

### President Bush Signs Jobs and Growth Tax Relief Reconciliation Act of 2003

On Wednesday, May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act"), which contains approximately \$318 billion of tax relief for individuals, businesses and investors. Although the Act represents the third largest tax cut in the nation's history, it is only a fraction of the \$726 billion package that was originally sought by the President. Key provisions of the Act include the following:

#### Reduction in Capital Gain Tax Rates

The Act reduces the maximum long-term capital gains tax rates from 20% to 15%. It also reduces to 5% (0% for 2008) the capital gain tax rate applicable to taxpayers that are in the 15% tax rate bracket. These lower rates apply to sales or exchanges of long-term capital assets and installment payments received on or after May 6, 2003, and are effective both for regular tax and alternative minimum tax purposes. Note, however, that the Act does not reduce the 25% rate applicable to gain from the sale of real estate attributable to previously claimed depreciation, nor does it affect the 28% rate applicable to gain from the sale of collectibles and to certain sales of small business stock.

The new capital gains tax rates sunset for taxable years beginning after December 31, 2008, after which the long term capital gains tax rates revert to 20% and 10%.

#### Reduction in Tax Rates on Dividends

The centerpiece of the Bush Administration's tax cut proposals was the elimination of taxation of dividends. The Act contains a compromise provision, under which certain dividends paid to individuals, trusts, and estates will be subject to the 15% maximum tax rate that applies to long term capital gains under the Act (or, in the case of taxpayers in lower income brackets, 5% through 2007 and 0% in 2008).

The reduction in the dividend tax rate applies to taxable dividends paid by domestic "C" corporations, as well as taxable dividends paid by an S corporation out of earnings and profits from periods prior to the effective date of its S election. However, dividends paid by tax-exempt corporations, deductible dividends paid by mutual savings banks, and deductible dividends paid to an ESOP are not eligible for the lower rate.

The lower rates also apply to dividends from certain "qualified" foreign corporations. A foreign corporation is "qualified" for the lower tax rate on its dividends if it is incorporated in a possession of the United States or eligible for the benefits of a comprehensive income tax treaty with the United States that provides for an information exchange program (as determined by the Treasury Department). (The current income tax treaty between the United States and Barbados has been singled out as one that **does not** qualify for these purposes.) In addition, even if a foreign corporation is itself not qualified, its dividends will qualify for the lower tax rates if the stock of the foreign corporation on which the dividends are paid is readily tradable on an established securities market in the United States (including ADRs).

In any case, dividends from a "foreign personal holding company," a "foreign investment company," or a "passive foreign investment company" cannot qualify for the lower tax rates.

The reduced rate is not available for a taxpayer who fails to satisfy a holding period requirement. Specifically, in order to qualify for the lower rates, the dividend recipient must hold the stock for more than 60 days during the 120-day period that straddles the ex-dividend date with respect to the dividend in question.

The reduced rate is also not available to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make payments related to the dividend with respect to positions in substantially similar or related property.

The new dividend tax rates apply to dividends received after December 31, 2002, without regard to whether the earnings and profits out of which the dividends are paid accumulated before or after that date. However, the reduced tax rates will expire on December 31, 2008, after which the tax rates generally applicable to ordinary income will apply to dividends.

### **Acceleration of Tax Rate Reductions**

Prior to passage of the Act, existing law generally imposed tax on the ordinary income of an individual at a maximum rate of 38.6%, with reductions in the top four brackets scheduled for 2004 and 2006 under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the Bush Administration's 2001 tax cut legislation. The Act accelerates the EGTRRA tax rate reductions, effective as of January 1, 2003. Thus, the maximum individual tax rate applicable to ordinary income received by an individual in 2003 is 35%, and the 35%, 30%, and 27% brackets are reduced to 33%, 28%, and 25%, respectively. After 2010 the tax rate reductions will sunset and the top marginal rate will then revert to the 39.6% rate in effect before EGTRRA took effect.

The Act also expands the 10% rate bracket for 2003-2004, after which it will revert to the levels allowed under prior law (which expands the 10% bracket again beginning in 2008).

In addition to accelerating the tax reductions, the Act accelerates the "marriage-penalty" relief provided in EGTRRA. Under the Act, the 15% bracket for joint filers is exactly twice as wide as the 15% bracket for singles and for "married-filing separate" taxpayers, and the standard deduction for joint filers is exactly double the amount for singles and "married-filing separate" taxpayers. Beginning in 2005, the relief provided by the Act will expire, and the phase-in of marriage penalty relief will revert to the schedule provided in EGTRRA.

