



Accutek Solutions
Doug Beecher, C.P.A.

51 North 1000 West, Suite 5
Hurricane, UT 84737
Tel: (435) 635-3684
Fax: (435) 635-5454
E-mail: dougbeecher@yahoo.com
Website: www.accuteksolutions.com

June 2003 - Taking Advantage of the 2003 Tax Cut

On May 28, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 into law. What does that mean for you, and what can you do to save more in taxes with this new law?

The new tax law was narrowly passed in the belief that the best way to boost the economy and increase the number of jobs is to target those who could keep more of their income and pay less in taxes. Almost everyone will benefit from the tax bracket decreases. Many families will benefit immediately from the child tax credit increase, and also from the efforts to eliminate the marriage tax penalty. New payroll withholding tables reflecting these changes will take effect by July 1, which will leave more money in many people's paychecks.

There are also significant business tax savings in the new law, passed with the hope that by giving increased incentives for the purchase of new equipment and by reducing taxes on capital gain income that business activity will increase and jobs will be created. An effort was also made to reduce double taxation of dividends paid from already taxed corporate income.

This tax law represents a large compromise in Congress. It was passed only by Vice President Cheney casting a tie-breaking vote, and is about half of what President Bush asked Congress to pass this year. Opponents of the new law do not believe it will create as many jobs as the President hopes, and believes it gives too much of the tax reductions to the wrong people.

In this article, I will describe what this new law will mean to you, and how much more of your income you will be able to keep after federal income taxes. You can decide on your own if this was a good or a bad law.

The series on how you can pay less taxes when filing next year will continue in July after this interruption to discuss the new law.

PERSONAL TAX SAVINGS

Increased Child Tax Credit

The child tax credit is increasing by \$400 for 2003 and 2004. If you claimed the child tax credit on your 2002 tax return, you will likely receive a check from the IRS for the \$400 increase in July or August. If the last two digits of your social security number are between 00 and 33, your check will be mailed July 25. If these digits are between 34 and 66, your check will be mailed August 1. The checks will be mailed August 8 for those with digits between 67 and 99.

You do not have to do anything more to receive this check. However, if you have a child that will turn 17 this year, the credit does not cover that child and you won't receive the credit or the advance payment for him or her.

Also if you owe other money to a government agency, you will probably receive a letter explaining where your advance payment was applied, instead of the check.

The child tax credit was \$600 before the new law, and is now \$1,000. After you receive your check for the \$400 increase, you will receive the other \$600 of the credit by filing your 2003 tax return early in 2004, as you have done in the past.

In 2005, the credit reverts to previous law, which called for the credit to be \$700 in that year. Many expect the law to be changed again before then to keep it at the \$1,000 level.

Tax Bracket Improvements

The 10% tax bracket is expanding to include the first \$7,000 of taxable income for singles and the first \$14,000 of taxable income for married couples. This will reduce taxes by at least \$50 for most singles and at least \$100 for most married couples.

Also, the 27, 30, 35, and 38.6 percent tax brackets have been reduced to 25, 28, 33, and 35 percent, respectively. For a single taxpayer with \$40,000 taxable income, tax will decrease by \$282, to \$6,810 from \$7,092. For married taxpayers with \$80,000 taxable income, tax will decrease by \$1,686 to \$13,620 from \$15,306. The larger tax decrease for married couples is the result of the partial elimination of the “marriage tax penalty” in the new tax law, which is explained in the next section.

Reducing the Marriage Tax Penalty

The marriage tax penalty describes a situation where two people marry and there is more tax on their combined income than the total of the tax each paid prior to their marriage. The new tax law goes a long way towards eliminating this inequity.

The standard deduction for married couples has increased from \$7,950 to \$9,500 and the 15% tax bracket has increased to include taxable income up to \$56,800 in the new law. These amounts are exactly double those of a single person. For married couples with taxable income of \$114,650 or less, the marriage tax penalty has been eliminated by the new law.

Under previous law, married couples with taxable income over \$47,450 were taxed at a 27% rate. The reason the married couple with \$80,000 taxable income in the last section got a larger tax decrease is because the \$1,122 marriage tax penalty they previously paid was eliminated.

For married taxpayers in the new 28% tax bracket, or higher, the marriage tax penalty still exists, but it has been reduced.

Reducing the Number of People Affected by the Alternative Minimum Tax (AMT)

For 2003 and 2004, the amount of income exempt from AMT increases to \$40,250 for single taxpayers and \$58,000 for married couples (note that the married figure is not double the single figure, and thus the marriage tax penalty continues for those subject to AMT). In 2005, the exemption returns to the lower amounts of \$33,750 for singles and \$45,000 for married couples. Again, many expect Congress to act before then to extend this improvement.

