THE EFFECT OF THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 ON REAL ESTATE INVESTORS

By J. Russell Hardin & Jack R. Fay

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On May 28, 2003 President George W. Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (hereinafter Act). This sweeping piece of legislation contains numerous amendments to the Internal Revenue Code that will cut Federal taxes by $320 billion over the next several years. Half of the new provisions accelerate tax cuts not set to take effect until 2006. Several of the provisions of the Act have implications for real estate investors.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code that are now the law or that will soon become the law and that pertain to real estate investments. Investors in real estate are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bill which, directly or indirectly, affect real estate investments. Some suggestions for tax planning are also included in the discussions. To determine the particular effect, if any, each of these provisions will have on a particular investment, each investor should consult with his/her CPA, Tax Attorney, or other tax professional.

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Exhibit 1

Taxable Years Beginning In:	The corresponding percentages shall be substituted for the following percentages:			
2000-2001	28%	31%	36%	39.6%
2002	27%	30%	35%	38.6%
2003 – 2010	25%	28%	33%	35%
2011 and there-after	28%	31%	36%	39.6%

INCOME TAX RATE CUTS

The Act focuses primarily on individuals and includes reductions in the four top marginal tax rates and expands the two lower tax brackets. The Act does not provide any major corporate tax relief, reflecting the Bush Administration's effort to limit tax relief to individuals. However, the individual rate cuts will provide relief to real estate investors who conduct business through sole proprietorships, partnerships and S Corporations.

Prior to the new law, rates ranged from 10% to 38.6%. The Act makes two major changes to the tax-rate structure:

1. The Act expands the 10% and 15% tax brackets.
2. The Act lowers all other individual tax rates.

The new tax law expands the 10% bracket from $12,000 of taxable income on a joint return to $14,000 and from $6,000 to $7,000 for single taxpayers. This expanded 10% tax bracket provides approximately $100 in additional tax relief for married couples and approximately $50 for single individuals. In addition, the 15% bracket was expanded to cover taxable income over $14,000 but not over $56,800 (formerly $12,000 to $47,450) for married individuals filing jointly. Single individuals will not experience an expansion of the 15% bracket. Their 15% bracket will still top off at $28,400.

The highest tax rate (38.6% for 2002) will be lowered by 3.6 percentage points to 35% while the 35% bracket is lowered to 33% and the 27% bracket is lowered to 25%. However, keep in mind that if Congress does nothing to change future rates, the tax rates revert to the year 2000 levels for 2011 and thereafter (*Exhibit 1*).

Tax Planning Tip:—Since the new tax rates will lower tax liabilities, individuals should be able to lower their estimated tax payments to reflect the lower tax rates. However, not all taxpayers will see a cut in their taxes. For example, the expansion of the 10% bracket does not affect heads of households and the expansion of the 15% bracket only applies to married individuals. In addition, when planning income flows on long-term investments, keep in mind that if the Congress does nothing to make these lower tax rates permanent, they will all increase in the year 2011.

ACCELERATED REDUCTION OF MARRIAGE PENALTY

In an effort to eliminate the marriage penalty imposed on most married couples filing jointly, the Act includes two provisions. First, the standard deduction for married couples is increased to double the amount of the standard deduction for single taxpayers in the years 2003 and 2004. Second, the width of the 15% tax bracket for married couples is increased to twice the width for single taxpayers in 2003 and 2004. These provisions were formerly scheduled to phase in over the period of time between 2005 and 2009. These reductions benefit

married couples who claim the standard deduction or who have taxable income greater than $47,450. The total tax relief provided to married couples by these provisions is estimated to be about $19 billion.

Tax planning tip—The doubling of the 15% bracket for married taxpayers is only effective for tax years 2003 and 2004. In 2005 the 15% bracket will only be 180% of the single bracket. The 15% bracket will be phased back up to 200% of the single bracket in 2008-2010 and will revert to year 2000 levels in 2011. Taxpayers may wish to determine whether items of income or deduction should be recognized in 2004 while the bracket size is double that of the single taxpayer.

