Jobs and Growth Tax Relief Reconciliation Act of 2003: A $350 Billion Tax Relief Package

Reducing Individual Income Taxes and Providing Tax Relief for Dividends and Capital Gains

On May 28, 2003, President Bush signed into law the $350 billion tax relief package approved by Congress on May 23, 2003. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Tax Act) will provide $330 billion in tax cuts and $20 billion in fiscal aid to state and local governments. Among other significant changes, the 2003 Tax Act accelerates previously enacted reductions in marginal tax rates, provides for a maximum 15 percent tax rate on dividends and long-term capital gains, enhances small business expensing and extends the first-year bonus depreciation for certain property used in a trade or business. To fit within budgetary guidelines, Congress scheduled the rate reduction provisions in the 2003 Tax Act to “sunset” after a period of time. Many observers believe such provisions will be made permanent, however, as it is unlikely a future Congress will opt to re-impose pre-2003 Tax Act rates. Significantly, the 2003 Tax Act does not include any revenue-raising provisions.

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Reduction in Individual Capital Gains Tax Rates

The 2003 Tax Act reduces the maximum individual net long-term capital gains tax rate five percentage points from 20 percent to 15 percent. Taxpayers in low income tax brackets (previously subject to a maximum 10 percent rate on long-term capital gains) will also be subject to a lower capital gains rate of 5 percent through 2007 and a special 0 percent rate effective in 2008. These reduced rates apply to sales and exchanges (and payments received) on or after May 6, 2003 through December 31, 2008, unless Congress chooses to further extend this provision. The lower rates will generally apply on a pass-through basis for any pass-through entity with qualifying gain taken into account on or after May 6, 2003. Similarly, the lower tax rates will apply to installment sale gain recognized by an individual on or after May 6, 2003, regardless of whether the sale transaction occurred prior to that date.

The lower capital gains tax rates do not apply to corporate taxpayers, however. The lower rates also do not apply to long-term capital gains from “collectibles,” which remain subject to a 28 percent maximum tax rate. Certain gains from depreciable real estate similarly remain subject to a 25 percent maximum tax rate. Deductions of capital losses against ordinary income continue to be limited to $3,000 per year for individual taxpayers.

The Economic Growth Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act) lowered the capital gains tax rate
for gain recognized with respect to property held for more than five years to 18 percent (8 percent for taxpayers in low income tax brackets). The 8 percent rate became effective in 2001, and the 18 percent rate was scheduled to become effective after 2005. The 2003 Tax Act, however, effectively repeals the 18/8 percent rates for gain recognized with respect to property held for more than five years until January 1, 2009, when the former capital gains rates (including the 18/8 percent rates) are scheduled to return. Thus, a taxpayer who would otherwise qualify for the 18 percent capital gains tax rate for sales in 2005 through 2008 will not receive any additional benefit apart from the newly instated 15 percent capital gains tax rate.

The capital gains tax rate reductions imposed by the 2003 Tax Act should further incentivize taxpayers to realize long-term capital gains rather than short-term capital gain or ordinary income. In fact, the spread between the highest marginal tax rate and the capital gains tax rate is now 20 percentage points, compared to 18.6 percentage points prior to the 2003 Tax Act.

Reduction in Individual “Qualified Dividend Income” Tax Rates

“Qualified dividend income” generally refers to dividends received during the tax year from domestic corporations and “qualified foreign corporations,” other than dividends from tax-exempt corporations, deductible dividends paid by mutual savings banks and deductible dividends paid on certain securities held by an ESOP. For tax years beginning after December 31, 2002, the 2003 Tax Act generally reduces the maximum individual income tax rates on qualified dividend income to 15 percent. The 15 percent reduced tax rate is effective until December 31, 2008. Taxpayers in low income tax brackets will generally be subject to a maximum tax rate of 5 percent (0 percent in 2008) on such dividend income.

