

KING & SPALDING LLP
CLIENT ALERT

June 2, 2003

Re: Jobs and Growth Tax Relief Reconciliation Act of 2003

On Wednesday, May 28, 2003, President Bush signed into law the third largest tax cut in U.S. history. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “Act”) affects three basic areas. First, the Act reduces the tax rates for long-term capital gains and applies those reduced rates to qualified dividends. Second, the Act provides additional bonus depreciation allowances for qualified property and increases the maximum amount that may be expensed by small businesses under section 179 of the Internal Revenue Code (the “Code”). Third, the Act reduces individual income tax rates, reduces the “marriage penalty” and increases child tax credits — all accelerations of provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”).

Reductions in Taxes on Dividends and Capital Gains of Individuals

- Reduction in Capital Gains Rates for Individuals. The Act reduces the tax rates on net long-term capital gains of individuals from 10% to 5% (0% for 2008) and from 20% to 15%, depending on the individual’s applicable tax bracket. These lower rates apply to both the regular income tax and the alternative minimum tax on capital gains from property held for more than one year (short-term capital gains continue to be taxed at ordinary income tax rates).¹ These lower rates apply to gains recognized or otherwise properly taken into account (*e.g.* under the installment method) on or after May 6, 2003 and before January 1, 2009. In the case of pass-through entities, the determination of when gains or losses are properly taken into account is made at the entity level. The Act eliminates the additional 2% rate reduction for property with a five-year holding period.

The changes to the capital gains rates under the Act are scheduled to sunset at the end of 2008, with the result that the 10% and 20% rate (and the 2% rate reduction for five-year property) will apply again in 2009 and subsequent tax years.

- Dividends Received By Individuals Taxed at Capital Gains Rates. The Act generally provides that dividend income received by an individual from domestic corporations and “qualified foreign corporations” is taxed at the new long-term capital gains rates described above. The Act does not change the character of dividend income (*i.e.* dividends will continue to be ordinary income and will not be netted with capital gains or losses). The Act also does not change the tax rate (30% absent a treaty reduction) on

¹ The new rates do not apply to “unrecaptured Section 1250 gain,” which will continue to be taxed at the rates applicable under pre-Act law.

dividends received by non-U.S. individuals (except in rare cases where the dividends constitute income effectively connected to a U.S. trade or business of the individual).

To be a qualified foreign corporation, a corporation must not be a foreign personal holding company, a foreign investment company, or a passive foreign investment company, and such corporation must either be (1) incorporated in a possession of the U.S. or (2) eligible for the benefits of a comprehensive income tax treaty with the U.S. that the Treasury Department determines is satisfactory for this purpose and which includes an exchange of information program.² However, in a significant expansion of this provision, a foreign corporation that is not otherwise a qualified foreign corporation is treated as qualified with respect to any dividend paid on stock that is readily tradable on an established securities market in the U.S.

To be eligible for the lower tax rate, common stock must be held for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date. For preferred stock, the required holding period is more than 90 days during the 180-day period beginning 90 days before the ex-dividend date. These 60- and 90-day holding periods generally are reduced by any period in which the individual has an option to sell, is under a contractual obligation to sell, has made (and not closed) a short sale of, or has granted an option to buy the same or substantially identical shares or has diminished his or her risk of loss by holding one or more positions with respect to substantially similar or related property.

The lower rates do not apply to: (1) dividends received from a tax-exempt organization or a tax-exempt farmers' cooperative; (2) dividends received from a mutual savings bank, cooperative bank, domestic building and loan association, or savings and loan; or (3) deductible dividends paid on employer securities.

Qualified dividend income generally is not treated as investment income for purposes of the investment interest limitation. Investors can elect to treat qualified dividend income as investment income against which investment interest can be deducted, but the election causes the income to no longer be eligible for taxation at capital gains rates.

To the extent an individual receives an "extraordinary dividend" (as defined under Code section 1059) that is eligible for the capital gains rates, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the extraordinary dividend.

Dividends paid by a regulated investment company ("RIC") or a real estate investment trust ("REIT") for a taxable year may be eligible for the reduced rates, but the amount eligible is limited to the amount of qualifying dividends received by the RIC (or REIT)

² The Joint Explanatory Statement of the Managers of the Conference Committee indicates that until the Treasury Department releases guidance, a foreign corporation will qualify if substantially all of its income in the tax year in which the dividend is paid is eligible for the benefits of any comprehensive income tax treaty that includes an exchange of information provision (other than the U.S.-Barbados Treaty). Most U.S. tax treaties have provisions on information exchange.

for the year unless at least 95% of the RIC's (or REIT's) gross income (specially calculated for this purpose) for that year consists of qualifying dividends.

The Act provisions affecting dividends will be effective for tax years 2003–2008 and will terminate thereafter.