INCREASE IN THE ALTERNATIVE MINIMUM TAX EXEMPTION

The Act is a double-edged sword when it comes to the Alternative Minimum Tax (AMT). The Act increases the individual AMT exemption amount by $9,000 (to $58,000) for married couples filing jointly and by $4,500 (to $40,250) for all single taxpayers. Even though this increase in the exemption is effective for 2003 and 2004, the provision expires at the end of 2004. This provision is a stop-gap measure to provide some AMT relief until Congress can address the issue in detail. However, if Congress takes no action to revise (or eliminate) the AMT provisions, the number of higher-income and middle-income taxpayers subject to the AMT could rise from 2.4 million this year to 33 million by 2010 when the AMT provisions of the ACT and the Economic Growth and Tax Relief Reconciliation Act of 2001 are fully phased in. Part of the increase is due to the lack of an inflation adjustment to the AMT exemption and part of it is due to the new lower tax rates. As a result, millions of taxpayers (primarily those making from $100,000 to $500,000) will realize little or no benefit from the new lower tax rates.

Tax planning tip—The Act specifically allows the reduced tax rate on capital gains and dividends for both regular income tax and AMT purposes. Taxpayers may want to consider selling some investments (that would generate capital gains) in 2004 that would have been sold in 2005 to potentially avoid the higher post-2004 AMT.

REDUCTION IN CAPITAL GAINS RATES

Generally, the maximum long-term capital gains tax rate for individuals is 20%. Individuals may use a lower rate of 10% if they are in the 10% or 15% tax brackets. However, if the capital asset has been owned for at least five years, the maximum capital gains rate is 18% for taxpayers who would otherwise be subject to the 20% rate and 8% for taxpayers who would otherwise be subject to the 10% rate.

The 2003 Act lowers the maximum tax rates on long-term capital gains. A 15% rate replaces the 20% rate under prior law and a 5% rate replaces the former 10% rate. A zero percent rate replaces the 5% rate for tax years beginning on January 1, 2008.

Some cautions are in order regarding the effect of the 2003 Act on long-term capital gains taxes. First, the reduction in long-term capital gains rates was not made retroactive to January 1, 2003. Therefore, sales of assets in 2003 that result in long-term capital gains will be subject to a transitional rule. The new lower capital gains rates apply only to long-term capital assets sold or exchanged on or after May 6, 2003. The higher rates are still in effect for sales of capital assets before May 6, 2003. Second, the Act did not reduce the overall maximum long-term capital gains tax rates. The 28% rate that is imposed on long-term capital gains from collectibles and from small business stock is unchanged. In addition, the maximum rate for unrecaptured Section 1250 gains remains at 25%. Finally, long-term capital gains rates revert to 2002 rates (20% and 10%) for tax years beginning in 2009 (if Congress fails to take action on this matter).

Tax Planning Tip—The new 5% long-term capital gains tax rate provides a significant opportunity for income and transfer tax planning. Taxpayers in the higher tax brackets could reduce the rate on long-term capital gains by gifting the appreciated property to children who are 14 years of age or older before selling the appreciated property. Assuming the children are in the lower tax brackets, the capital gains tax rate would be reduced from 15% to 5% of the taxable long-term gain.

ELIMINATION OF FIVE-YEAR HOLDING PERIOD

For tax years beginning after December 31, 2000, individuals could take advantage of special low long-term capital gains tax rates if they held the capital asset for more than five years. The 2003 Act eliminates this special five-year holding period rule. In other words, the new lower long-term cap-

ital gains tax rates discussed above are effective for ordinary long-term capital gains (gains on capital assets held for more than one year).

Tax Planning Tip—Many higher income individuals made a "deemed sale election" on their 2001 tax returns under Section 311 of the Taxpayer Relief Act of 1997 in order to have the five-year property rule apply to capital assets acquired before January 1, 2001. Under the 1997 Act, this election is irrevocable. However, it is likely that Congress overlooked this issue when passing the 2003 Act. If Congress later permits revocation of the election, amended returns should be filed at that time.

