, it is important to remember that not all property qualifies for both provisions. In general, the 50% bonus provision **only applies to new** property, while IRC §179 **applies to both new and used** property. To enhance a taxpayer's total depreciation deduction, the taxpayer could make an IRC §179 election on property that does not qualify for bonus depreciation. That means an IRC §179 election should be made on used equipment purchases, or on property that qualifies for the 30% bonus instead of the 50% bonus if other property exists that qualifies for the 50% bonus.

Observation. The enhanced IRC §179 deduction and first year "bonus" depreciation provision provide the potential for many taxpayers to deduct asset purchases each year. However, such a strategy also eliminates the payment of self-employment tax. Depending on the particular taxpayer's set of facts, such a strategy could lead to minimal or nonexistent social security coverage. Relatively young taxpayers with minor children may need to be paying at least some self-employment tax to be able to provide benefits for family members.

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Example 5. Mary purchased a new ECG machine for $75,000 on February 24, 2003. Mary then purchased a new portable X-Ray machine for $175,000 on August 15, 2003, and a used autoclave for $45,000 on September 1, 2003.

Mary has several options for handling the depreciation deduction attributable to these assets for 2003. Mary could, for example, do the following:

1. Claim IRC §179 depreciation on the ECG machine:

Purchase price	$75,000
IRC §179 deduction	75,000
Remaining basis to be depreciated	0

2. Take the 50% bonus depreciation on the portable X-Ray machine:

Purchase price	$175,000
50% bonus depreciation	87,500
Remaining basis to be depreciated	87,500

3. Claim the IRC §179 amount on the used autoclave:

Purchase price	$45,000
IRC §179 deduction	25,000
Remaining basis to be depreciated	20,000

Thus, for 2003, Mary would be entitled to $187,500 of IRC §179 depreciation and bonus depreciation plus an amount for regular depreciation on the ECG machine, X-Ray machine and autoclave.

As an alternative, Mary could claim the 30% bonus depreciation on the ECG machine, and IRC §179 depreciation along with the 50% bonus depreciation on the X-Ray machine.

1. Claim the 30% bonus amount on the ECG machine:

Purchase price of ECG machine	$75,000
30% bonus amount	22,500

2. Claim IRC §179 depreciation and the 50% bonus depreciation on the portable X-Ray machine:

Purchase price of X-Ray machine	$175,000
§179 deduction	100,000
50% bonus amount:	37,500
Remaining basis to be depreciated	37,500

Thus, Mary would be entitled to $160,000 of IRC §179 depreciation and bonus depreciation plus an amount for regular depreciation on the three assets.

Observation. Taxpayers will have a great deal of flexibility in handling depreciation deductions of business assets under the new law. Given the interplay of IRC §179 depreciation, the bonus depreciation amounts (30% and 50% amounts) and the ability to elect out of the bonus depreciation provisions, the opportunity exists to target income to a specific level.

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CAPITAL GAINS

The 2003 Act reduces the income tax rate on long-term capital gains for individuals from 10% to 5% for those in the 10% or 15% brackets and from 20% to 15% for those in higher income tax brackets. There is no change in capital gains taxed to corporations.

Note. Short-term capital gains continue to be taxed at ordinary income rates. The maximum tax rate on ordinary income is 35%.

The rate reduction on long-term capital gains applies to both regular tax and AMT calculations. For those in the 15% income tax bracket, the Act reduces the rate on long-term capital gains to zero for taxable years beginning after 2007 and before 2009 (unless changed in the meantime).

The provision applies to sales after May 5, 2003, in taxable years ending on or after May 6, 2003, and continues through 2008.

Observation. JGTRRA will increase the paperwork burden associated with reporting capital gains. Because the effective date of the rate change is not January 1, 2003, there will not be a uniform rate on capital gains for 2003.

The following table summarizes recent years capital gain provisions.

		Tax Rate	
Date of Sale	**Holding Period**	**Individuals in 15% Bracket**	**Individuals in Higher Brackets**
Sales before May 7, 1997	Property held more than one year	15%	28%
Sales after May 6, 1997, and before July 29, 1997	Property held more than one year	10%	20%
Sales after July 28, 1997, and before Jan. 1, 1998	Property held more than one year, but 18 months or less	15%	28%
Sales after Dec. 31, 1997, through May 5, 2003	Property held more than one year	10%	20%
Sales after May 5, 2003, and before Jan. 1, 2009	Property held more than one year	5% (0% for tax years beginning after 2007 and before 2009)	15%
Sales after Dec. 31, 2008	Property held more than one year	10%	20%

Note. The new rates apply not only to sales and exchanges on or after May 6, 2003, but also to payments received on existing contracts (such as installment sales). It is also important to note that certain categories of capital assets such as collectibles that were taxed at rates above 20% will continue to be taxed at those higher rates.

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Observation. JGTRRA increases the differential between ordinary income and net capital gains. Consequently, the relative tax advantage of net capital gains over regular ordinary income (other than dividends) for those in the top bracket has increased from 18.6% (38.6% – 20%) to 20% (35% – 15%).

Under EGTRRA, the capital gains tax rate for gain on property held for more than five years was lowered to 18% (8% for lower income taxpayers). The lower rates began in 2001 for taxpayers in the 15% bracket. After 2005, the rates will begin for taxpayers in higher brackets (for property held at least five years starting after 2000). EGTRRA contained a mechanism for individuals to elect a "deemed sale" of capital gain assets in order for currently held items to eventually qualify for the lower 18% rate. A taxpayer could elect the deemed sale treatment, recognizing and paying tax on the capital gain on an asset as though it had been sold on January 1, 2001.

The "deemed sale election" appeared to many taxpayers to be a prudent move. JGTRRA changes that view. Under JGTRRA, the 18% and 8% rates are effectively repealed until 2009 when the pre-JGTRRA capital gains rates are scheduled to return. The repeal of the 8% and 18% rates are effective May 6, 2003.

Observation. Because the "deemed sales" election was irrevocable, those taxpayers making that election in 2001 now have no way to recoup the prematurely paid taxes unless the Congress provides relief. But they do have a new basis to show for the extra gain recognized in the deemed sale.

Those who would qualify for the 18% rate for sales in 2005-2008 will receive no additional benefit other than the new general 15% capital gains rate.

Note. The elimination of the 5% rate for some taxpayers will cause some problems. For taxpayers that made a deemed sale election on a 2001 return to recognize gain as if property had been sold on January 1, 2001, who then sell the property before 2009, no tax benefit will be obtained for having paid tax on the pre-2001 appreciation of the asset (and at a 20% rate) except for the higher basis. A deemed sale election was necessary for pre-2001 assets (the rules for the 18% 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 upon showing a reasonable cause. Perhaps the IRS will allow taxpayers who had previously made the election to revoke it.

The IRS has revised Schedule D and the associated worksheet for 2003. Schedule D provides for at least **three types of "long-term" capital asset sales**. Sales of assets held for more than:

- Five years before May 6, 2003,
- One year before May 6, 2003, and
- One year after May 5, 2003.

Form 6251 (AMT) and Form 8801 (AMT Credit) are revised to reflect the new rates and types of gain. The IRS will have to promulgate rules to account for the limit on net IRC 1231 losses, capital loss carryforwards, and carryforwards not allowed due to passive activity rules or at-risk rules. Mutual fund companies and other pass-through entities will also have to segregate these sales in their reports to customers. Taxpayers with capital gains from mutual funds will be required to compute the tax on Schedule D. Sample draft forms follow.