The rate benefits to individual shareholders for dividend income generally will not be sufficient to overcome the tax benefits available to U.S. corporate issuers from interest deductions. Thus, taxpaying U.S. corporations generally will continue to prefer debt financing in most circumstances. Non-U.S. corporate issuers, however, may find U.S. stock issuances attractive, depending upon local law treatment.

Reducing the tax rate on dividends to the capital gain rate, but not eliminating the tax on dividends as under President Bush's original proposal, will remove the potential incentive to structure corporate acquisitions and divestitures to produce dividend income. However, the relative neutrality between dividend and capital gain income will make many dividend-producing structures more acceptable when individual shareholders are involved.

- Related Provisions. The Act repeals Code section 341 (relating to “collapsible corporations”) and lowers the accumulated earnings tax and personal holding company tax rates to 15%. In addition, the Act treats ordinary income on the disposition of certain Code section 306 stock as dividend income for purposes of applying the capital gains rates. These provisions are effective for tax years 2003-2008 and will terminate thereafter.

Growth Incentives for Business

- Increase and Extension of Bonus Depreciation. Under the Job Creation and Worker Assistance Act of 2002, taxpayers were allowed to deduct depreciation on property owned or used in a trade or business, plus a 30% initial depreciation deduction on new property in the first year the property was placed into service. This 30% “bonus” depreciation was limited to certain “qualified property.” For this purpose, qualified property generally included (1) tangible property with a recovery period of 20 years or less, (2) certain computer software, (3) water utility property, and (4) certain nonresidential leasehold improvements.

The Act allows a 50% initial depreciation deduction for qualified property acquired after May 5, 2003 and before January 1, 2005. Property will be eligible for the 50% initial depreciation, however, only if no written binding contract for the acquisition was in effect before May 6, 2003. For property that is manufactured, constructed or produced by a taxpayer for its own use, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. In either case, the property must be placed in service before January 1, 2005 in order to qualify for the 50% bonus depreciation.

The Act permits taxpayers to elect to take 30% bonus depreciation in lieu of 50% bonus depreciation with respect to classes of qualified property placed in service during the

taxable year. Alternatively, taxpayers may elect to take neither the 30% nor the 50% bonus depreciation on classes of qualified property placed in service during the taxable year.

- Increase in Code Section 179 Expensing. The Act provides for an increase in the maximum amount that may be expensed by small businesses under Code section 179 (in lieu of claiming depreciation) to \$100,000 for qualifying depreciable property placed in service in tax years 2003–2005. The Act also provides for an increase in the phase-out threshold, raising it to \$400,000 for tax years 2003–2005 (*i.e.* the \$100,000 deduction is reduced by the amount by which the cost of the qualifying property placed in service during the tax year exceeds \$400,000). Both amounts are indexed for inflation in tax years 2004–2005, and thereafter will revert to their pre-Act levels of \$25,000 and \$200,000, respectively. The Act also extends Code section 179 treatment to off-the-shelf computer software that is placed into service in tax years 2003–2005.

General Individual Income Tax Relief Provisions

- Acceleration of Reduction in Individual Income Tax Rates. The 2001 Act provided a schedule under which certain ordinary income rates were reduced over a period of years. The Act accelerates this decrease, effectively creating rate brackets of 25%, 28%, 33%, and 35% for tax years 2003 through 2010. In 2011, the rates will revert to their pre-2001 Act levels of 28%, 31%, 36%, and 39.6%, respectively.
- Acceleration of the Child Tax Credit. The Act increases the child tax credit amount from \$600 to \$1000 for the years 2003 and 2004. After 2004, the child tax credit reverts to the previous schedule provided by the 2001 Act (\$700 in 2005 and increasing gradually until the end of 2010). Starting in July 2003, refund checks will be sent out for the 2003 tax year based on the 2002 filing status of the individual.
- Acceleration of the 15-percent Individual Income Tax Rate Bracket Expansion for Married Taxpayers Filing Joint Returns. The Act increases the size of the 15% rate bracket for joint filers to twice that of single filers for tax years 2003 and 2004. For tax years 2005 and thereafter, the rate will revert to the schedule provided for by the 2001 Act. This means that for the tax year 2005 the size of the bracket will be 180% of the size of the bracket for single filers. In the following years the ratio will gradually increase and will be 200% for 2008 until the end of 2010 when the provision terminates.
- Increase in Standard Deduction for Married Taxpayers Filing Joint Returns. The 2001 Act provided an increasing percentage rate by which the individual standard deduction would be multiplied to arrive at the joint filing standard deduction. The Act accelerates the 2003 and 2004 joint standard deduction for married taxpayers filing jointly to 200% of the standard deduction for individuals. After 2004, the rate will revert to the deduction schedule provided for by the 2001 Act — 174% in 2005 and gradually increasing to 200% in 2009 until the end of 2010 when the provision terminates.
- Acceleration of 10-percent Individual Income Tax Rate Bracket Expansion. The Act increases the 10% bracket for single filers in 2003 to \$7,000 for individual filers and

\$14,000 for married joint filers. For tax year 2004, the Act provides an additional inflation adjustment. For tax years 2005–2007 the income level subject to the 10% rate will revert to \$6,000 and \$12,000 for individual filers and joint filers, respectively, returning to \$7,000 and \$14,000, respectively, again in 2008 until the end of 2010 when the provision terminates.

