CCH Tax Briefing:
2003 ECONOMIC GROWTH TAX PLAN

Special Report

January 8, 2003

Highlights

- *Accelerated marginal rate cuts*
- *Expanded 10 percent bracket*
- *Marriage penalty relief*
- *Dividend tax relief*
- *Increased child tax credit*
- *AMT enhancement*
- *Higher small business expensing*
- *Retroactive to January 1, 2003*

Inside

Bush Unveils $674 Billion Stimulus Package; Tax Cuts, Dividends Exclusion Retroactive To Start Of 2003

President Bush announced an economic stimulus package on January 7, containing more than $670 billion in individual and business tax cuts over ten years. If approved by the Congress, the package would be the third tax cut in three years, slashing federal taxes more than $2 trillion since 2001. To win approval, President Bush must solidify support among Republicans and, more importantly, secure enough votes from Democrats. Both tasks will not be easy as the White House and Congress search for ways to boost the economy and pay for the war on terrorism. Nevertheless, the President's proposal will control the debate and significantly shape the major tax bill that is anticipated to come out of Congress this Spring.

Caution. Despite media reports to the contrary, President Bush has *not* proposed eliminating all taxes on all dividends. Only certain dividends are eligible for tax-free treatment. For example, dividends paid on stock in tax-deferred retirement accounts will remain subject to tax. More on this important difference later.

BACKGROUND

Last November, after Republicans won control of the Senate and retained control of the House, President Bush announced that he would propose an economic stimulus package early in 2003. The President hinted that his plan would call for accelerating the individual rate cuts under 2001's *Economic Growth and Tax Relief Reconciliation Act* (EGTRRA) and give other incentives to encourage business investor spending.

Comment President Bush's early comments brought immediate criticism from Democrats for not targeting tax relief to lower and middle income taxpayers.

INDIVIDUAL TAX CUTS

The Bush plan targets tax incentives for individuals and businesses as well as channeling funds to states for training unemployed workers. Highlights of the individual incentives are:

ACCELERATED MARGINAL RATE CUTS

Under EGTRRA, the individual marginal tax rates gradually decline over the next four years. The Bush plan would accelerate the rate cuts scheduled for 2004 and 2006 and make them effective as of January 1, 2003. Accelerating the rate cuts would cost $29 billion in 2003 and $64 billion overall.

If the Bush plan is approved, individual tax rates for 2003 would be:

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Proposed for 2003	Existing for 2003
10;	10
15;	15
25;	27
28;	30
33; and	35; and
35 percent	38.6 percent

Impact *See the tables on page 3 for examples of the maximum dollar savings in 2003 under the Bush plan for a cross-section of individual taxpayers.*

Comment If the Bush plan is approved, income tax withholding would be changed retroactive to January 1, 2003. A senior Treasury official stated that Treasury is ready to issue the appropriate tax withholding tables as soon as Congress passes the legislation. Wage earners would receive a boost in take-home pay based on reduced withholding.

Comment Like all other accelerated EGTRRA relief that is part of the Bush plan, the new rates are still scheduled to sunset after 2010 and return to the pre-2001 levels of 15, 28, 31, 36 and 39.6 percent.

Impact *Throughout 2002, many Republicans had been pressing for a cut in the capital gains rate. The Bush plan –and its cost to the federal budget—virtually guarantees that no reduction in the long-term capital gains rate will be considered this year. As a result, the gap between regular income tax rates and capital gains rates will be smaller, making tax planning to achieve capital gains status still valuable but certainly less urgent. Capital gains rates are generally 20 percent for most taxpayers (10 percent for those in the 15 percent bracket or lower; 18/8 percent rate for five-year property).*

Example. For joint filers with income of up to $114,650 (the top of the existing 27 percent bracket), each $100 of regular income (including net short-term capital gain) would be taxed at $25 under the Bush plan, while $100 in long-term capital gain continues to carry a $20 tax, or only a $5 difference.

Impact *With corporate rates no longer a bargain when compared against individual income tax rates, operating as a passthrough entity or as a sole proprietorship may make more sense under the Bush plan. For example, the effective corporate tax rate in 2002 for taxable income within the $100,000-$335,000 level is 39 percent; within the $75,000-$100,000 level, 34 percent; and within $335,000-$10,000,000 level, 35 percent. Personal service corporations are subject to a flat 35 percent rate on all income.*

"If approved by the Congress, the package would be the third tax cut in three years, slashing federal taxes more than $2 trillion since 2001."