TAXABILITY OF DIVIDENDS

The taxation of dividends was an area in which President Bush focused a lot of energy during 2003. His reasoning was that if taxation of dividends is eliminated, the stock market should go up in value and help spur the economy. Dividends paid by corporations to individuals have been taxed as ordinary income for many, many years. Prior to the passage of the 2003 Act, dividends received by higher income individuals in 2003 could have been taxed at a 38.6% tax rate. There had been no rate reductions or other tax breaks for dividends since 1986. In early 2003, President Bush called for the complete elimination of individual taxes on dividends. When the 2003 Act was finally signed into law on May 28, 2003, a provision to reduce, not to eliminate taxes on corporate dividends paid to individuals, was included.

The Act reduces the top federal tax rate for dividends received by individuals to 15% and 5%. These are the same rates that apply to long-term capital gains. The reduced rates apply to qualified dividends received on or after January 1, 2003. A zero percent rate will apply to taxpayers in the 10 or 15% brackets for 2008 only. Dividends that are ineligible for the reduced rates include (but are not limited to) dividends paid by: credit unions, mutual insurance companies, farmers' cooperatives, tax-exempt cemetery companies, and dividends on stock purchased with borrowed funds if the dividends were included in investment income in claiming an interest deduction. If Congress takes no action to make these changes permanent, dividends received in 2009 and later years will be taxed at 2002 rates.

Tax Planning Tip—Corporations which pay little or no income tax due to a large amount of expense deductions may prefer to pay employee-shareholders a portion of their compensation as dividends instead of salaries. The advantage to individuals is that qualified dividends are taxed at lower rates than ordinary income. The advantage to corporations is that no employment taxes are paid on the dividends paid to the employee-shareholders.

DIVIDENDS PASSED THROUGH REITS AND RICS

A regulated investment company (RIC) is a corporation that invests in stocks and other securities and satisfies a number of tests spelled out in the Internal Revenue Code. RICs are taxed as corporations but can deduct their dividends. The shareholders of RICs are usually taxed on their dividends under the general rules applying to dividends. A real estate investment trust (REIT) is similar to a RIC except that it invests in real estate. Like a RIC, a REIT is taxed on its income and can deduct its dividends paid.

The rules regarding dividends passed through RICs and REITs are coordinated with the new rules for taxation of dividends under the 2003 Act. However, dividends from REITs will generally not qualify for the reduced dividend rates. A portion of REIT dividends will be classified as dividend income subject to the lower rates if the dividends are attributable to income which was subject to corporate tax at the REIT level, or they are attributable to dividend income which was received by the REIT from corporations in which the REIT is a shareholder.

INCREASE AND EXTENSION OF BONUS DEPRECIATION

The Job Creation and Worker Assistance Act of 2002 created a 30% additional first-year depreciation allowance for qualifying property. The property must generally be acquired after September 10, 2001 and before September 11, 2004 and be placed in service by December 31, 2004. The allowance is only available for new property that is depreciable under the Modified Accelerated Cost Recovery System (MACRS) and has a useful life of 20 years or less.

The Act of 2003 raises the provision for additional first-year depreciation to an amount equal to 50% of the adjusted basis of qualified property (taxpayers may elect to continue to use the 30% rate). Generally, to qualify, the property must

have been acquired on or after May 6, 2003 and before January 1, 2005. Property does not qualify if there was a binding written contract for the acquisition in effect before May 6, 2003.

Tax Planning Tip—Bonus depreciation is not a deduction for "earnings and profits" purposes. Therefore, a REIT can only benefit from bonus depreciation if its taxable income exceeds its dividends paid deduction. A REIT may then be able to use bonus depreciation to reduce its taxable income so that its taxable income is equal to its dividends paid deduction.

INCREASED SECTION 179 EXPENSING

The Act provides that the maximum dollar amount that may be deducted under Internal Revenue Code Section 179 is increased from $25,000 to $100,000 for property placed in service in tax years beginning after 2002 and before 2006. The deduction will also be adjusted for inflation each year. The amount eligible to be expensed may not exceed the taxable income derived by the taxpayer from the active conduct of a trade or business. The deduction disallowed by this limitation may be carried forward. The Act also increased the point at which phase-out of the qualifying investment begins from $200,000 to $400,000. This phase-out threshold will also be indexed for inflation.