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Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax— Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227

2003

Attachment Sequence No. 32

Name(s) shown on Form 1040 | Your social security number

Draft as of 8/29/2003

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 38, and go to line 2. Otherwise, enter the amount from Form 1040, line 35, and go to line 7. (If zero or less, enter as a negative amount.)	1	
2	Medical and dental. Enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2½% of Form 1040, line 35	2	
3	Taxes from Schedule A (Form 1040), line 9	3	
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 26	5	
6	If Form 1040, line 35, is over $139,500 (over $69,750 if married filing separately), enter the amount from line 9 of the worksheet for Schedule A (Form 1040), line 28	6	( )
7	Tax refund from Form 1040, line 10 or line 21	7	( )
8	Investment interest expense (difference between regular tax and AMT)	8	
9	Depletion (difference between regular tax and AMT)	9	
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11	Interest from specified private activity bonds exempt from the regular tax	11	
12	Qualified small business stock (see instructions)	12	
13	Exercise of incentive stock options (excess of AMT income over regular tax income)	13	
14	Estates and trusts (amount from Schedule K-1 (Form 1041), line 9)	14	
15	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15	
16	Disposition of property (difference between AMT and regular tax gain or loss)	16	
17	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17	
18	Passive activities (difference between AMT and regular tax income or loss)	18	
19	Loss limitations (difference between AMT and regular tax income or loss)	19	
20	Circulation costs (difference between regular tax and AMT)	20	
21	Long-term contracts (difference between AMT and regular tax income)	21	
22	Mining costs (difference between regular tax and AMT)	22	
23	Research and experimental costs (difference between regular tax and AMT)	23	
24	Income from certain installment sales before January 1, 1987	24	( )
25	Intangible drilling costs preference	25	
26	Other adjustments, including income-based related adjustments	26	
27	Alternative tax net operating loss deduction	27	( )
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $173,000, see page 7 of the instructions.)	28	

Part II Alternative Minimum Tax

29 Exemption. (If this form is for a child under age 14, see page 7 of the instructions.)

IF your filing status is . . .	AND line 28 is not over . . .	THEN enter on line 29 . . .
Single or head of household	$112,500	$40,250
Married filing jointly or qualifying widow(er)	150,000	58,000
Married filing separately	75,000	29,000

If line 28 is **over** the amount shown above for your filing status, see page 7 of the instructions. . . . **29**

30	Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 33 and 35 and stop here	30	
31	• If you reported capital gain distributions directly on Form 1040, line 13a; you reported qualified dividends on Form 1040, line 9b; **or** you had a gain on both lines 16 and 17a of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 65 here. • **All others:** If line 30 is $175,000 or less ($87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result.	31	
32	Alternative minimum tax foreign tax credit (see page 7 of the instructions)	32	
33	Tentative minimum tax. Subtract line 32 from line 31	33	
34	Tax from Form 1040, line 41 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 44)	34	
35	**Alternative minimum tax.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 42	35	

For Paperwork Reduction Act Notice, see page 8 of the instructions. Cat. No. 13600G Form **6251** (2003)

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Part III Tax Computation Using Maximum Capital Gains Rates

Caution: *If you* ***did not*** *complete Part IV of Schedule D (Form 1040), see page 8 of the instructions before you complete this part.*

36 Enter the amount from Form 6251, line 30 36

37 Enter the amount from Schedule D (Form 1040), line 26, or line 13 of the Schedule D Tax Worksheet on page D-11 of the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see page 8 of the instructions) 37

38 Enter the amount from Schedule D (Form 1040), line 19 (as refigured for the AMT, if necessary) (see page 8 of the instructions) 38

39 If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from line 37. Otherwise, add lines 37 and 38, and enter the **smaller** of that result or the amount from line 10 of the Schedule D Tax Worksheet (as refigured for the AMT, if necessary) 39

40 Enter the **smaller** of line 36 or line 39 40

41 Subtract line 40 from line 36 41

42 If line 41 is $175,000 or less ($87,500 or less if married filing separately), multiply line 41 by 26% (.26). Otherwise, multiply line 41 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result . . . . . ▶ 42

43 Enter the amount from Schedule D (Form 1040), line 30, or line 19 of the Schedule D Tax Worksheet on page D-11 of the instructions for Schedule D (Form 1040), whichever applies (as figured for the regular tax) (see page 8 of the instructions) 43

44 Enter the **smaller** of line 36 or line 37 44

45 Enter the **smaller** of line 43 or line 44 45

46 Enter the amount from Schedule D (Form 1040), line 31 or line 20 of the Schedule D Tax Worksheet on page D-11 of the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see page 8 of the instructions) 46

47 Enter the **smaller** of line 45 or line 46. If line 45 is zero, go to line 55 . . 47

48 Multiply line 47 by 5% (.05) . . . . . ▶ 48

49 Subtract line 47 from line 45. If zero or less, enter -0- and go to line 55 . . 49

50 Enter your qualified 5-year gain, if any, from Schedule D (Form 1040), line 35 (as refigured for the AMT, if necessary) (see page 8 of the instructions) 50

51 Enter the **smaller** of line 49 or line 50 51

52 Multiply line 51 by 8% (.08) . . . . . ▶ 52

53 Subtract line 51 from line 49 53

54 Multiply line 53 by 10% (.10) . . . . . ▶ 54

55 Subtract line 47 from line 46 55

56 Subtract line 45 from line 44 56

57 Enter the **smaller** of line 55 or line 56 57

58 Multiply line 57 by 15% (.15) . . . . . ▶ 58

59 Subtract line 57 from line 56 59

60 Multiply line 59 by 20% (.20) . . . . . ▶ 60

If line 38 is zero or blank, skip lines 61 and 62 and go to line 63. Otherwise, go to line 61.

61 Subtract line 44 from line 40 61

62 Multiply line 61 by 25% (.25) . . . . . ▶ 62

63 Add lines 42, 48, 52, 54, 58, 60, and 62 63

64 If line 36 is $175,000 or less ($87,500 or less if married filing separately), multiply line 36 by 26% (.26). Otherwise, multiply line 36 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result 64

65 Enter the **smaller** of line 63 or line 64 here and on line 31 65

Draft as of 8/29/2003

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Form **8801**

Department of the Treasury
Internal Revenue Service (00)

Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts

► See instructions on pages 3 and 4.
► Attach to Form 1040, 1040NR, or 1041.

OMB No. 1545-1073

2003

Attachment Sequence No. 74

Name(s) shown on return	Identifying number

Draft as of 7/28/2003

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 1, 6, and 10 of your 2002 Form 6251. Estates and trusts, see instructions	1	
2	Enter adjustments and preferences treated as exclusion items (see instructions)	2	
3	Minimum tax credit net operating loss deduction (see instructions)	3	( )
4	Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than $173,000 and you were married filing separately for 2002, see instructions	4	
5	Enter: $49,000 if married filing jointly or qualifying widow(er) for 2002; $35,750 if single or head of household for 2002; or $24,500 if married filing separately for 2002. Estates and trusts, enter $22,500	5	
6	Enter: $150,000 if married filing jointly or qualifying widow(er) for 2002; $112,500 if single or head of household for 2002; or $75,000 if married filing separately for 2002. Estates and trusts, enter $75,000	6	
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	
8	Multiply line 7 by 25% (.25)	8	
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15 and go to Part II. Form 1040NR filers, see instructions	10	
11	• If **for 2002** you reported capital gain distributions directly on Form 1040, line 13, **or** had a gain on both lines 16 and 17 of Schedule D (Form 1040) (lines 15a and 16, column (2), of Schedule D (Form 1041)), complete Part III of Form 8801 and enter the amount from line 48 here. • **All others:** If line 10 is $175,000 or less ($87,500 or less if married filing separately for 2002), multiply line 10 by 26% (.26). Otherwise, multiply line 10 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2002) from the result.	11	
12	Minimum tax foreign tax credit on exclusion items (see instructions)	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	
14	Enter the amount from your 2002 Form 6251, line 34, or 2002 Form 1041, Schedule I, line 55	14	
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	

Part II Minimum Tax Credit and Carryforward to 2004

16	Enter the amount from your 2002 Form 6251, line 35, or 2002 Form 1041, Schedule I, line 56	16	
17	Enter the amount from line 15 above	17	
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	
19	**2002 minimum tax credit carryforward.** Enter the amount from your 2002 Form 8801, line 26	19	
20	Enter the total of your 2002 unallowed nonconventional source fuel credit and 2002 unallowed qualified electric vehicle credit (see instructions)	20	
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	
22	Enter your 2003 regular income tax liability minus allowable credits (see instructions)	22	
23	Enter the amount from your 2003 Form 6251, line 33, or 2003 Form 1041, Schedule I, line 54	23	
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on your 2003 Form 1040, line 52; Form 1040NR, line 48; or Form 1041, Schedule G, line 2d	25	
26	**Minimum tax credit carryforward to 2004.** Subtract line 25 from line 21. Keep a record of this amount because you may use it in future years	26	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 10002S Form **8801** (2003)