EXPANDED 10-PERCENT TAX BRACKET

The Bush plan would also accelerate expansion of the 10-percent tax bracket to 2003 from its original 2008 start. Beginning immediately in 2003, the 10-percent rate would apply to the first $7,000 in income for single taxpayers, up from $6,000 under EGTRRA, and the first $14,000 in income for married couples, up from $12,000 under EGTRRA (the head of household cut off of $10,000 remains the same). In addition, the income thresholds would be indexed for inflation starting in 2004.

Impact *Since the 10-percent rate applies to all taxpayers irrespective of marginal tax bracket, every single filer paying taxes at a marginal rate above the 10-percent bracket will receive a tax benefit of $50, and every joint filer a $100 benefit from the new 10-percent bracket levels.*

Impact *Under EGTRRA, the $6,000/$12,000 levels were not to be adjusted for inflation until after 2008. The revenue cost of this provision for 2003 is estimated at $5 billion. With inflation, however, the new $7,000/$14,000 endpoints would increase to over $8,000/$16,000 by 2008. This is the primary reason for this provision's $48 billion price tag over 10 years when compared to the $64 billion cost over ten years for the acceleration of all the higher rate brackets into 2003. Expanding the 10 percent bracket would cost $5 billion in 2003 and $48 billion overall.*

MARRIAGE PENALTY RELIEF

Under EGTRRA, relief from the so-called "marriage penalty" will take effect starting in 2005 under a phase-in plan that would last through 2009. The Bush plan would accelerate and compress this relief so that it would begin immediately in 2003. Marriage penalty relief comes in two ways:

- The standard deduction for married couples is increased exactly twice the amount of the standard deduction for single taxpayers; and
- The 15 percent tax bracket for married couples is expanded so that the top dollar amount of that bracket for

married couples filing jointly is exactly double that of a single taxpayer.

Impact *For 2003, the standard deduction for joint filers would increase from $7,950 to $9,500. The top dollar amount in the 15 percent bracket would increase from $47,450 to $56,800. For couples above the 15 percent bracket, that's at least a 10 percentage point savings on this latter difference (25 percent bracket over the 15 percent bracket), which when combined with at least a 25 percent bracket savings on the increase in the standard deduction, equals at least $1,322.50 in the pocket of married couples filing joint returns. Those couples earning salaries relatively equal to one another will realize this amount as "marriage penalty relief." Those couples with one principal wage earner will actually realize a "marriage bonus."*

Impact *The top of the 10 percent bracket is already adjusted to eliminate the marriage penalty. The marriage penalty continues for brackets above the 15 percent level (although those couples share in the adjustment of the 15 percent rate).*

Accelerating marriage penalty relief would cost $19 billion in 2003 and $58 billion overall.

DIVIDENDS

The centerpiece of all the tax cuts in Bush's new economic stimulus proposal, and certainly the most controversial, is an exclusion of dividends paid by corporations to individuals from those shareholders' taxable income. The proposal, however, is not a 100 percent income exclusion for all dividends in every case and, therefore, imposes a level of significant complexity on what otherwise would be a fairly straightforward provision. In any event, this provision would be retroactively applied to dividends paid starting January 1, 2003.

The income exclusion only applies if the funds the corporation is used to pay the dividend have already been subject to tax at the corporate level (the corporation has paid tax on the funds). Any dividends paid by a corporation in excess of previously taxed corporate income would not be eligible for the income exclusion.

Impact *The principal reason for not providing a blanket income exclusion for dividend income is that the Bush Administration is promoting this tax cut by touting the fact that it eliminates the very unpopular "double taxation" of corporate income. Many investors have long decried the unfairness of taxing regular corporate income twice, both at the corporate and at the shareholder level. Elimination of the unpopular double taxation of corporate dividends may win some Democratic support. The White House claims that eliminating this double taxation of corporate profits will return $20 billion to the economy this year alone.*

Impact *Some experts fear that tying the dividend exclusion to the double-tax concept will create significant headaches for corporations now embroiled in tax shelter problems. The distribution of income sheltered from tax by a tax shelter would arguably be subject to tax on the shareholder level.*

Impact *President Bush also hopes to sell the dividend tax cut on Capitol Hill by arguing that almost half of the tax savings resulting from the income exclusion for dividends will go to senior citizens, who rely on dividends as a steady source of retirement income. According the President, the average savings for senior citizens who receive dividends will be $936.*

Impact *Under the current Bush plan, dividends paid on stock held in one corporation in another corporation would not be subject to this exclusion was presented, to apply only to individuals. There is already in the Code a dividend received deduction between corporations varying based on owenership.*

Corporate complications. If the dividend tax cut passes Congress, corporations would face a more complicated process when issuing dividends. When they send shareholders Form 1099 to report dividend payments, they will be obligated to calculate how much of the dividend can be excluded from income and how much is taxable. Pam Olson, Assistant Treasury Secretary (Tax Policy) indicated that this would involve a relatively simple set of calculations.

