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September 2003 - New Capital Gains and Dividend Tax Rules for 2003

The May 2003 tax law included big reductions in capital gains taxes. This article discusses the key points you will want to know about these changes.

May 6, 2003 Is An Important Date

Long-term capital gains on assets sold on or after May 6, 2003 qualify for the new lower rates. The rate is 5% if you are in the 10 or 15% tax brackets, and 15% if you are in any of the other tax brackets. In all cases, this is a 5% tax cut. It is a \$500 tax savings for every \$10,000 in gains on the sale of capital assets held longer than one year.

If the sale was before May 6, 2003, you will pay the previous tax rates. The old rates included a special provision for property held over 5 years, which gave a 2% reduction. When you file your 2003 tax return, you will identify whether the item was sold before or after May 6, and whether it was held over 5 years to determine the tax rate you will pay.

Here is a summary of the long-term capital gain rates for 2003 for non-corporate taxpayers:

<u>Date Sold</u>	<u>Your tax bracket</u>	<u>Property held 1 year or less</u>	<u>Property held 1-5 years</u>	<u>Property held over 5 years</u>
Before May 6	10% or 15%	Your tax bracket	10%	8%
Before May 6	Above 15%	Your tax bracket	20%	18%
May 6 or later	10% or 15%	Your tax bracket	5%	5%
May 6 or later	Above 15%	Your tax bracket	15%	15%

Special Rule for Your Principal Residence

When you sell your home a generous exclusion applies. The home must have been your principal residence for at least two years out of the last five years. If you meet this requirement, the first \$250,000 of capital gain is income tax-free if you are single. The first \$500,000 of capital gain is income tax-free if you are married and file a joint return.

It does not matter what you do with the money. You do not have to buy a new home. If you do buy a new home and make it your principal residence for at least two years, you can sell that home and again exclude the gain under these same guidelines. These rules have existed since 1997, and there were no changes for 2003.

If your gain is larger than these thresholds, you pay capital gains taxes on the excess at the rates shown in the table in the previous section of this article.

Most Dividends are Now Taxed as Capital Gains

Most dividends received on or after May 6, 2003 will be taxed the same as long-term capital gains. The exceptions will be taxed as ordinary income, and include:

- Dividends received from deposits in credit unions, mutual savings banks, or similar financial institutions.
- Dividends received from tax-exempt farmers cooperatives.
- Most dividends on securities of your employer that are held in an employee stock ownership plan.
- Dividends from a mutual fund that come from interest earnings of the mutual fund.

Long-Term Planning Using The 2003 Capital Gains and Dividend Rates

The 2003 capital gain and dividend tax rates are scheduled to apply through 2008. Beginning January 1, 2009, the rules return to those in effect before the 2003 Tax Act.

Unfortunately, this makes long-term planning difficult. There is nothing to stop Congress and the President from changing these rules again before 2009. It is probably safe to plan on these new lower rates through at least the end of 2004, but not necessarily beyond then. After the November 2004 elections, a new Congress and President may make further changes in 2005.

Differences for Corporations

Capital gains are taxed at ordinary income rates for C corporations. This did not change in the 2003 Tax Act. For this reason, I generally recommend that C corporations do not own real estate. If desired, some or all of the shareholders in the C corporation can form a separate limited partnership, limited liability company, or S corporation for the purpose of owning real estate, which can be rented to the C corporation or to other parties. This will preserve the benefit of significantly lower capital gains tax rates when the real estate is eventually sold.

Dividend income earned by C corporations also remained the same in 2003. To avoid full triple taxation, there is a 70% exclusion on dividend income of C corporations. The exclusion results in a 4.5% effective dividend tax rate for C corporations in the 15% tax bracket, a 7.5% effective dividend tax rate for corporations in the 25% tax bracket, and a 10.2% effective dividend tax rate for corporations in the 34% tax bracket.

Special Note for Home Offices and Other Depreciable Property

If you use part of your principal residence for business, a special rule applies when you sell your home. You will probably be required to treat your home as two separate properties. The portion that is used as a residence is treated under the generous tax exclusions rules described at the beginning of this article. The business portion is subject to capital gain tax under the same rules as other depreciable real estate. The depreciation is subject to recapture, and is taxed separately from the remaining capital gain. The tax law for these sales is very complex, so you will want to get help from a professional tax advisor before making any decisions in this area.

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! Please call or e-mail me (doug@accuteksolutions.com) for an initial consultation to discuss your personal situation and how the tax laws might benefit you. Your first 30-minute visit is free to

let you sample what we can do for you at no cost or obligation. We also invite you to submit questions you'd like to have answered in a future article!

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