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Form 8801 (2003) Page **2**

Part III **Tax Computation Using Maximum Capital Gains Rates**

Caution: *If you did not complete Schedule D (Form 1040) for 2002 because you reported capital gain distributions directly on Form 1040, line 13, or your 2002 taxable income was zero or less, see the instructions before completing this part.*

27	Enter the amount from line 10		**27**
28	Enter the amount from line 23 of your 2002 Schedule D (Form 1040) (line 21 of the 2002 Schedule D (Form 1041)) or line 9 of your 2002 Schedule D Tax Worksheet*	**28**	
29	Enter the amount from line 19 of your 2002 Schedule D (Form 1040), or line 15d, column (2), of the 2002 Schedule D (Form 1041)	**29**	
30	If you did not complete the 2002 Schedule D Tax Worksheet, enter the amount from line 28. Otherwise, add lines 28 and 29, and enter the **smaller** of that result or the amount from line 4 of your 2002 Schedule D Tax Worksheet	**30**	
31	Enter the **smaller** of line 27 or line 30		**31**
32	Subtract line 31 from line 27		**32**
33	If line 32 is $175,000 or less ($87,500 or less if married filing separately for 2002), multiply line 32 by 26% (.26). Otherwise, multiply line 32 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2002) from the result ▶		**33**
34	Enter the amount from line 28 of your 2002 Schedule D (Form 1040) (line 26 of the 2002 Schedule D (Form 1041)) or line 16 of your Schedule D Tax Worksheet.* Enter -0- if you did not complete Part IV of your 2002 Schedule D (Form 1040) (Part V of 2002 Schedule D (Form 1041))	**34**	
35	Enter the **smaller** of line 27 or line 28	**35**	
36	Enter the **smaller** of line 34 or line 35	**36**	
37	Enter the amount from your 2002 Schedule D (Form 1040), line 29 (or 2002 Schedule D (Form 1041), line 27) (if you did not complete that line, enter -0-) **37**		
38	Enter the **smaller** of line 36 or line 37	**38**	
39	Multiply line 38 by 8% (.08) ▶		**39**
40	Subtract line 38 from line 36	**40**	
41	Multiply line 40 by 10% (.10) ▶		**41**
42	Subtract line 36 from line 35	**42**	
43	Multiply line 42 by 20% (.20) ▶		**43**
	If line 29 is zero or blank, skip lines 44 and 45 and go to line 46.		
44	Subtract line 35 from line 31	**44**	
45	Multiply line 44 by 25% (.25) ▶		**45**
46	Add lines 33, 39, 41, 43, and 45		**46**
47	If line 27 is $175,000 or less ($87,500 or less if married filing separately for 2002), multiply line 27 by 26% (.26). Otherwise, multiply line 27 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2002) from the result		**47**
48	Enter the **smaller** of line 46 or line 47 here and on line 11		**48**

* The 2002 Schedule D Tax Worksheet is on page D-9 of the 2002 Instructions for Schedule D (Form 1040) (page 35 of the 2002 Instructions for Form 1041).

Form **8801** (2003)

Draft as of 7/28/2003

Observation. It is estimated that the number of taxpayers filing Schedule D will increase by approximately six million.

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DIVIDEND PROVISIONS

Under JGTRRA, "qualified dividend income" received by an individual shareholder from a domestic or qualified foreign corporation will be taxed at a maximum rate of 15% for most taxpayers. Lower income individuals will pay tax on dividend income at a 5% rate. The lower rates are retroactive to January 1, 2003, and expire for tax years after 2008. As with the new capital gain rates, the 5% rate expires on December 31, 2007, and is 0% for 2008. The old pre-JGTRRA rates return in 2009.

Observation. The lower rates apply only to qualified stock dividends, not interest-bearing accounts such as CDs, government bonds or savings accounts.

Note. Although qualifying dividends will be taxed at the same rate as capital gains, a taxpayer who has both net capital losses and dividend income will not offset those losses against dividends.

The 2003 Form 1099-DIV, Box 1b reports qualified dividends that will be taxed at the 15% rate.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		**1a** Total ordinary dividends $	OMB No. 1545-0110 **2003** Form **1099-DIV**	**Dividends and Distributions**
		1b Qualified dividends $		
		2a Total capital gain distr. $	**2b** Post-May 5 capital gain distr. $	**Copy B** **For Recipient**
PAYER'S Federal identification number	RECIPIENT'S identification number	**2c** Qualified 5-year gain $	**2d** Unrecap. Sec. 1250 gain $	
RECIPIENT'S name		**2e** Section 1202 gain $	**2f** Collectibles (28%) gain $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		3 Nontaxable distributions $	**4 Federal income tax withheld** $	
Street address (including apt. no.)			**5** Investment expenses $	
City, state, and ZIP code		**6** Foreign tax paid $	**7** Foreign country or U.S. possession	
Account number (optional)		**8** Cash liquidation distributions $	**9** Noncash liquidation distributions $	

Form **1099-DIV** (keep for your records) Department of the Treasury - Internal Revenue Service

Note. Dividends paid on foreign corporation stocks and American Depository Receipts that are readily tradable on U.S. securities markets are eligible for the lower rates. Also, dividends from stocks issued by companies incorporated in a U.S. possession or eligible for benefits under a comprehensive income tax treaty with the United States qualify for the new lower rates – the corporation must qualify for the treaty benefits for substantially all of its income for the tax year in which the dividends are paid. However, dividends paid by foreign personal holding companies, foreign investment companies and passive foreign investment companies will not qualify.

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> **Observation.** It is imperative to maintain accurate records for 2003 transactions. Unlike the reduction in tax rates for ordinary income and qualifying dividends which are retroactive to January 1, 2003, the reduced capital gains rates only apply to capital gains from sales or exchanges made (and installment sale payments received) beginning May 6, 2003. For 2003, 1099-DIV filers will be required to compute and report to recipients the amount of gain after May 5, 2003.

Example 6. Before 2003, a taxpayer in the highest marginal rate (38.6%) who receive a dividend of $50,000 would pay $19,300 ($50,000 × 38.6%) in taxes. Under JGTRRA, the same $50,000 of dividend income will trigger a tax liability of $7,500 ($50,000 × 15%), for a net tax reduction of $11,800 ($19,300 – $7,500). However, a taxpayer in the lowest marginal bracket before JGTRAA (10%) would see a relatively smaller percentage tax reduction on dividends (down to 5%).

Qualified Dividend Income Exclusions

Certain types of dividend income are specifically excluded from the definition of "qualified dividend income." The following types of dividend income are **excluded from the lower rates** under JGTRRA:

1. Stock owned for less than 60 days in the 120-day period beginning 60 days before the ex-dividend date (the date the stock sells without dividend)

Example 7. On August 14, 2003 Allen Corporation announced that a dividend would be paid on August 29, 2003 to its shareholders on record as of August 15, 2003. The ex-dividend date is August 13, 2003. The beginning of the 120-day period is 60 days prior to August 13 (June 14). The end of the 120-day period is October 12.

Scenario A. Jerry purchased stock in Allen Corporation on July 31, 2003 and sold the stock on September 25, 2003. He received the dividend, but it does not qualify for the lower rates since he held the stock for only 56 days.

Scenario B. Elaine purchased stock in Allen Corporation on July 31, 2003. She sold her shares on September 30, 2003. Since she held her shares for 61 days, her dividend is taxed at the lower rates.

Scenario C. George bought shares of Allen Corporation on August 14, 2003, right after he heard the announcement. He did not sell his shares in 2003. He cannot exclude the dividend because as of October 11, he held the shares for only 58 days.