In addition, corporations with dividend reinvestment programs for dividends paid from funds on which the corporation was already taxed to taxpayers authorizing the reinvestment of their dividends would be involved in more complicated calculations and record-keeping. The corporation would theoretically have to keep track of the amount of tax savings that these taxpayers would be due (that was reinvested) and add that amount to the shareholders basis in the stock.

Impact *Some stock analysts have expressed concern that repealing taxes on dividends would favor older companies that do not create as many jobs as the younger companies, which tend to reinvest their dividends. Executives at companies that already pay dividends, often in the more established indus-*

tries, seemed more willing to increase their payouts in response to the tax change. There have even been predictions that technology companies would soon follow this lead since investors would crave immediate returns.

Impact *The President's proposal would not affect people who own stock in 401(k)'s and tax-deferred individual retirement accounts since their dividends would remain untaxed initially and then taxed at the ordinary income tax rates if the money is withdrawn. The Administration does believe that stock values will rise generally because of this provision.*

This proposal would cost $20 billion in 2003 and $364 billion over 10 years.

CHILD TAX CREDIT

Under EGTRRA, the $600 child tax credit is scheduled to rise to $1,000 by 2010. President Bush has called on Congress to accelerate the increase in the credit to 2003.

Checks will be sent. As a bonus to many families, qualifying taxpayers would receive advance payments of the increased child tax credit for the 2003 tax year. Treasury officials expect to send out advance refund checks this July to cover this increase for 2003, computing entitlement based on children claimed on 2002 returns.

Impact *President Bush included an increase in the child tax credit to make his plan more attractive to Democrats. White House staff are quick to tout the benefits of the Bush plan to families, mindful of the need for Democratic votes in the Senate. White House Spokesperson Ari Fleischer said immediately after the President's announcement that 34 million families with children would receive an average $1,473 tax cut in 2003.*

Accelerating the child tax credit would cost $16 billion in 2003 and $91 billion over 10 years.

ALTERNATIVE MINIMUM TAX

To make certain that the accelerated tax cuts do not throw people into being subject to the alternative minimum tax (AMT), the AMT exemption for married couples would increase by $8,000 and the exemption for single taxpayers would increase by $4,000.

Impact *This proposal does not address the underlying problems that will continue to subject an increasingly larger number of taxpayers to the AMT. Nor would it extend the temporary EGTRRA four-year increase in the AMT exemption beyond 2004. Together with the Bush plan increase, the new AMT exemption during the 2003-2004 period would be $57,000 for joint filers and $39,750 for single taxpayers.*

This proposal would cost $8 billion in 2003 and $29 billion overall.

BUSINESS INCENTIVES

Supersized Section 179 expense allowance

The maximum annual Code Sec. 179 expense allowance for 2002 is $24,000. Under current law, this dollar limitation increases to $25,000 in 2003 and later tax years. The Bush proposal would triple the dollar limitation to $75,000 beginning in 2003. At the same time, the trigger point of the investment limitation phaseout would increase from $200,000 to $325,000. The $75,000 and $325,000 figures would be indexed for inflation beginning in 2004. Currently, there are no inflation adjustments.

The investment limitation currently requires the reduction of the $25,000 dollar limitation by $1 for each dollar of qualifying property purchased in excess of $200,000. Thus, the current allowance is completely phased out at $225,000 ($225,000 - $25,000 = $200,000). Under the President's plan, a business would need to invest at least $400,000 in qualifying property before the proposed $75,000 expense allowance is fully eliminated ($400,000 - $325,000 = $75,000).

Example. ABC corporation places $380,000 of depreciable equipment in service in 2003. It must reduce its otherwise allowable $75,000 expense deduction by $55,000 ($380,000 - $325,000). Under current law, ABC could expense no amount since it has spent more than $225,000 in 2003.