Under the 2003 Tax Act, qualifying dividends received by an individual shareholder will therefore be taxed at the same rates applicable to net capital gain. The lower rates also apply to qualifying income deemed to constitute dividends, such as distributions treated as dividends pursuant to Section 305 of the Internal Revenue Code of 1986 (the Code). It is interesting to note that the benefits of the new reduced dividend tax rate are not conditioned upon the level of taxes paid by the corporation (as President Bush had originally proposed), except with respect to “RICs” and “REITs” as described on page 4.

The 2003 Tax Act also provides that amounts treated as ordinary income under Section 306 of the Code are treated as qualified dividend income. Prior to the 2003 Tax Act, an amount realized on a disposition of Code Section 306 stock (primarily, preferred stock received as a tax-free stock dividend or certain preferred stock received in a tax-free reorganization or spin-off) was treated as ordinary income in an amount equal to the value of the tainted stock on the day it was received, to the extent such value would have been a dividend if cash had instead been distributed to the shareholder. Under the 2003 Tax Act, to the extent a shareholder recognizes income on the disposition of Code Section 306 stock, such income is taxed at a maximum rate of 15 percent.

Dividends are not eligible for reduced rates, however, unless the shareholder meets certain holding period requirements. Specifically, the stock must be held for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date. When measuring the required holding period, a taxpayer may not include periods during which the risk of loss has been diminished through, for example,
certain hedging transactions. In the case of preferred stock, the relevant holding period is 90 days during the 180-day period beginning 90 days before the ex-dividend date.

A “qualified foreign corporation” includes any foreign corporation whose stock is readily tradable on an established securities market in the United States. A qualified foreign corporation also includes a foreign corporation eligible for the benefits of a comprehensive income tax treaty with the United States that is deemed satisfactory by the IRS for purposes of this provision and that includes an exchange of information program (other than the current treaty with Barbados). Subject to further guidance on this issue, a foreign corporation will be eligible for the benefits of a comprehensive income tax treaty for these purposes if it would qualify for the benefits of the treaty with respect to substantially all of its income in the taxable year in which the dividend is paid. A qualified foreign corporation does not include, however, any foreign corporation qualifying as a “foreign personal holding company,” a “foreign investment company,” or a “passive foreign investment company” for either the tax year in which the dividend is paid or the preceding tax year. This limitation is significant to the extent it prevents taxpayers from converting other types of passive income (e.g., interest, rents or royalties) into qualified dividend income taxable at reduced rates. Foreign tax credits associated with dividends from qualified foreign corporations will be limited to reflect the new reduced tax rates for such dividends.

The reduced tax rates on dividend income do not affect withholding taxes on dividends paid to foreign persons (currently a 30 percent withholding rate or a lower applicable treaty rate). However, the backup withholding rate (which can apply when a taxpayer fails to furnish a taxpayer identification number, fails to report certain payments or in certain other situations) has been reduced to 28 percent as a result of the lowering of marginal tax rates discussed below.

Although it is difficult to determine the planning opportunities created by the lower dividend tax rates because the rate cut does not eliminate double taxation of corporate earnings, it appears the 2003 Tax Act may make stock consideration relatively more attractive in acquisitive and corporate financing transactions, at least as compared to debt. In addition, by increasing the after-tax value of dividends, the 2003 Tax Act encourages shareholders to take value out of corporations in the form of dividend distributions (and may encourage corporations to consider refinancing or incurring new debt in order to fund such dividend distributions).