2. Dividends paid by:
   - Credit unions
   - Mutual insurance companies
   - Farmers' cooperatives
   - Tax-exempt cemetery companies
   - Nonprofit voluntary employee benefit associations
3. Employer securities owned by an employee stock ownership plan (ESOP), to the extent the dividends are deductible under IRC §404(k)
4. Dividends paid from a corporation exempt from tax under IRC §§501 and 521 in the tax year preceding the tax year of the dividend payment

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5. Amounts that would be deductible under IRC §591 (that necessarily includes any mutual savings bank, savings and loan, domestic building and loan, cooperative bank, or other type of bank eligible for the dividends paid deduction under IRC §591)
6. Any dividend described in IRC §404(k)
7. Dividends paid under IRC §246(c) that fail to meet the revised holding period
8. Stock purchased with borrowed funds if the dividend was included in investment income in claiming an interest deduction

> **Observation.** This provision, along with the new 15% maximum rate on long-term capital gains, will make short-term investing less tax efficient.

Example 8. In 2003, Randy has W-2 wages of $20,000, and $3,000 of unemployment compensation. Randy likes to play the stock market, so he decides to borrow money to purchase a high dividend utility stock. The total interest on the loan for 2003 is $4,000. The 2003 dividend paid by the utility company is $2,000. Randy has enough expenses in 2003 that he can itemize his deductions, and he has no other investment income.

Question A. Will Randy be able to take advantage of the lower dividend tax rate?

Answer A. It depends. If Randy does not include the dividend income as investment income for the purpose of determining his investment interest deduction. However, the completed forms show Randy used the dividend income to compute his allowable investment interest expense deduction.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. **Macon Water Corporation**		1a Total ordinary dividends $ 2000.00 1b Qualified dividends $ 2000.00	OMB No. 1545-0110 **2003** Form **1099-DIV**	**Dividends and Distributions**
		2a Total capital gain distr. $	2b Post-May 5 capital gain distr. $	**Copy B** **For Recipient**
PAYER'S Federal identification number **88-0000000**	RECIPIENT'S identification number **999-88-7777**	2c Qualified 5-year gain $	2d Unrecap. Sec. 1250 gain $	
RECIPIENT'S name **Randy**		2e Section 1202 gain $	2f Collectibles (28%) gain $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		3 Nontaxable distributions $	**4 Federal income tax withheld** $	
Street address (including apt. no.)			5 Investment expenses $	
City, state, and ZIP code		6 Foreign tax paid $	7 Foreign country or U.S. possession	
Account number (optional)		8 Cash liquidation distributions $	9 Noncash liquidation distributions $	

Form **1099-DIV** (keep for your records) Department of the Treasury - Internal Revenue Service

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For Example 8

Schedules A&B (Form 1040) 2003 — OMB No. 1545-0074 — Page 2

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.
Randy

Your social security number: 999 88 7777

Schedule B- Interest and Ordinary Dividends

Attachment Sequence No. 08

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See page B-1 and the instructions for Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

			Amount
5	List name of payer ▶		
	Macon Water Co.	5	2,000
6	Add the amounts on line 5. Enter the total here and on Form 1040, line 9a . ▶	6	2,000

Note. If line 6 is over $1,500, you must complete Part III.

Draft as of 6/30/2003

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For Example 8

Form **4952** — Department of the Treasury, Internal Revenue Service

Investment Interest Expense Deduction

► Attach to your tax return.

OMB No. 1545-0191 — 2003 — Attachment Sequence No. 12B

Name(s) shown on return: Randy — Identifying number: 999-88-7777

Draft as of 8/18/2003

Part I	**Total Investment Interest Expense**				
1	Investment interest expense paid or accrued in 2003 (see instructions)			1	4,000
2	Disallowed investment interest expense from 2002 Form 4952, line 7			2	
3	**Total investment interest expense.** Add lines 1 and 2			3	4,000
Part II	**Net Investment Income**				
4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a	2,000		
b	Qualified dividends included on line 4a	4b	2,000		
c	Subtract line 4b from line 4a			4c	0
d	Net gain from the disposition of property held for investment	4d			
e	Enter the **smaller** of line 4d or your net capital gain from the disposition of property held for investment ►	4e			
f	Subtract line 4e from line 4d			4f	0
g	Enter the amount from line 4b and 4e that you elect to include in investment income (see instructions). ►			4g	2,000
h	Investment income. Add lines 4c, 4f, and 4g			4h	2,000
5	Investment expenses (see instructions)			5	0
6	**Net investment income.** Subtract line 5 from line 4h. If zero or less, enter -0-			6	2,000
Part III	**Investment Interest Expense Deduction**				
7	Disallowed investment interest expense to be carried forward to 2004. Subtract line 6 from line 3. If zero or less, enter -0-			7	2,000
8	**Investment interest expense deduction.** Enter the **smaller** of line 3 or 6. See instructions			8	2,000

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

A Change To Note

In general, qualified dividends are excluded from investment income. But, you can make an election on Form 4952, line 4g, to include qualified dividends in investment income. See the instructions for line 4g for more details.

Purpose of Form

Use Form 4952 to figure the amount of investment interest expense you can deduct for 2003 and the amount you can carry forward to future years. Your investment interest expense deduction is limited to your net investment income.

For more information, see **Pub. 550,** Investment Income and Expenses.

Who Must File

If you are an individual, estate, or a trust, you must file Form 4952 to claim a deduction for your investment interest expense.

Exception. You do not have to file Form 4952 if **all** of the following apply.

- Your investment interest expense is not more than your investment income from interest and ordinary dividends minus any qualified dividends.
- You have no other deductible investment expenses.
- You have no disallowed investment interest expense from 2002.

Allocation of Interest Expense

If you paid or accrued interest on a loan and used the loan proceeds for more than one purpose, you may have to allocate the interest. This is necessary because different rules apply to investment interest, personal interest, trade or business interest, home mortgage interest, and passive activity interest. See **Pub. 535,** Business Expenses.

Specific Instructions

Part I—Total Investment Interest Expense

Line 1

Enter the investment interest expense paid or accrued during the tax year, regardless of when you incurred the indebtedness. **Investment interest expense** is interest paid or accrued on a loan or part of a loan that is allocable to property held for investment (as defined on page 2).

Include investment interest expense reported to you on Schedule K-1 from a partnership or an S corporation. Include amortization of bond premium on taxable bonds purchased after

For Paperwork Reduction Act Notice, see back of form. Cat. No. 13177Y Form **4952** (2003)

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For Example 8

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2003 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2003, or other tax year beginning , 2003, ending , 20 OMB No. 1545-0074

Label (See instructions on page 21.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	Your social security number
Randy		999 88 7777
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 21.	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 21.		

Presidential Election Campaign (See page 21.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? . . . ▶ You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

Filing Status
Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 21.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child. (See page 21.)

Exemptions

6a ☐ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a
b ☐ **Spouse**

No. of boxes checked on 6a and 6b

c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 22)
				☐
				☐
				☐
				☐
				☐

If more than five dependents, see page 22.