Impact *The investment limitation has the practical effect of limiting the currently allowable expensing deduction to small and mid-size business taxpayers. The $125,000 increase in the limitation from $200,000 to $325,000, however, would make the deduction available to even more businesses.*

Impact *The incentive to purchase a heavy SUV may become irresistible as a result. Under the Bush plan, the full amount of the cost (up to $75,000) of a heavy SUV would be expensed in one year since the normal depreciation caps on business automobiles don't apply to vehicles with a gross weight of more than 6,000 pounds.*

Impact *When a taxpayer places assets with different MACRS recovery periods in service, it is generally advanta-*

geous to expense the assets with the longest MACRS recovery period. With the increased expense deduction amount, some taxpayer's won't need to make this evaluation. Further, the increased allowance will make it even easier for taxpayers to avoid the mid-quarter convention by allocating the allowance to property placed in service in the last quarter of their tax year. Amounts expensed under Code Sec. 179 are not taken into account in determining whether a taxpayer has placed more than 40 percent of the basis of its depreciable property in service in the last quarter, which causes the mid-quarter convention to apply.

Comment Increasing small business expensing has strong bipartisan support. Rep. John Spratt, D-S.C., senior Democrat on the House Budget Committee, indicated shortly after the President's announcement that $50,000 in increased expensing could be a compromise figure for Democrats and Republicans.

Caution. The President's proposal does not change the present-law rule that prevents the carryforward of any amount that cannot be deducted by reason of the investment limitation. Thus, in the preceding example, ABC cannot carry the $55,000 disallowed amount to 2004.

The President's proposal does not change the taxable income limitation either. This rule limits the expense allowance deduction to the total amount of taxable income derived from the active conduct of all trades or businesses that a taxpayer is engaged in during the tax year. Thus, in order to take advantage of the full amount of the proposed increase, a taxpayer needs to receive at least $75,000 of active taxable income. However, the current carryforward rules allow any amounts disallowed under this rule to be carried forward and claimed in future tax years.

The estimated cost of this proposal is $2 billion in 2003 and $16 billion over ten years.

RE-EMPLOYMENT ACCOUNTS

In addition to extending unemployment benefits, President Bush called on Congress to create new "personal re-employment accounts" for unemployed workers. Qualifying individuals would receive $3,000 for job retraining, child care, transportation or other unemployment-related expenses. If the recipient secures employment within 13 weeks, he or she would be entitled to keep any of the $3,000 that is unspent as a "bonus." The program would be administered through the states at a cost of $3.6 billion.

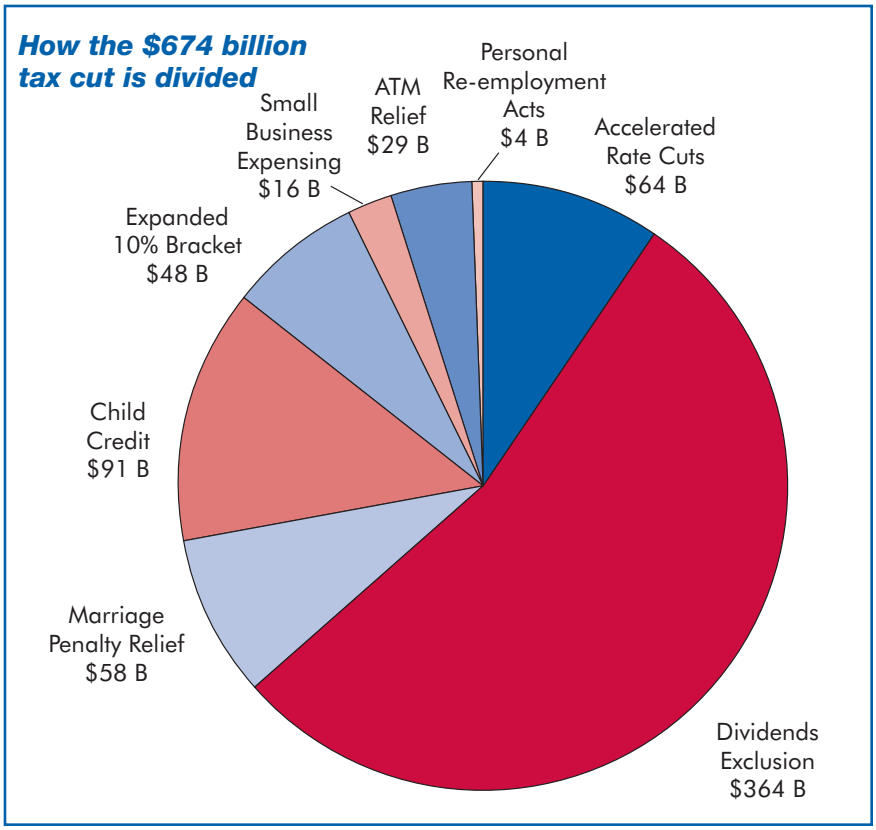
Comment Re-employment accounts apparently would be taxed in the same manner as traditional unemployment benefits.