- Increase in Alternative Minimum Tax Exemption. For tax years 2003-2004, the Act increases the alternative minimum tax exemption for single filers to \$40,250 and for taxpayers filing joint returns to \$58,000. For 2005 and subsequent tax years, these amounts would revert to their pre-2001 levels of \$33,750 for single filers and \$45,000 for joint filers.

Notable Provisions Omitted from the Act

The Act does not include a number of revenue raising provisions that initially were passed by the Senate. These provisions included the codification of the “economic substance doctrine,” which would have generally required that, prior to claiming tax benefits, a taxpayer show both a non-tax business purpose for entering into a transaction, and that the transaction materially changed the taxpayer’s economic position. Other Senate-passed provisions excluded from the Act include provisions relating to the expatriation or inversion of U.S. corporations, extending Code Section 269 to acquisitions of an interest in a corporation without regard to whether the taxpayer acquired “control,” the so-called “Enron provisions,” and the requirement that the chief executive officer of a corporation sign its tax return. Some of these provisions may reappear in subsequent legislation.

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This memorandum provides only a summary of the new tax provisions. If you have any questions or would like more information regarding the tax legislation, please call one of the attorneys listed below or any other member of our tax practice group.

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Table Summarizing Tax Reduction Provisions of Jobs and Growth Tax Relief Reconciliation Act of 2003

Description	Year	2003	2004	2005	2006	2007	2008	2009	2010	2011
Child Tax Credit		\$1,000	\$1,000	\$700	\$700	\$700	\$700	\$800	\$1,000	\$500
10% Bracket										
– Single filers		\$7,000	\$7,000 ¹	\$6,000	\$6,000	\$6,000	\$7,000	\$7,000 ¹	\$7,000 ¹	\$0
– Joint filers		\$14,000	\$14,000 ¹	\$12,000	\$12,000	\$12,000	\$14,000	\$14,000 ¹	\$14,000 ¹	\$0
Marriage Penalty Relief										
– standard deduction ²		200%	200%	174%	184%	187%	190%	200%	200%	?
– 15% bracket ²		200%	200%	180%	187%	193%	200%	200%	200%	?
Income Tax Rates ³										
– 28% rate		25%	25%	25%	25%	25%	25%	25%	25%	28%
– 31% rate		28%	28%	28%	28%	28%	28%	28%	28%	31%
– 36% rate		33%	33%	33%	33%	33%	33%	33%	33%	36%
– 39.6% rate		35%	35%	35%	35%	35%	35%	35%	35%	39.6%
AMT Exemption Amounts										
– Single filers		\$40,250	\$40,250	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750
– Joint filers		\$58,000	\$58,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000
First Year Bonus Depreciation Allowable		30%/50% ⁴	50%	0%	0%	0%	0%	0%	0%	0%
Section 179										
– Expense amount		\$100,000	\$100,000 ¹	\$100,000 ¹	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000
– Threshold amount		\$400,000	\$400,000 ¹	\$400,000 ¹	\$200,000	\$200,000	\$200,000	\$200,000	\$200,000	\$200,000
Long-Term Cap Gain Rates										
– Lower bracket taxpayers		5% ⁵	5%	5%	5%	5%	0%	10% (8%) ⁶	10% (8%) ⁶	10% (8%) ⁶
– Higher bracket taxpayers		15% ⁵	15%	15%	15%	15%	15%	20% (18%) ⁶	20% (18%) ⁶	20% (18%) ⁶
Qualifying Dividend Rates										
– Lower bracket taxpayers		5%	5%	5%	5%	5%	0%	taxed at ordinary income rates		
– Higher bracket taxpayers		15%	15%	15%	15%	15%	15%	taxed at ordinary income rates		

1. Subject to increase to reflect cost-of-living adjustment.
2. Year columns indicate amounts applicable to joint filers as a percentage of amounts applicable to single filers.
3. Rate shown in “Description” column are the rates as in effect prior to the Economic Growth and Tax Relief Act of 2001.
4. 30% rate is available for qualified property purchased before May 6, 2003; 50% rate is available for purchases of qualified property after May 5, 2003.
5. The 5- and 15-percent rates apply to gains recognized on or after May 6, 2003. For gains recognized before May 6, 2003, the applicable rates are 10% (8% for 5-year gain) for lower bracket (i.e., 10- or 15-percent bracket) taxpayers and 20% (18% for 5-year gain) for higher bracket taxpayers.
6. Amount in parentheses indicates applicable rate for 5-year gain property.