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see page 22)
Dependents on 6c not entered above
Add numbers on lines above ▶

d Total number of exemptions claimed

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	20,000
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	2,000
b	Qualified dividends (see page 25)	9b 0		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 25)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13a	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13a	
b	If box on 13a is checked, enter post-May 5 capital gain distributions	13b		
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount (see page 25)	15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 25)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	3,000
20a	Social security benefits 20a	b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	

Adjusted Gross Income

23	Educator expenses (see page 29)	23		
24	IRA deduction (see page 29)	24		
25	Student loan interest deduction (see page 31)	25		
26	Tuition and fees deduction (see page 32)	26		
27	Moving expenses. Attach Form 3903	27		
28	One-half of self-employment tax. Attach Schedule SE	28		
29	Self-employed health insurance deduction (see page 33)	29		
30	Self-employed SEP, SIMPLE, and qualified plans	30		
31	Penalty on early withdrawal of savings	31		
32a	Alimony paid b Recipient's SSN ▶	32a		
33	Add lines 23 through 32a		33	
34	Subtract line 33 from line 22. This is your **adjusted gross income** ▶		34	25,000

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For Example 8

Form 1040 (2003) Page 2

Tax and Credits

Standard Deduction for—

- People who checked any box on line 36a or 36b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $4,750

Married filing jointly or Qualifying widow(er), $9,500

Head of household, $7,000

35	Amount from line 34 (adjusted gross income)			35	25,000
36a	Check if: ☐ **You** were born before January 2, 1939, ☐ Blind. ☐ **Spouse** was born before January 2, 1939, ☐ Blind. Total boxes checked ▶ 36a ☐				
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 36b ☐				
37	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			37	7,000
38	Subtract line 37 from line 35			38	18,000
39	If line 35 is $104,625 or less, multiply $3,050 by the total number of exemptions claimed on line 6d. If line 35 is over $104,625, see the worksheet on page 35			39	3,050
40	**Taxable income.** Subtract line 39 from line 38. If line 39 is more than line 38, enter -0-			40	14,950
41	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972			41	1,893
42	**Alternative minimum tax** (see page 37). Attach Form 6251			42	
43	Add lines 41 and 42 ▶			43	1,893
44	Foreign tax credit. Attach Form 1116 if required	44			
45	Credit for child and dependent care expenses. Attach Form 2441	45			
46	Credit for the elderly or the disabled. Attach Schedule R	46			
47	Education credits. Attach Form 8863	47			
48	Retirement savings contributions credit. Attach Form 8880	48			
49	Child tax credit (see page 39)	49			
50	Adoption credit. Attach Form 8839	50			
51	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	51			
52	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify	52			
53	Add lines 44 through 52. These are your **total credits**			53	
54	Subtract line 53 from line 43. If line 53 is more than line 43, enter -0- ▶			54	1,893

Self-emplo... Attach Sche... SE

Draft as of 6/23/2003

SCHEDULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Schedule A— Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

2003

Attachment Sequence No. **07**

Name(s) shown on Form 1040: **Randy**

Your social security number: **999 88 7777**

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1			
	2	Enter amount from Form 1040, line 35 [2]				
	3	Multiply line 2 by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	
Taxes You Paid (See page A-2.)	5	State and local income taxes	5			
	6	Real estate taxes (see page A-2)	6			
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	5,000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13	2,000		
	14	Add lines 10 through 13			14	7,000

Gifts by cash or check. If you made any gift of $250 or...

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Example 9. Use the same facts at **Example 8,** except Randy does not receive unemployment compensation. Instead he receives $3,000 of interest income from a CD in addition to the Macon Water Co. dividend. His total investment income is $5,000.

Question A. Will Randy be able to take advantage of the lower dividend tax rate?

Answer A. Yes. Since Randy has interest income, he can offset the investment loan interest against the interest income. This increases his interest expense deduction and still leaves $1,000 of dividend income to be taxed at the lower dividend rate. The combination of these benefits results in net tax savings of $397.

SCHEDULES A&B (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Schedule A— Itemized Deductions
(Schedule B is on back)
► Attach to Form 1040. ► See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. 07

Name(s) shown on Form 1040: Randy
Your social security number: 999 88 7777

Caution. Do not include expenses reimbursed ...

	9	... 5 through 8			9	
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	5,000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ►	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13	4,000		
	14	Add lines 10 through 13			14	9,000

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For Example 9

Form **4952** Department of the Treasury Internal Revenue Service

Investment Interest Expense Deduction

▶ Attach to your tax return.

OMB No. 1545-0191 2003 Attachment Sequence No. 12B

Name(s) shown on return: Randy — Identifying number: 999-88-7777

Part I Total Investment Interest Expense

1	Investment interest expense paid or accrued in 2003 (see instructions)		1	4,000
2	Disallowed investment interest expense from 2002 Form 4952, line 7		2	
3	**Total investment interest expense.** Add lines 1 and 2		3	4,000

Part II Net Investment Income

4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a 5,000		
b	Qualified dividends included on line 4a	4b 2,000		
c	Subtract line 4b from line 4a		4c	3,000
d	Net gain from the disposition of property held for investment	4d 0		
e	Enter the **smaller** of line 4d or your net capital gain from the disposition of property held for investment ▶	4e 0		
f	Subtract line 4e from line 4d		4f	0
g	Enter the amount from line 4b and 4e that you elect to include in investment income (see instructions). ▶		4g	1,000
h	Investment income. Add lines 4c, 4f, and 4g		4h	4,000
5	Investment expenses (see instructions)		5	
6	**Net investment income.** Subtract line 5 from line 4h. If zero or less, enter -0-		6	4,000

Part III Investment Interest Expense Deduction

7	Disallowed investment interest expense to be carried forward to 2004. Subtract line 6 from line 3. If zero or less, enter -0-		7	
8	**Investment interest expense deduction.** Enter the **smaller** of line 3 or 6. See instructions		8	4,000

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** 2003 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2003, or other tax year beginning , 2003, ending , 20 — OMB No. 1545-0074

Label (See instructions

Your first name and initial: Randy — Last name — Your social security number: 999 88 7777

If a joint return, spouse's first name and initial — Last name — Spouse's social security number

above ▶

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	20,000
8a	**Taxable** interest. Attach Schedule B if required		8a	3,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	2,000
b	Qualified dividends (see page 25)	9b 1,000		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 25)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C		12	

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For Example 9

Schedule D (Form 1040) 2003 Page **2**

Part III Taxable Gain or Deductible Loss

17a	Combine lines 7b and 16 and enter the result. If a loss, enter -0- on line 17b and go to line 18. If a gain, enter the gain on Form 1040, line 13a, and go to line 17b below		17a	0
b	Combine lines 7a and 15. If zero or less, enter -0-. Then complete Form 1040 through line 40		17b	0
	Next: • If both lines 16 and 17a of Schedule D are gains **or** you have qualified dividends on Form 1040, line 9b, complete **Part IV** below (unless Form 1040, line 40, is zero). • Otherwise, skip the rest of Schedule D and complete Form 1040.			
18	If line 17a is a loss, enter here and on Form 1040, line 13a, the **smaller** of **(a)** that loss or **(b)** ($3,000) (or, if married filing separately, ($1,500)) (see page D-6 of the instructions)		18	( )
	Next: • If you have qualified dividends on Form 1040, line 9b, complete Form 1040 through line 40, and then complete **Part IV** below (but skip lines 19 and 20). • Otherwise, skip **Part IV** below and complete the rest of Form 1040.			

Part IV Tax Computation Using Maximum Capital Gains Rates

If line 16 or line 17a is zero or less, skip lines 19 and 20 and go to line 21. Otherwise, go to line 19.