IMPACT ON STATES

Combined, state deficits amount to nearly $100 billion, almost the same amount of the Bush plan tax cuts for 2003. Despite predictions that the President would propose direct aid to the states to offset declining revenues, the Bush plan's only aid to states is $3.6 billion for personal re-employment accounts.

The Treasury Department's position on why the Bush Administration did not specifically include aid to the states in the President's economic stimulus package was that it was not appropriate. Treasury officials maintain that the surest way for the federal government to help the states is to improve the nation's economy, since state tax revenues are primarily in trouble because of the economy.

State revenues fell primarily due to the bursting of the stock "bubble" in 2000, which has led to a drastic fall in the collection of the capital gains tax. The



BY THE NUMBERS

Sample 2003 Tax Rate Schedules Under The Bush Plan

Single

$0 to $7,000	10% of taxable income
$7,000 to $28,400	$700 + 15% of taxable income in excess of $7,000
$28,400 to $68,800	$3,910 + 25% of taxable income in excess of $28,400
$68,800 to $143,500	$14,010 + 28% of taxable income in excess of $68,800
$143,500 to $311,950	$34,926 + 33% of taxable income in excess of $143,500
$311,950 and over	$90,514.50 + 35% of taxable income in excess of $311,950

Married Filing Joint

$0 to $14,000	10% of taxable income
$14,000 to $56,800	$1,400 + 15% of taxable income in excess of $14,000
$56,800 to $114,650	$7,820 + 25% of taxable income in excess of $56,800
$114,650 to $174,700	$22,282.50 + 28% of taxable income in excess of $114,650
$174,700 to $311,950	$39,096.50 + 33% of taxable income in excess of $174,700
$311,950 and over	$84,389 + 35% of taxable income in excess of $311,950

Sample Tax Savings In 2003 Under The Bush Plan

Single taxpayer—no children, $50,000 of income

	Bush	Present Law	Savings	% of AGI
Adjusted Gross Income	$50,000	50,000		
Std. Deduction	4,750	4,750		
Personal Exemptions	3,050	3,050		
Taxable Income	42,200	42,200		
Tax	7,360	7, 686	$326	.65%

Married couple—two children under age 17, $100,000 of income, $15,000 of itemized deductions

	Bush	Present Law	Savings	% of AGI
Adjusted Gross Income	$100,000	100,000		
Itemized Deductions	15,000	15,000		
Personal Exemptions	12,200	12,200		
Taxable Income	72,800	72,800		
Tax	11,820	13,362	$1,542	
Child Credit	(2,000)	(1,200)	$800	
Tax after credits	9,820	12,162	$2,342	2.34%

Single individual , $100,000 of income including $3,000 of dividend income, $15,000 of itemized deductions

	Bush	Present Law	Savings	% of AGI
Adjusted Gross Income	$97,000	100,000		
Itemized Deductions	15,000	15,000		
Personal Exemptions	3,050	3,050		
Taxable Income	78,950	81,950		
Tax	16,852	18,813	$1,961	1.96%

Married couple - two children under age 17, $300,000 of income including $10,000 of dividend income, and $50,000 of itemized deductions

	Bush	Present Law	Savings	% of AGI
Adjusted Gross Income	$290,000	300,000		
Itemized Deductions*	45,485	45,185		
Personal Exemptions*	4,148	3,172		
Taxable Income	240,367	251,643		
Tax	60,767	69,607	$8,840	
Child Credit	(0)	(0)	0	
Tax after credits	60,767	69,607	$8,840	2.95%

* As reduced under present-law phaseout for high-income taxpayers

Administration's plan to eliminate the dividend tax is an attempt to boost the stock market, the result of which would be an increase in State revenue from capital gains taxation. However, critics believe that the overall impact on the stock market will be minimal because most dividend income is already distributed to non-profit entities such as pension plans, which already enjoy the benefits of tax exempt status.

