The Jobs and Growth Tax Relief Reconciliation Act of 2003: What Businesses and Investors Need to Know

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA" or the "Act"). The Act offers numerous incentives for businesses and investors to make investment decisions in a highly-favorable tax environment. This Report focuses on the key business and investment provisions in JGTRRA – the increased depreciation and expensing provisions, and the reduction in tax rates on dividends and capital gains – and how a business or investor may benefit from the new rules.

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I. Depreciation and Business Expensing Incentives

The Act provides a very favorable climate for capital investment. Specifically, JGTRRA increases the amount that small businesses may expense with regard to costs incurred to purchase certain types of business property. The Act also provides an additional first-year depreciation allowance equal to 50% of the qualifying property's adjusted basis. These provisions are described in greater detail below.

A. Increased Small Business Expensing Opportunity

Prior to the enactment of JGTRRA, taxpayers could elect to deduct immediately up to $25,000 of the cost of tangible business property placed in service during the taxable year. This deduction is reduced dollar-for-dollar by the amount by which the cost of all qualifying property placed in service during the taxable year exceeded $200,000. Thus, if the cost of the qualifying property exceeded $225,000, the taxpayer could not benefit from this election.

JGTRRA significantly expands this provision, both by increasing the maximum amount that can immediately be deducted, as well as by expanding the categories of property that qualify for this election. For taxable years beginning in 2003, the amount of the qualifying expenses that may be deducted is increased to $100,000 and the phase-out threshold is increased to $400,000. These amounts will be indexed annually for inflation in 2004 and 2005. In addition, costs incurred to purchase off-the-shelf computer software used in a business now qualify for the expensing election. These changes are retroactive to the beginning of 2003 and will remain in effect for 2004 and 2005.

B. Special Depreciation Allowance

Generally, a taxpayer may depreciate property used in a trade or business or held for the production of income. In most cases, the amount of the depreciation deduction for tangible property is determined under the modified accelerated cost recovery system ("MACRS"). Based upon the type of property, MACRS defines the method of depreciation and the applicable recovery period. With the exception of residential rental property and nonresidential real property, MACRS recovery periods range from 3 to 25 years.

Last year's Job Creation and Worker Assistance Act of 2002 allowed taxpayers to take an additional first-year depreciation deduction equal to 30% of the adjusted basis of certain qualified property. JGTRRA expands upon this provision by permitting taxpayers to recognize a first-year depreciation deduction equal to 50% of the adjusted basis of qualified property (the "50% bonus depreciation incentive").

To qualify for the 50% bonus depreciation incentive, the property must satisfy the following tests:

1. The property must be "qualified property," which is defined as: (a) property with a recovery period of 20 years or less, (b) capitalized computer software that may be recovered over 3 years, (c) water utility property, or (d) qualified leasehold improvements.
2. The original use of the qualified property must begin with the taxpayer after May 5, 2003.
3. The taxpayer must acquire, have entered a binding contract to acquire, or have begun the manufacture, construction, or production of the property after May 5, 2003 and before January 1, 2005.
4. The taxpayer must place the property in service before January 1, 2005. For property with a recovery period of at least 10 years and certain transportation property, the placed in service date is extended to January 1, 2006.

Special rules apply with respect to self-constructed property. Also, qualified property acquired by a taxpayer in a like-kind exchange or an involuntary conversion is eligible for the 50% bonus depreciation incentive. Taxpayers who claim the 50% bonus depreciation incentive under JGTRRA may not claim the additional 30% depreciation.

C. What Does This Mean to Business Investment?

- **The provisions provide small and mid-size businesses with a temporary but powerful economic incentive for capital expenditures before 2005.**

The following example illustrates the significant tax incentives that can be gained from the two provisions. In June 2003, a printing business agreed to purchase new high-speed copying equipment at a cost of $400,000. The equipment is considered 5-year property under the MACRS rules. The equipment will be placed in service on September 1, 2003, and it is the only equipment purchased in 2003. As a result of JGTRRA, the business will be able to recoup $280,000, or 70%, of the equipment cost in the year of purchase, as illustrated below:

Equipment cost June 2003	$400,000
JGTRRA Small business expensing deduction	(100,000)
	$300,000
JGTRRA 50% first-year depreciation	(150,000)
	$150,000
MACRS depreciation (200% declining balance method and half-year convention)	(30,000)
Balance	$120,000

The $120,000 balance would be recovered in subsequent years pursuant to the normal MACRS depreciation rules.

- **The 50% bonus depreciation incentive applies to a broad array of assets and transactions.**

The 50% bonus depreciation incentive applies to categories of assets that traditionally have not been covered by the MACRS depreciation rules. Perhaps most significant is that qualified leasehold improvements qualify for the bonus depreciation incentive (but not for the expensing provision). For this purpose, a qualified leasehold improvement is any improvement to an interior portion of a building that is nonresidential real property. The improvement must be made pursuant to a lease, and the improvement must be made in an area that is occupied exclusively by the lessee. Also, the improvement must be placed in service more than 3 years after the date the building was first placed in service. Common areas, building enlargements, elevators and escalators, and internal structural framework do not qualify as leasehold improvements.

Also significant is that qualified property acquired by a taxpayer in a like-kind exchange or an involuntary conversion is considered new, qualifying property eligible for the 50% bonus depreciation incentive.