19	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-6			19
20	Enter your 28% rate gain, if any, from line 7 of the worksheet on page D-9 of the instructions			20
	If lines 19 and 20 are zero, go to line 21. Otherwise, complete the worksheet on page D-10 of the instructions to figure the amount to enter on lines 35 and 53 below, and skip all other lines below.			
21	Enter your taxable income from Form 1040, line 40			21: 12,950
22	Enter the **smaller** of line 16 or line 17a, but not less than zero		22: 0	
23	Enter your qualified dividends from Form 1040, line 9b		23: 1,000	
24	Add lines 22 and 23		24: 1,000	
25	Amount from line 4g of Form 4952 (investment interest expense)		25: 0	
26	Subtract line 25 from line 24. If zero or less, enter -0-			26: 1,000
27	Subtract line 26 from line 21. If zero or less, enter -0-			27: 11,950
28	Enter the **smaller** of line 21 **or:** • $56,800 if married filing jointly or qualifying widow(er); • $28,400 if single or married filing separately; or • $38,050 if head of household		28: 12,950	
	If line 27 is more than line 28, skip lines 29–39 and go to line 40.			
29	Enter the amount from line 27		29: 11,950	
30	Subtract line 29 from line 28. If zero or less, go to line 40		30: 1,000	
31	Add lines 17b and 23*	31: 1,000		
32	Enter the **smaller** of line 30 or line 31		32: 1,000	
33	Multiply line 32 by 5% (.05)			33: 50
	If lines 30 and 32 are the same, skip lines 34–39 and go to line 40.			
34	Subtract line 32 from line 30		34	
35	Enter your qualified 5-year gain, if any, from line 8 of the worksheet on page D-8	35		
36	Enter the **smaller** of line 34 or line 35		36	
37	Multiply line 36 by 8% (.08)			37
38	Subtract line 36 from line 34		38	
39	Multiply line 38 by 10% (.10)			39
	If lines 26 and 30 are the same, skip lines 40–49 and go to line 50.			
40	Enter the **smaller** of line 21 or line 26		40: 1,000	
41	Enter the amount from line 30 (if line 30 is blank, enter -0-)		41: 1,000	
42	Subtract line 41 from line 40		42: 0	
43	Add lines 17b and 23*	43: 1,000		
44	Enter the amount from line 32 (if line 32 is blank, enter -0-)	44: 1,000		
45	Subtract line 44 from line 43	45: 0		
46	Enter the **smaller** of line 42 or line 45		46: 0	
47	Multiply line 46 by 15% (.15)			47: 0
48	Subtract line 46 from line 42		48: 0	
49	Multiply line 48 by 20% (.20)			49: 0
50	Figure the tax on the amount on **line 27.** Use the Tax Table or Tax Rate Schedules, whichever applies			50: 1,446
51	Add lines 33, 37, 39, 47, 49, and 50			51: 1,496
52	Figure the tax on the amount on **line 21.** Use the Tax Table or Tax Rate Schedules, whichever applies			52: 1,596
53	**Tax on all taxable income.** Enter the **smaller** of line 51 or line 52 here and on Form 1040, line 41			53: 1,496

*If line 25 is more than zero, see instructions for amount to enter.

Schedule D (Form 1040) 2003

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For Example 9

Form 1040 (2003) Page **2**

Tax and Credits	35	Amount from line 34 (adjusted gross income)	35	25,000
	36a	Check if: ☐ **You** were born before January 2, 1939, ☐ Blind. ☐ **Spouse** was born before January 2, 1939, ☐ Blind. **Total boxes checked** ▶ 36a ☐		
Standard Deduction for—	b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 36b ☐		
• People who checked any box on line 36a or 36b **or** who can be claimed as a dependent, see page 34.	37	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	37	9,000
	38	Subtract line 37 from line 35	38	16,000
	39	If line 35 is $104,625 or less, multiply $3,050 by the total number of exemptions claimed on line 6d. If line 35 is over $104,625, see the worksheet on page 35	39	3,050
	40	**Taxable income.** Subtract line 39 from line 38. If line 39 is more than line 38, enter -0-	40	12,950
• All others:	41	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972	41	1,496
	42	**Alternative minimum tax** (see page 37). Attach Form 6251	42	
Single or Married filing separately,	43	Add lines 41 and 42 ▶	43	1,496
	44	Foreign tax credit. Attach Form 1116 if required 44		

Qualified Dividend Income Exclusions (continued)

9. Stock to which related payments must be made with respect to substantially similar or related property (short-sales)

10. "Payments in lieu of dividends" which are received by a person whose stock is loaned to a short-seller

Every short stock sale involves a brokerage firm or a bank that acts as a lender of the stock. There is also a borrower and a buyer involved in the sale. The only person entitled to the dividend paid by the company is the buyer of the stock. The lender is entitled to a "cash in lieu" dividend payment which is paid by the borrower of the shares.

Prior to the new law, it did not make a difference whether the lender received the actual dividend or a "cash in lieu" payment. However, since a "cash in lieu" payment does not qualify for the preferential tax rate, the borrower may want additional payment to compensate for the tax differential.

On September 17, 2003, the IRS released Notice 2003-67. This notice provides guidance to brokers and individuals regarding the reporting of payments in lieu of dividends. For calendar year 2003, brokers will not be penalized for reporting these payments on a Form 1099-DIV if they make a good faith effort to satisfy the information reporting requirements. The IRS has revised its instructions for Form 1099-MISC to require the payments in lieu of dividends to be reported in box 8 of Form 1099-MISC.

The IRS is expected to revise Rev. Proc. 2003-28 to allow brokers to furnish composite substitute statements for Form 1099-DIV and Form 1099-MISC.

The good news for taxpayers is that if they receive a Form 1099-DIV reporting payments in lieu of dividends, they may treat the payment as a dividend, unless they know, or have reason to know, the actual character of the payment.

The IRS is also expected to amend Treas. Reg. §1.6045-2 to provide new rules for brokers to use in determining which shares are loanable and to permit them to use a new hierarchical method to allocate transferred shares to a new pool of loanable shares.

Special Types of Dividends

Dividends received from a real estate investment trust (REIT) or regulated investment company (RIC) (also known as mutual funds) are generally not considered a dividend. However, distributions from an REIT or RIC are eligible for the lower rates to the extent that the REIT or RIC derives its income from dividends of corporate payers. If an RIC or REIT derives 95% or more of its income from dividends, all of its distributions will qualify. If not, only the portion of distribution that is from corporate stock dividends is eligible for the lower dividend rates. In reality, money market and bond mutual fund distributions will generally not qualify (as well as most REIT dividends) unless they derive 95% or more of their income from dividends.

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> **Observation.** Based on these provisions, taxable bonds and REITs are best held in tax-sheltered accounts, such as a 401(k) or a traditional IRA, where at least they'll get tax-deferred growth. Dividend-paying stocks are now relatively more attractive.

If an individual receives an "extraordinary dividend" (based on IRC §1059(c)) from stock that is eligible for the new lower rates, any loss on the sale of that stock is treated as a long-term capital loss and can be offset by the dividend. However, this special treatment of dividends as investment income is available only if the taxpayer elects to treat the dividend as not eligible for the capital gains rates.

> **Note.** The 15% tax on dividend income will not be netted with the 15% capital gains tax rate. This means that current and carryover capital losses will not be able to be used. The IRS is expected to issue guidance on how to account for the limit on net IRC §1231 losses, capital loss carryforwards and other events.

An important point to remember is that dividends paid into a tax-free fund, such as a 401(k) plan, are not eligible for the reduced tax rate. They were not subject to tax under prior law and will not be subject to tax under JGTRRA.

> **Observation.** Questions exist about how dividend tax relief will impact stock valuation for publicly traded and closely-held companies. Also, the lower dividend tax rate may stiffen competition for municipal bonds. An argument can be made that municipal bonds and dividend-paying stocks have complementary, rather than competing, roles in a balanced portfolio since stocks are more volatile than bonds.

Dividends will not be treated as "investment income" for purposes of determining the limitation on deductibility of investment interest expense, unless the taxpayer elects to treat the dividend as not eligible for capital gains rates. This means taxpayers must now elect to include dividend income in investment income, taxing the dividends at regular rates, but thereby electing to offset the dividends by investment interest expense. Otherwise, the presumption will be that the lower dividend rate is intended to apply.

> **Note.** While it may be possible to borrow in order to acquire dividend-paying stocks, it will be necessary to analyze the taxpayer's entire portfolio to determine if the interest expense deduction will be limited due to insufficient investment income from other sources.

If an individual receives a dividend qualifying for the lower rate that exceeds 10% of the individual's basis in their stock interest, any loss on the sale of the stock, to the extent of the dividends, will be a long-term capital loss.

The JGTRRA rates apply in computing an individual's AMT liability.

> **Note.** Qualified dividends will be reported on Schedule D, along with capital gains.

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OTHER PLANNING IMPLICATIONS FOR RATE REDUCTIONS

Business Planning Implications

JGTRRA does not define the term "dividends received from a corporation." Under IRC §316, a dividend is defined as a "distribution of property…out of earnings and profits accumulated after February 28, 1913, or out of…earnings and profits of the taxable year…". This means a dividend is defined as a distribution with respect to the corporation's stock, to the extent of accumulated or current earnings and profits. Under IRC §1368(c), a dividend of an S corporation is defined as the portion of a distribution in excess of the corporation's accumulated adjustments account to the extent the distribution does not exceed the S corporation earnings and profits. Thus, for S corporations with accumulated earnings and profits, there seems to be no prohibition against reducing S corporate earnings and profits through the use of qualified dividends. This could have the effect of eliminating a number of potential problems for S corporations with large amounts of passive income.