If you were not subject to AMT before, you still aren't. If you have paid AMT in the past, and would like to know how this change might affect you, that is a personal computation that you will want to discuss with your professional advisor.

BUSINESS TAX SAVINGS

Dividend and Capital Gain Income

There is an inequity between dividends paid by C corporations and other types of income. Generally, income is taxed to the person who ultimately receives it, and is deducted as an expense by the person (or business) paying it. Dividends paid by C corporations are not deducted as an expense, meaning the corporation has already paid tax on the money, and the person receiving the dividend pays tax on it again.

President Bush asked that this be repealed entirely. What actually passed Congress was a compromise, which calls for taxes on dividends to be reduced for 2003 through 2008. For those in the 10 and 15 percent tax brackets, the tax on dividends will be 5% for 2003 through 2007, and zero in 2008. For everyone else, the tax on dividends will be 15% for the entire 2003 through 2008 period. After 2008, taxes on dividends will return to the ordinary income tax bracket you are in, ranging from 10 to 35%.

Capital gains will be taxed at the same rate as dividends in the period from 2003 through 2008, and will then return to the previous rates of 10 and 20% in 2009. Note that these capital gain tax rates have usually been lower than those for dividends and other income, and are scheduled to return to this position in 2009.

The new tax rates will apply to dividends and capital gains received on or after May 6, 2003.

Many people have avoided purchasing stock in companies that pay dividends in the past, preferring to buy stock in companies they hoped would produce larger capital gains, partly because the taxes would be lower. The new tax law temporarily helps to even the playing field between the two types of stocks. In this era of increased concern about corporate financial reporting and with the stock market decline in recent years, there is more interest in stocks that pay dividends. Dividend paying stocks provide another way to earn income besides waiting for a capital gain that may or may not come, and provide some assurance that the company is actually earning income. Until 2008, these people will now pay the same tax on dividend and capital gain income. If President Bush and a Congress that agrees with him is re-elected next year, you can plan on him trying again to repeal entirely tax on dividend income. This will certainly be a major campaign issue between those who agree and those who disagree with this position. Right now, there is virtually the same number of people on each side of the issue, so the coming elections will make a big difference to you, whichever side you agree with.

Larger Business Equipment Purchase Incentives

Businesses normally deduct from taxable income expenses that they pay in order to earn income in that year. Equipment usually benefits a business over several years, and so they generally will deduct a portion of the cost of the equipment in each year that is benefited, rather than all at once in the year the purchase is made. This process of gradually deducting the cost of business equipment over a period of several years is called depreciation.

For many years, there have been various tax incentives designed to allow business to take these depreciation deductions quicker, hoping that more equipment would be purchased and more jobs created in industries that produce the equipment. It was also an attempt to help new businesses with the large expenses they incur when first opening.

The new tax law expands these incentives in several ways. One is an increase to \$100,000 in the amount of equipment bought in a year that can be expensed in that same year, rather than over several years. Each business gets to choose which way to claim the equipment depreciation deduction, depending on what they expect will be best for them. The old law allowed up to \$25,000 in equipment to be expensed in the year of purchase, so this is a major change. It affects equipment purchased in 2003 through 2005.

This election is also available to companies buying up to \$400,000 of equipment in a year, whereas before it was only \$200,000. Another new feature is that companies will now have the ability to later revoke this election, if they determine in a future year that they would have been better off to claim the deduction over several years rather than all in the year of purchase.

After September 11, 2001, there was another equipment incentive passed to encourage businesses to rebuild. As another option, they could choose to expense 30% of all the equipment purchased in the next three years, through September 11, 2004. The new law signed May 28, 2003 continues this opportunity, and adds an additional choice to expense 50% of all equipment purchased between May 6, 2003 and December 31, 2004.

Finally, businesses that buy “off-the-shelf” computer software can now expense it in full in the year purchased, rather than over 3 to 5 years. They will have full use of the other equipment purchase incentives, even if they use the software purchase incentive.

Each business will want to review whether new equipment will benefit them, and which is the best tax option for their new equipment if they choose to buy. There are certainly powerful new incentives, and many choices to make. They apply to all businesses, ranging from part-time and home businesses, to the largest international companies.

Important Note!

The information in this article is intended to inform you of some of the financial opportunities provided in the tax laws or elsewhere. It is not intended to give you specific advice for your personal situation. If you need such advice, please contact a qualified professional! If you have not met with me before, please call or e-mail me (doug@accuteksolutions.com) for a free initial 30-minute consultation to discuss your personal situation and how the tax laws might benefit you. Questions you'd like to have answered in a future article are also welcome!

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