Currently, many states are exploring stimulus packages of their own to attract business investment, such as tax-free economic zones and other incentives. However, for those states whose tax system "piggy-backs" the federal tax code, some of the changes in the Bush plan will hit them initially with lower revenues. The dividends exclusion and the additional expensing of business equipment threaten the biggest drain on state tax revenues. States anticipate that they will lose $5 billion on the dividend exclusion alone. Estimates show that California and New York would be hardest hit, losing 1.13 billion and 551 million dollars, respectively. This is also on top of an already touchy state budget crisis.

Critics also allege that the dividend may have an adverse effect on a State's borrowing ability. The dividend cut would purportedly draw money away from the bond market. To make bond investments more attractive to investors, States would have to offer higher interest rates. In addition, Critics allege that the size of the Bush plan would enlarge long term deficits and increase government borrowing. Both of these factors would put additional strain on State budgets. According to critics, the long term effect of these strains could result in job losses as States cut programs to balance their budgets. Instead of cutting an additional source of State revenue, critics advocate increasing State funding to alleviate the budgetary strains, a position consistent with current Democratic proposals.

DEMOCRATIC RESPONSE

According to President Bush, his plan generates economic growth not just over the short term but for the long-term. His

long-term approach is at odds with many Democrats who support ideas to immediately stimulate the economy, such as a payroll tax holiday and rebates.

Nancy Pelosi, D-Calif., new House Minority Leader criticized the Bush plan as a stimulus plan for only the wealthy. According to Pelosi, the dividend tax cut could cost $250 billion during the next 10 years. Taxpayers earning more than $1 million a year would receive 25 percent of its benefit.

Comment Pelosi has repeatedly questioned the viability of the dividend cut, pointing out that dividends are not taxed twice if a company has no tax liability. Many taxpayers keep their stock in tax-free retirement funds, which exempts their dividend payments from taxes at the time they are received, added Pelosi. Republicans have countered that the dividend cut would not benefit only the very wealthy since over the past ten years, stock ownership among middle income taxpayers has soared to record levels.

Democratic alternatives to the Bush plan include:

- ***Rebates.*** Democrats would repeat the 2001 "rebates," which were part of EGTRRA. Rebates could range from $300 to $600 depending on a taxpayer's filing status.
- ***Business investment.*** Businesses would be able to depreciate up to 50 percent of the cost of new equipment.
- ***Aid to states.*** Not part of the Bush plan, but supported by many in Congress, is direct aid to the states to compensate them for budget shortfalls due to increased spending for homeland security.
- ***Payroll taxes.*** Many Democrats support a temporary suspension of federal payroll taxes to boost wage earners' take-home pay and spending. Some have been proposing that payroll tax relief also be extended to employers, thereby particularly assisting small businesses and well as individuals. Bush Administration officials have criticized the proposal as possibly jeopardizing the health of the social security and Medicare trust funds.

MORE TO COME...

Even though Republicans control both the Senate and the House, they do not have a large enough majority in the Senate to pass tax legislation without support from Democrats. Under current Senate rules, 60 votes are necessary to pass tax legislation and Republicans control 51 seats. Republicans could try to move the Bush plan under the budget reconciliation process, which would require a simple majority.

Defections of just two or three Republicans could doom the President's plan. Some key swing Republicans have indicated that the Bush plan does not go far enough in boosting the economy in the short term and aiding lower and middle income taxpayers, an argument shared by many of their Democratic colleagues. In addition, some Democrats who supported the big 2001 tax cut either are no longer in office or have gone on record as saying they will not support another tax cut.

New Senate Majority Leader Bill Frist, R-Tenn., cautioned that "there will be adjustments" to the Bush plan. Nevertheless, the President holds a strong position to promote his agenda. Many experts are predicting that the President should get at least two-thirds of what he is proposing.

One possible target for change would be the dividend exclusion with represents over half the revenue cost of the entire tax plan. President Bush surprised many members of Congress by calling for 100 percent repeal of certain dividend taxes after early reports out of the White House indicated that he would propose a 50 percent reduction in dividend taxes. Already, leading Republicans and Democrats have indicated that the 50 percent figure could be a fall back position. Scaling back the proposal may be all that is needed to push the rest of his plan through.

Stay tuned!