Tax Planning Tips

1. Off-the-shelf computer software now qualifies for the deduction.
2. Equipment purchases should be structured, whenever possible, to make sure the $400,000 phase-out threshold is not surpassed.
3. If a taxpayer purchases assets which have different useful lives, it is usually better to apply Section 179 to the assets with the longest lives to maximize depreciation deductions.
4. Before deciding to elect Section 179, a firm should give consideration to long-range tax planning. For example, if a taxpayer is currently in the 15% tax bracket but expects to be in a higher bracket in the near future, the taxpayer may choose to forgo the Section 179 deduction in the current year so that larger depreciation deductions may be taken in later years when the tax rate is higher.

MISCELLANEOUS PROVISIONS

Taxpayers who have a child, stepchild, sibling, step-sibling or a descendant of any of these, or an eligible foster child who is under age 17 at the close of the calendar year, who is a U.S. citizen or resident alien, and for whom the taxpayer is allowed a dependency exemption, is eligible for the child tax credit. The Act of 2003 increases the amount of the child tax credit from $600 to $1,000 for tax years 2003 and 2004. However, the child tax credit will reduce to $700 for 2005 through 2008, and then rise to $800 for 2009, and return to $1,000 for tax year 2010. Without action by Congress, the child tax credit drops back down to $500 per qualifying child in 2011 and thereafter.

The accumulated earnings tax, a tax imposed on corporations that accumulate too much in earnings and profits while paying little in dividends, is lowered from the highest individual tax rate to a rate of 15%. The accumulated earnings tax rate is equal to the tax rate on dividends that will apply to most shareholders. The rate will revert back to the highest individual rate for tax years beginning after December 31, 2008.

Personal holding company rules penalize closely held corporations for earnings that remain undistributed to shareholders. These rules are designed to prevent corporations from being used to accumulate investment income or salaries on behalf of shareholders. A personal holding company is a corporation which at any time during the last half of the tax year had more than 50% of its stock owned by not more than five individuals and 60% or more of the corporation's income is personal holding company income. The Act of 2003 reduces the personal holding company tax rate to 15%. However, in 2009, the personal holding company tax rates will return to ordinary income tax levels (currently forecasted to be 35%).

CONCLUSION

This article has attempted to summarize some of the tax changes in the 2003 Tax Act. The focus has been on the changes that would directly or indirectly affect real estate investors and small businesses. The authors see no movement toward tax simplification by the U.S. Congress and the President, but the Jobs and Growth Tax Relief Reconciliation Act of 2003, hopefully, will meet the objectives of improving the economy and providing some relief to taxpayers. Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this Act commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act.

Appendix

The table below summarizes several of the tax changes discussed in this article.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Capital Gains										
Capital Gains Rate	20%	15%	15%	15%	15%	15%	15%	20%	20%	20%
Rate for taxpayers in 10% or 15% bracket	10%	5%	5%	5%	5%	5%	0%	10%	10%	10%
Dividends										
Dividends Rate	*	15%	15%	15%	15%	15%	15%	*	*	*
Rate for taxpayers in 10% or 15% bracket	*	5%	5%	5%	5%	5%	5%	*	*	*
**Ordinary rates apply*										
Income Tax Rates										
Highest Bracket	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6%
Fifth Bracket	35%	33%	33%	33%	33%	33%	33%	33%	33%	36%
Fourth Bracket	30%	28%	28%	28%	28%	28%	28%	28%	28%	31%
Third Bracket	27%	25%	25%	25%	25%	25%	25%	25%	25%	28%
Second Bracket	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Lowest Bracket	10%	10%	10%	10%	10%	10%	10%	10%	10%	**
***No 10% bracket*										
AMT Exemption										
Joint Filers	$49,000	$58,000	$58,000	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000
Single Filers	$35,750	$40,250	$40,250	$33,750	$33,750	$33,750	$33,750	$33,750	$33,750	$33,750
Section 179 Expensing										
Deduction Amount	$24,000	$100,000	$100,000	$100,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000