The JGTRRA dividend taxation provisions will have some impact on entity selection and how owners are compensated. While the prospect of double taxation of corporate earnings (with respect to C corporations) is a factor in the choice of business entity, it is clearly not the only factor (or even the most significant factor in all situations) and its impact has been diminished under the new legislation. However, because the Act did not reduce corporate income tax rates, from a tax standpoint, pass-through tax entities will generally be more desirable. For those presently in C corporations subject to double taxation on corporate earnings, one strategy may be to borrow funds to buy stocks and take a deduction on the interest paid. With the lower (15%) tax rate on dividend income, the interest rate deduction will partially insulate dividend income from taxation. Likewise, for existing C corporations, salaries may be reduced to the extent not needed to offset income (i.e., large depreciation deductions), thereby allowing the payment of dividends to owners. That will have the effect of reducing the effective tax rate even further.

Observation. Closely-held firms should examine compensation packages for owners. The standard practice of providing a relatively high salary and a lower level of dividends may no longer be as valid a strategy from a tax perspective. Likewise, extracting cash from a firm by renting property to it may be less advantageous under JGTRRA, since rents are not tax favored, but are deductible to the corporation.

Example 10. Unicorn, Inc. is a profitable S corporation that converted to S status in 1992. During its C corporation years, Unicorn, Inc. generated a lot of earnings and profits. Normally Unicorn, Inc. pays its shareholders with a distribution out of current earnings and the shareholders pay tax at their regular rate. Under JGTRRA, with dividends taxed at a 15% rate, an incentive is present to pay the dividend from previously taxed income which would be dividend income to the shareholder and taxed only at 15%.

REMOVING ASSETS FROM THE C CORPORATION

Because of the lower capital gains and dividend tax rates, taxpayers may want to draw cash or property out of their C corporations. While they will still have double taxation, the rates may be lower now than in future years. Unless the corporate shareholders want to completely liquidate the corporation, they will probably choose to make dividend distributions or stock redemptions.

Dividend Distributions

A distribution of cash or other assets to a shareholder will generally be a dividend to the shareholder. Therefore, the shareholder will report the FMV of the assets received as gross income, to the extent of the corporation's earnings and profits. The corporation will not get a deduction for the distribution of any of the assets. Moreover, the corporation must recognize gain on each appreciated asset as if it were sold to the shareholder to whom it was distributed.

The shareholder will report ordinary income for the FMV of the assets received. The shareholder will not be able to use any basis he might have in the stock, unless there is a complete liquidation of the corporation. This means that after the distribution, the shareholder could have a high basis stock, with very little asset value remaining in the corporation. Liquidation of the corporation at this time may result in a capital loss to the shareholder. Thus, they will have gross ordinary income to the extent of the dividend and a capital loss on liquidation, subject to capital loss limitations.

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Example 11. Success Farms, Inc., a C corporation, has the balance sheet that follows. Amana Success, the sole shareholder wishes to receive a cash dividend of $1,000,000. She receives other income which puts her above the 15% tax bracket. Amana will only pay 15% on the $1,000,000, or $150,000 tax. However, AGI-based phaseouts will apply, and she will be subject to AMT. Under the prior law, she could have paid up to $380,900 tax. Since the corporation has only $100,000 of cash, it will be required to dispose of its marketable securities. This will result in a taxable gain to the corporation of $200,000. This will be taxed at the corporation's normal tax rate.

Assets	Basis	FMV
Cash	$ 100,000	$ 100,000
Marketable securities	850,000	1,050,000
Equipment	320,000	560,000
Land	430,000	1,290,000
Total	$1,700,000	$3,000,000
Liabilities and Shareholder's Equity		
Liabilities	$ 300,000	$ 300,000
Common Stock	2,500	2,500
Retained earnings	1,397,500	2,697,500
Total	$1,700,000	$3,000,000

Caution. The tax consequences of the above example, might be different, depending of the earnings and profits of the corporation.

Note. Pages 637–643 in Chapter 13 of the *2001 University of Illinois Farm Income Tax Workbook* contain an excellent discussion the tax consequences of dividend distributions.

PROPERTY DISTRIBUTION

Example 12. Use the same facts and balance sheet from **Example 11**, except Amana wishes to take the land as a property distribution from Success Farms, Inc. The corporation will recognize a capital gain of $860,000, the difference between the land basis ($430,000) and its FMV ($1,290,000). Since corporations do not have a preferential capital gain tax rate, the corporation **could** pay over $300,000 tax on the distribution. Amana upon receiving the distribution will recognize dividend income of $1,290,000 and will pay additional taxes of approximately $200,000 (15% of $1,290,000 plus AMT, and so on). Therefore, the total tax cost of removing the land from the corporation could be as high as $500,000.

Through tax planning, the corporation may be able to reduce its tax liability if it can produce a loss from operations for the year. Consideration should also be given to the fact that the land is now owned by Amana. Any future appreciation will belong to Amana who has a basis of $1,290,000 in the land. Also, the tax liability is no different than if the corporation sold the land and then distributed the cash to Amana.

Stock Redemption

A "stock redemption" is simply a purchase by the corporation of its own stock from its stockholders.[5] From the shareholder's view, redemption of his stock is simply a sale of the corporation's own stock back to the corporation.

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When the shareholder wants to dispose of part or all of his interest in the business, a stock redemption may be useful as a financing technique.

The tax consequences of the stock redemption depend on whether it is treated as an exchange of the shareholder's stock for corporate assets or as a dividend.

Exchange. If the redemption is treated as an exchange, the shareholders must report the gain and may be allowed to report loss from the sale of the stock to the corporation. The gain or loss may be treated as a capital gain or loss. The gain or loss is determined by subtracting the FMV of the asset from the basis in the shares redeemed.

Dividend. If the redemption is treated as a dividend, the shareholder must report ordinary income to the extent of the corporation's earnings and profits.

If the corporation distributes property to the shareholder, it will recognize a gain if the FMV of the property distributed exceeds the corporation's basis in the property.

> **Note.** The rules regarding stock redemptions can be complex. They are discussed on pages 645-649 in Chapter 13 of the *2001 University of Illinois Farm Income Tax Workbook.*

Except for the deduction for stock basis, the tax difference between a redemption and a dividend distribution are currently the same. However, in the past and in the future, when the current tax provisions sunset, the difference can be substantial.

> **Note.** Under JGTRRA, a question is raised as to whether Incentive Stock Options (ISOs) have gained or lost advantage relative to non-qualified stock options. Ultimately, the answer depends on several factors, such as the size and tax bracket of the corporation issuing the option, the tax bracket of the employee, whether the employee is subject to the AMT and whether employees will hold the option shares long-term. However, the IRS issued rules in June that make it easier to reward key employees with ISOs and get the reduced top rate on capital gains under JGTRRA. The revised ISO regulations specify that shareholders must approve the plan, the options must not be transferable, a $100,000 limit per employee applies and S corporations can have ISOs.

INVESTMENT PLANNING

For investors, one strategy may be to measure the tax advantage under the new law by comparing after-tax net income on gain or income taxed at the regular rates. For investors in the highest marginal rate under the new law (35%), they are clearly better off by having long-term capital gains taxed at 15%, then having the same amount of short-term capital gains taxed at 35%.

Another strategy may be to compare the after-tax net income from one dollar of long-term capital gains or qualifying dividends to the after-tax net from one dollar of gain or income taxed as ordinary income. Investors will have to consider the relative tax advantage of investing in inherently riskier investments that may yield long-term capital gain profits and dividends as compared to safer investments that yield more highly taxed ordinary income.

Investors also have to decide whether to wait out the long-term holding period (one year and one day) or sell before the holding period is satisfied and have the investment subjected to tax at a higher rate. Also, if an investment declines in value before the holding period for long-term gain has been achieved, an investor must decide whether it is best to sell the asset and incur the higher tax rate or hold the asset and risk the potential for further value declines and achieve the lower tax rate.