In an effort to reduce the number of taxpayers who pay alternative minimum tax as a result of the reductions in regular income taxes produced by the legislation, the Act provides a rather modest increase in the AMT exemption. For example, the Act increases the AMT exemption for joint filers from \$49,000 to \$58,000. These changes will sunset after 2004.

The Act also increases the tax credit for each dependent child, stepchild, foster child or grandchild under the age of seventeen from \$600 to \$1,000 (phasing out starting at an adjusted gross income of \$75,000 for singles and \$110,000 for joint filers). Those eligible for the credit will receive a rebate check from the government for \$400 for each child claimed on their 2002 returns. This change expires after 2004.

### Growth Incentives for Business

The Act provides growth incentives for businesses in the form of first year depreciation allowances. These incentives are expected to save taxpayers over \$10 billion.

*Enhanced First-Year Bonus Depreciation.* In the Job Creation and Worker Assistance Act of 2002 ("JCWAA"), Congress introduced a first-year bonus depreciation deduction equal to 30% of the cost of qualifying new assets placed in service after September 10, 2001, and before September 11, 2004. The bonus depreciation is generally available for property having a recovery period of less than 20 years, computer software, water utility property and certain leasehold improvement property, but is not available for used property.

The Act provides an additional first-year bonus depreciation deduction for regular and alternative minimum tax purposes equal to 50% of the adjusted tax basis of new (but not used) property placed in service during the year. In any case where the 50% bonus depreciation applies to property, the tax basis of the property is reduced by the amount of the bonus depreciation, and the remainder is depreciable under the MACRS rules generally applicable to the property.

The 50% bonus depreciation deduction is available for new (but not used) property placed in service after May 5, 2003 and before January 1, 2005 (provided a binding written contract for the purchase of the property is not in effect prior to May 6, 2003). The Act extends the 30% bonus depreciation deduction to qualifying property placed in service prior to January 1, 2006, but not qualifying for the 50% bonus depreciation (e.g., because a binding contract to purchase the property existed prior to May 6, 2003).

*Increase in Section 179 Depreciation Allowance.* Section 179 of the Code permits small businesses to deduct 100% of the cost of most new and used tangible business assets (other than real estate). Prior to the Act, the amount that could be deducted was limited to \$25,000, reduced by the amount by which the cost of section 179 property placed in service during the year exceeds \$200,000.

The Act increases the section 179 limitation to \$100,000. It also increases the cost of section 179 property that can be placed in service without reducing the amount of the section 179 deduction from \$200,000 to \$400,000. Each of these amounts are to be adjusted for inflation.

In addition, the Act provides for the first time that off-the-shelf computer software is eligible for the section 179 deduction.

The increased section 179 depreciation allowance and the eligibility of software for the section 179 deduction apply only through 2005. Thereafter, prior law will apply.

*Increased Limits on Depreciation of Vehicles.* Under current law the annual depreciation deductions that may be claimed with respect to automobiles are subject to specified dollar limitations. Prior to the Act, the limitation on the amount of the first year's depreciation deductions for new (but not used) automobiles was increased by \$4,600 to \$7,160. The Act's new 50% bonus depreciation rule has the favorable effect of increasing the first-year depreciation deduction for a new automobile to \$10,210, provided the automobile is placed in service on or after May 6, 2003. The effect of the Act's change will be to enhance the tax advantages of purchasing new, rather than used, automobiles.

### Future Legislation

As noted above, many of the tax cut provisions are scheduled to expire on specified dates in the future. These sunset provisions were included to keep the cost of the tax package under \$320 billion – perceived as a requirement for Senate approval.

Because the timing of the expiration of the tax cuts will likely make them significant issues in the next two Presidential elections, there will almost certainly be future legislative efforts to extend the tax cuts (or make them permanent). The temporary nature of the tax reductions, and the uncertainty as to whether Congress will take future action to make some or all of these changes permanent, make tax planning difficult, at best.

It should also be noted that many of the more significant provisions of the bills that passed the Senate and House (many of them revenue raisers) were stripped from the bill by the Conference Committee, including:

- Corporate tax shelter provisions (including clarification of the economic substance doctrine)
- Provisions to curtail the use of nonqualified deferred compensation plans for corporate executives
- Limitations on deductions for charitable contributions of certain types of intellectual property
- Provisions designed to discourage so-called “inversion” transactions pursuant to which U.S. corporations reincorporate offshore for tax reasons

Many of these provisions, though not included in the Act, are likely to reappear in future tax legislation, e.g., the Energy Tax Incentives Act of 2003, sponsored by Senator Grassley of Iowa. The Foley & Lardner Tax Group will closely monitor these and other developments and keep our clients and colleagues apprised of developments as they occur.

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