

## U.S. Individual Income Tax: Highest Tax Rate



Source: United States Treasury. Note: Red line indicates projected tax rates based on the recently enacted tax law.

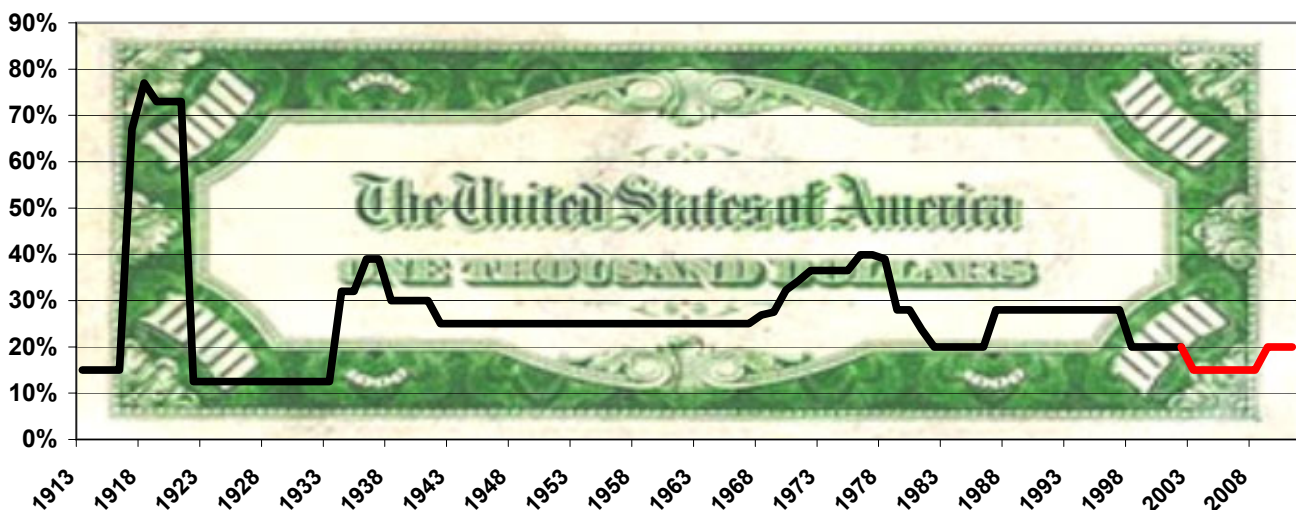
## The Jobs and Growth Tax Relief Reconciliation Act of 2003 - lower taxes, for a while...

"You're looking at a poor man who thinks the capital gains tax [cut] is the best thing that could happen to this country, because that's when the work will come back. People say capital gains are for the rich, but I've never been hired by a poor man."  
*New Jersey painting contractor - 1995*

As the third tax cut in as many years, the Jobs and Growth Tax Relief Reconciliation Act of 2003 offers taxpayers another dose of tax relief. For investors, one of its key features includes cutting the rate paid on dividends (from as much as 38.6%) and long-term capital gains (now 20%) to 15%. And for those in the two lowest tax brackets it also creates a 5% rate (that falls to zero for just one year in 2008). The new rates apply to dividends received in 2003 and capital gains taken after May 5, 2003.

There's just one challenge in planning for these changes and that's the automatic sunset provision. Without an act of Congress the dividend and capital gain reductions evaporate and revert to their old higher levels after 2008. Of course, Congress is constantly changing the tax rates anyway (see charts) so the challenges are not new.

## Capital Gains Tax Rates



Source: United States Treasury. Note: Red line indicates projected tax rates based on the recently enacted tax law.

"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."

*J.B. Colbert, 1619-1683, French government official*

### **A Little Tax History - taxing gunpowder & feathers**

Over time Congress has felt the need to change the income tax rates numerous times in response to wars, economic events and in pursuit of various social goals. For example, when the Civil War erupted, Congress passed the Revenue Act of 1861, imposing tax on personal incomes for the first time. The income tax was levied at 3% on all incomes higher than \$800 per year. By the spring of 1862 it was clear that the war would not end quickly and with the Union's debt growing daily it was equally clear that the Federal government would need additional revenues. In 1862 the Congress passed new excise taxes on such items as playing cards, gunpowder, feathers, telegrams, iron, leather, pianos, yachts, billiard tables, drugs, patent medicines, and whiskey. Many legal documents were also taxed and license fees were collected for almost all professions and trades. The need for Federal revenue declined sharply after the war and most taxes were repealed. The income tax was abolished in 1872 and the main source of Government revenue derived from liquor and tobacco taxes.

Income taxes were brought back again in 1913 after 36 States ratified the 16th Amendment to the Constitution. One of the problems with the new income tax law was how to define "lawful" income. Congress amended the law in 1916 by deleting the word "lawful" from the definition of income. As a result, all income became subject to tax, even if it was earned by illegal means. Collecting the tax was another matter...

### **The Most Recent Tax Law Changes - focusing on dividends**

As for this latest round of tax law changes, one major change for investors is that both long-term capital gains and dividends will be taxed at the same level. Under prior tax law, assuming a 38.6% income tax rate, an investor receiving \$100,000 in dividend income would pay \$38,600 in taxes. Under the new law, the same dividend income will be taxed at 15%, resulting in a \$15,000 tax liability, a net tax reduction of \$23,600.

As shown in the above example, the new tax law creates a powerful incentive for investors to find ways to convert ordinary income into dividend income. Thus, preferred stock and high dividend paying common stock may become attractive to income-oriented investors. Because interest income from corporate bonds will still be taxed at ordinary income tax rates, dividends from stocks will enjoy a big tax advantage over the next several years.

The new tax law includes a provision to prevent an investor from buying a stock one day, collecting a dividend the next, and selling it the day after. To qualify for the 15% rate on dividends, an investor must own common stock for more than 60 days during a 120-day holding period that begins 60 days before the stock's ex-dividend date (For preferred stock, the relevant holding period is 90 days during the 180-day period). This means that an investor must bear some risk of loss, as the 15% dividend tax rate doesn't apply if the stock is held for less than 61 days or if risk of loss is protected (hedged). In those cases the investor must pay regular income tax rates.

Some observers have even gone so far as to suggest that the new law could spell the end for stock options. They suggest that corporate managers would rather receive certain dividend income and get taxed at a 15% rate, than receive an uncertain payout from stock options and get taxed at a 15% rate. To pursue this goal, some corporations might be tempted to create a separate class of preferred stock paying a very large dividend that could be given to executives as compensation in lieu of stock options. This will be something for investors to keep a close eye on!

The new tax law may provide taxpayers with a host of other opportunities to reduce their taxes. For example, some taxpayers might want to consider gifting investments that have appreciated to their children in order to take advantage of the new low 5% capital gain rate. Or perhaps, the taxpayer might wait until 2008 when the low-bracket capital gain rate is scheduled to drop to zero for just one year (if it's not repealed before then).

**Caveat:** Please remember that while we are informed about many of the new tax law changes, we are not in the business of providing tax advice. We encourage you to check with your tax advisor to gain an understanding of how the tax law changes may directly impact you. By the way, we are not authorized to print money, thus the one thousand dollar note on the front is not legal tender.

### **Madison Financial Advisors**

2010 Madison Road, Suite 200 - Cincinnati, Ohio 45208 - Tel: (513) 871-4555 - [www.madisonadvisors.com](http://www.madisonadvisors.com)