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Example 13. Anne O. Meter will be in the 35% tax bracket for 2003. On December 2, 2002, she buys stock in Floor-Mart. By October 31, 2003, she has earned a $25,000 profit.

If Anne sells the stock on October 31, the sale would trigger $8,750 of capital gains tax ($25,000 × .35). This would provide her a net profit of $16,250 on her investment.

If Anne waits another month and one day before selling the stock, the sale would trigger only $3,750 of capital gains tax ($25,000 × .15), and would result in a net profit of $21,250.

If the Floor-Mart stock begins declining in value in the fall of 2003, Anne must decide whether to hold the stock or sell it before satisfying the long-term capital gain holding period. If she waits and sells after satisfying the holding period requirement, she may still come out ahead compared to selling before satisfying the long-term gain holding period requirement. In any event, Anne must remember that the tax implications of her decision to sell or not is only one factor in her decision-making process. She must also consider basic market fundamentals.

In general, growth stocks and dividend-paying equities should be held in taxable accounts to take advantage of the lower dividend and capital gains tax rates. Consequently, a general investment strategy under JGTRRA would be to invest in growth and income stocks since a taxpayer in the highest marginal rate will be taxed at a 15% rate on dividends compared to 38.6% under pre-JGTRRA law. Also, if investment income is needed to cover living expenses, those investments should not be in IRAs or similar investment vehicles that carry a penalty for early withdrawal. Likewise, frequent trading is less favorable under the lower JGTRRA rates since short-term capital gains remain taxed at higher regular income tax rates (possibly as high as 35%). Funds that have high turnover and are actively trading will generate short-term gains and should generally be avoided. That means index funds will be relatively more attractive because of their minimal turnover.

Observation. If frequent trading is done, such trading should occur in tax-sheltered accounts where the triggering of short-term gains is not an issue. Beware that some mutual funds, especially small-cap funds, tend to have higher turnover and should be held in tax-deferred accounts. Also, taxpayers trading close to the ex-dividend date should closely watch the 60-day rule since some stock trades may take more than one day to settle.

Observation. JGTRRA will place pressure on cash-rich companies to increase dividend payouts as opposed to investing in acquisitions or growth plans.

CHARITABLE GIVING

The lower capital gains rates may also have a dampening effect on the use of appreciated property for charitable purposes, both directly and through split-interest vehicles such as charitable remainder trusts. Taxpayers will have less incentive to make charitable gifts of such property if their tax rate on the sale would be 15% or less.

Observation. The asset mix of charitable remainder trusts should be reviewed. Under JGTRRA, the reduced capital gains and dividend tax rates tend to favor stock portfolios.

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TRANSFER TAX PLANNING

The lower capital gains rates may also influence various aspects of transfer tax planning. Before JGTRRA, the lowest rate on capital gains was 8% for assets held over five years. High bracket taxpayers could reduce the rate of tax on 5-year appreciated assets (from 20% to 8%) or 1-year assets (from 20% to 10%) by gifting them to lower-income taxpayers, such as children 14 years or older, before sale. If the child is in the 10% bracket, the gain on the child's sale will be taxed at just 5%. As mentioned previously, under JGTRRA, the 5% rate applies to gains from assets held more than one year. In addition, the 5-year holding period rule has been repealed (although this holding period springs back into existence in 2009).

One strategy may be to transfer assets to children, or other low-income taxpayers to cut the effective tax rate on these gains by two-thirds. However, if assets are transferred to a child or someone else, the transferee will have legal ownership, and the gift and generation-skipping transfer tax may apply.

> **Note.** The Kiddie Tax, which generally applies the parents' tax rate to the unearned income of children under the age of 14, continues to apply.

RETIREMENT PLANNING

The benefit of the lower capital gains rates under JGTRRA will not apply to gains generated within qualified plans, such as IRC §401(k) plans and IRAs. Distributions from these accounts will still be taxed as ordinary income regardless of the source of income. Consequently, taxpayers with investments in IRC §401(k) plans and IRAs may want to review those investments in light of the new rates.

For taxpayers receiving appreciated employer securities as a lump-sum distribution from an employer-sponsored retirement plan, the net unrealized appreciation of these securities is eligible for the new 15% and 5% rates.

While mutual funds will be able to pass qualifying dividends through to their shareholders at the new lower rates, mutual fund dividends from other sources, such as interest and short-term capital gains, will continue to be taxed at ordinary income rates. Ordinary dividends that a mutual fund pays may consist of up to three components:

- dividends,
- interest, and
- short-term capital gains from portfolio investments.

Beginning in 2003, mutual funds will begin paying two types of ordinary dividends:

- Those that qualify to be taxed at the 15% rate (or less), and
- Those that are taxed at an investor's ordinary income tax rate.

> **Note.** See page 658 in this chapter for a sample of the 2003 Form 1099-DIV.

EDUCATION PLANNING

With lower capital gains rates under JGTRRA, outright gifts of capital gain property to lower-income taxpayers (such as children) now carry less tax cost and avoid a number of limitations and restrictions of education savings accounts. Likewise, JGTRRA could provide an additional incentive for the use of custodial accounts as a way for taxpayers to save for college expenses of children. Uniform Transfer to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) accounts have been overshadowed in recent years by the so-called "Section 529" plans. Under a §529 plan, withdrawals are tax-free until 2011, whereas withdrawals from UTMA and UGMA accounts are taxed at the child's tax rate. Hence, the JGTRRA reduction in capital gains rates for persons in the 10% and 15% tax brackets with children over age 13 will be able to sell stock at a 5% rate through 2007 and at 0% in 2008. Because custodial accounts are the primary vehicles used to transfer securities to children (securities cannot be transferred to a §529 plan), JGTRRA tends to benefit custodial accounts over §529 plans.

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Note. The advantages and disadvantages of custodial accounts must be considered carefully for each client. While the first $750 in earnings in a custodial account is tax-exempt, stock transfers must be made to children age 14 and over since children under age 14 pay tax at their parents' rate. Care should be taken to ensure that stock sales won't push the child's income above the 15% bracket. Also, §529 plans offer more control than do custodial accounts. With a custodial account, while the funds can be tapped at any time for any purpose that benefits the child, the parents lose control of the funds after the child reaches the age of majority under state law. With a §529 plan, the custodian retains complete control over the funds for life and can even switch beneficiaries. Thus, a custodial account may be preferable for clients planning to spend the account funds before the child gains control of the assets or if the child is older and ready to enter school and will need the funds in the account. Special gift tax rules also apply to §529 plans.

CORPORATE "PENALTY" TAXES

Before enactment of JGTRRA, IRC §531 imposed an accumulated earnings tax at the highest marginal individual income tax rate on the accumulated earnings and profits of C corporations in excess of $250,000 ($150,000 for certain service corporations) that could not be justified by the reasonably anticipated needs of the business. While JGTRAA does not eliminate the accumulated earnings tax, it does reduce the accumulated earnings tax rate to 15% for tax years beginning after December 31, 2002.

Similarly, before JGTRRA, IRC §541 imposed a personal holding company tax on "personal holding company income" of C corporations equivalent to the highest marginal income tax rate for individuals. JGTRRA does not repeal the personal holding company tax, but does reduce the rate to 15%. The provision is effective for tax years beginning after December 31, 2002.

CORPORATE ESTIMATED TAX

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.[6] For corporations that are on a calendar tax year, estimated payments must be made by April 15, June 15, September 15 and December 15. Under JGTRRA, 25% of corporate estimated tax payments due on September 15, 2003, are not due until October 1, 2003.

ENDNOTES

1 IRS News Release IR-2003-69

2 IRS website, Questions and Answers about the Child Tax Credit, Question #9

3 IRC §§168(k)(1)(B); (k)(4)(A)

4 IRC §§168(B)(2)(C); (b)(3)(D); (B)(5)

5 IRC §317(b)

6 IRC §6655

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