**Acceleration of Reductions in Marginal Tax Brackets**

The 2001 Tax Act provided for reductions in marginal tax brackets to become effective in 2004 and 2006. The 2003 Tax Act accelerates these marginal tax rate reductions, effective retroactively on January 1, 2003. The maximum tax rate of 38.6 percent applicable to an individual taxpayer’s ordinary income in 2002 has been reduced to 35 percent. The rate reductions are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Marginal Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>27% 30% 35% 38.6%</td>
</tr>
<tr>
<td>2003</td>
<td>25% 28% 33% 35%</td>
</tr>
</tbody>
</table>

All marginal rate cuts are subject to the 2001 Tax Act’s sunset provision. Thus, for tax years beginning after December 31, 2010, rates revert back to the pre-2001 Tax Act rates.
**RICs and REITs: Application of Reduced Rates on Dividends and Long-Term Capital Gains**

Regulated investment companies (RICs) are permitted to distribute long-term capital gains to shareholders as “capital gain dividends.” Under the 2003 Tax Act, the capital gain dividends qualify for the lower 15 percent rate on long-term capital gains to the extent the distribution is attributable to long-term capital gains on or after May 6, 2003. Similarly, long-term capital gains on the sale of shares in a RIC on or after May 6, 2003 will also qualify for the lower capital gains rates. If at least 95 percent of the RIC’s gross income (other than long-term capital gains) is qualifying dividend income, then the RIC will also be able to designate 100 percent of its ordinary income dividends as qualifying for the reduced dividend tax rate.

Because real estate investment trusts (REITs) receive a dividends paid deduction enabling them to avoid corporate level tax, most ordinary dividend distributions made by REITs are not eligible for the reduced tax rates. However, REIT dividends attributable to income taxed at the REIT level (e.g., if the REIT distributed less than 100 percent of its taxable income) or to dividends the REIT received from other taxable corporations (e.g., its taxable REIT subsidiaries) are eligible for the lower tax rates. In addition, capital gain distributions made by REITs are eligible for the reduced capital gains tax rates provided by the 2003 Tax Act, except to the extent of “unrecaptured Section 1250 gain” (essentially long-term gain attributable to real estate depreciation), which continues to be taxed at 25 percent.

**Increase in First-Year Bonus Depreciation**

The 2003 Tax Act increases the bonus depreciation deduction for certain “qualified business property” previously enacted under the Jobs Creation and Workers Assistance Act of 2002. “Qualified business property” includes computer software, property with a depreciable life of 20 years or less, water utility property and certain leasehold improvement property. Under the 2003 Tax Act, a taxpayer may claim a 50 percent bonus depreciation deduction (in lieu of the former 30 percent deduction) for such qualified business property in the year the property is placed in service, so long as (i) the taxpayer is the first user of that property, (ii) the property is acquired after May 5, 2003 and before the end of 2004 and (iii) the property is placed in service after May 5, 2003 and before the end of 2004 (or, in the case of certain longer-lived property, before the end of 2005). Property does not qualify for the 50 percent bonus depreciation if there existed a binding written contract for the acquisition in effect before May 6, 2003. A taxpayer may also elect out of the application of the new bonus depreciation deduction.

**Increase in Expensing for Small Businesses**

Under prior law, a business taxpayer could elect to deduct immediately rather than depreciate up to $25,000 in tangible personal property used in a trade or business for the tax year. The annual expense limit was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeded $200,000. There was no provision for either the annual expense limit or the
$200,000 phaseout threshold to be increased to reflect inflation. The 2003 Tax Act boosts the aggregate cost business taxpayers may expense for any tax year to $100,000 for property placed in service in tax years beginning in 2003, 2004 and 2005. In addition, the starting dollar amount for reduction of the expensing ceiling is increased to $400,000 for tax years beginning after 2002 and before 2006. For the 2004 and 2005 tax years, the $100,000 and $400,000 amounts described above are each indexed annually for inflation. For the 2003, 2004 or 2005 tax years, taxpayers may make or revoke the election on an amended return without IRS consent.

Alternative Minimum Tax Relief

While it is expected the various tax incentives provided by the 2003 Tax Act will push more taxpayers into an alternative minimum tax position, some relief is provided by an increase in the alternative minimum tax exemption amounts. The 2003 Tax Act increases the exemption amount for single taxpayers to $40,250 (from $35,750) and the exemption for married couples to $58,000 (from $49,000), effective only for the 2003 and 2004 tax years.
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