II. The Reduction in Tax Rates on Capital Gains and Dividends

A. Capital Gains

The Act reduces the maximum rate on long-term capital gains for individuals to 15% (thereby eliminating the 18% capital gains rate for property held 5 years). The reduced long-term capital gains tax rate, which applies for purposes of both the regular tax and the alternative minimum tax, is effective for gains taken into account on or after May 6, 2003. The Act also reduces the capital gains rate for individual taxpayers in the lowest income tax bracket to 5% (from 10%) through 2007; in 2008, the tax rate on qualifying dividends and long-term capital gains for such taxpayers is reduced to zero.

The pre-JGTRRA capital gains rate structure, effective for long-term capital gains incurred prior to May 6, 2003, returns in 2009. In addition, the Act leaves in place the 25% maximum rate on long-term capital gains from real estate assets to the extent of unrecaptured real estate depreciation. Similarly, the 28% maximum rate for long-term capital gains from collectibles remains in effect.

B. Tax Treatment of Dividends

Perhaps the centerpiece of the Act was the reduction of the maximum rate on qualifying dividends received by individuals. The reduced tax rate, 15%, applies for purposes of both the regular tax and the alternative minimum tax, and is effective for dividends received after December 31, 2002 and before January 1, 2009.

Although most dividends received from domestic corporations and qualified foreign corporations are eligible for the reduced rates, the Act denies the benefits of the reduced rates to certain types of dividends. In particular, the reduced dividends tax rate is not available with respect to:

1. Dividends received from organizations exempt from Federal Income Tax under section 501;
2. Payments in lieu of dividends;
3. Dividends paid on stocks that fail to meet the required holding period; and
4. Dividends paid by a foreign corporation that was a foreign personal holding company, foreign investment company, or passive foreign investment company in the taxable year the dividend was paid or in the taxable year preceding the payment.

Dividends from a real estate investment trust ("REIT") are generally not eligible for the lower rate except to the extent the dividends represent income taxed at the REIT or qualified REIT subsidiary level.

The Act also imposes a required holding period for the stock on which a dividend is paid. The required holding period for common stock is 60 days within the 120-day period that begins 60 days prior to the ex-dividend date. The required holding period for preferred stock is 90 days during the 180-day period beginning 90 days before the ex-dividend date. Days on which the shareholder has hedged the shares do not count toward the required holding period.

Certain dividends of a foreign corporation are eligible for the reduced dividends tax rate. To qualify, the foreign corporation must be eligible for the benefits of a comprehensive income tax treaty with the United States which include an exchange of information program. Dividends of a foreign corporation that do not meet this threshold test may still qualify for the reduced dividend rates if the stock (or American Depository Receipt) upon which the dividend was paid is readily tradable on an established securities market in the United States.

Lastly, the Act lowers the tax on accumulated taxable income and undistributed personal holding company income from 38.6% to 15%.

C. Implications

- **Harmonizing the rates should simplify many transaction structures.**

As a result of JGTRRA, the maximum tax rate on dividend income for individuals now equals the maximum tax rate on capital gains for individuals – the last time the rates were ostensibly equal (that is, ignoring the 5% surtax) was prior to the enactment of the Revenue Reconciliation Act of 1990. In many instances, equalizing the rates will simplify corporate acquisition and disposition transactions – in these cases, the need to use a particular transactional form to achieve a desired tax rate no longer exists.

- **Other tax characteristics and attributes become more critical.**

Equalizing the tax rates for dividends and capital gains eliminates a significant tax issue that oftentimes dictates the form of the transaction. Much like the environment that existed following the Tax Reform Act of 1986 (in which ordinary income and net capital gains were taxed at a maximum rate of 28% for individuals), greater emphasis will be placed on the collateral tax consequences of a transaction. Issues such as utilization of tax basis, income characterization, and tax attributes, while important before the law change, become far more significant in the new paradigm. For example, a shareholder with a low stock basis may be more willing to receive a distribution in the form of a dividend because of the resulting effects on the corporation's earnings and profits calculation. Similarly, the existence of net operating losses and/or capital losses will have a greater impact on the structure of the transaction than it did prior to the Act.

- **Taxpayers will have less incentive to defer income.**

The 15% maximum tax rate on capital gains and dividends, which is scheduled to expire on December 31, 2008, may result in a decreased use of traditional income deferral techniques. This is particularly true for deferral techniques that result in ordinary income treatment in a later year, such as an ESOP. If a shareholder/owner concludes that the historically low 15% rate is indeed a temporary measure, he or she may decide to forego the traditional income deferral techniques and instead incur the tax liability in today's low-rate environment. Such long-term tax planning is further hampered by the uncertain fate surrounding the estate tax rules, which under current law are reduced through 2009, repealed for 2010, and resurrected in 2011.

- **Not all investment activity will benefit from the reduced rates.**

Although the Act significantly reduces the maximum tax rate on dividends and capital gains, the Act may actually increase the cost of certain investment activities. For example, the cost of entering into a short sale is now higher because payments in lieu of dividends are not eligible for the reduced rates. Thus, lenders of securities may demand a grossed-up "in lieu of" payment to account for the rate differential. Also, using leverage to acquire dividend-paying stocks may expose a taxpayer to increased costs of borrowing because qualified dividend income is not considered "investment income" for purposes of determining the amount of deductible investment interest expense, and so, to such extent, the taxpayer will not be able to deduct its investment interest expense.

- **Other consequences.**

There are a number of planning opportunities for closely-held businesses that should be considered, but only on a case-by-case basis.

III. Conclusion

The tax law changes under JGTRRA create a very favorable tax-friendly climate for businesses and investors. Please be sure to consult with us regarding how your specific business or investment situation can benefit from the new tax laws.

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