# TAX CUTS: Solution or Illusion?

*By Maye Albanez*

This past May 28th, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003. Over the next ten years, the new tax package includes $320 billion in tax cuts, $20 billion in aid to state and local governments, and $10 billion in child credits for low-income people who do not pay taxes.

***Prior to evaluating the merits or faults*** behind the new tax law, it is important to first understand the current distribution of federal tax payments across US taxpayers. According to government statistics, in the year 2000, the bottom 50% of filers had next to no federal income tax liability, since the top half paid 96.1% of the taxes due. The top 5% of all taxpayers paid 56.5% of federal taxes due, while the top 1% of all taxpayers paid 37.4% of all federal taxes due.

***On the positive side,*** many economists believe the tax package will provide a significant short-term lift. By itself, the tax cut is expected to boost gross domestic product by roughly 0.5% this year and another 0.5% next year. Add that to aggressive rate cutting by the Fed, a weak dollar that should help US exporters, big federal spending on defense and domestic security, and the pace for an economic recovery is likely to pick up.

***On the other hand,*** if the economy does not rebound strongly enough to pay for all these cuts, the current tax breaks may not be sustainable. Note that many expected state tax increases could offset the benefit of federal cuts. Tax cuts could come at a price of increased budget deficits, possibly higher interest rates and slower growth down the road.

**HIGHLIGHTS OF THE NEW TAX LAW**

- Rate cuts for both long-term capital gains and stock dividends
- Rate cuts for all income brackets
- Increase in the child tax credit from $600 to $1,000
- Elimination of the marriage penalty
- Increase in alternative minimum tax allowances
- $20 billion to state aid
- Increase of expensing of business-equipment purchases from the current $25,000 to a revised $100,000
- Bonus write-off for new equipment purchases by larger firms from 30% to 50%

This is a tax bill where 83% of the reductions will take place in the first three years. Rates will then rise to

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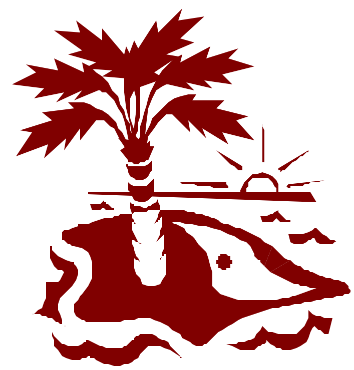
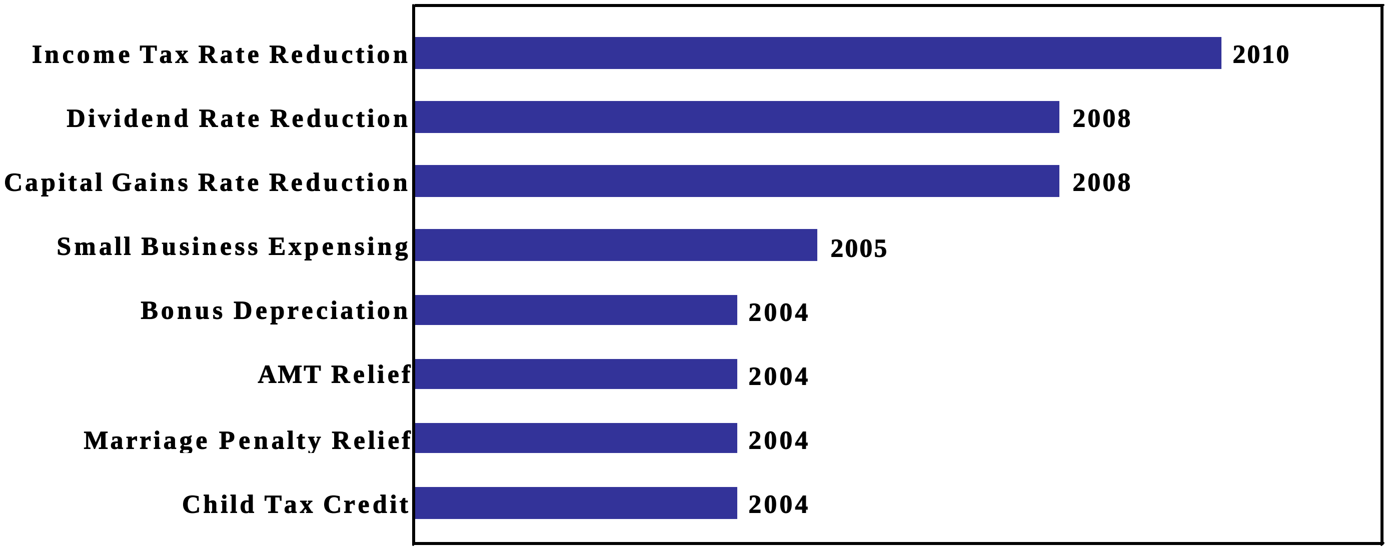


## *Inside:*

## EXPIRATION OF TAX CUTS




**Tax Cuts end 12/31 of year shown.**
**Except for capital gains rate cut which begins 5/6/03, all other are effective 1/1/03.**

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current levels again. The chart above illustrates the timing of such reductions and their sunset provisions.

Since the jury is still out as to how long these tax cuts will actually last, we think it is important to work inside the parameters of the cuts in place as a result of the new law. Following is a list of examples of investment strategies you may wish to consider and notes on some of the others:

### CAPITAL GAINS RATE REDUCTION

Effective 5/6/03, long-term capital gains will be taxed at a maximum of 15% instead of 20% through the end of 2008. For taxpayers in the 10% and 15% tax brackets, capital gains rate will drop to 5% from 5/6/03 through the end of 2007, and to zero in 2008.

- Consider transferring appreciated growth stocks to your children or grandchildren age 14 and over between now and the year 2007. In 2008, consider selling these stocks free of capital gains tax.
- Take your losses, but consider letting your gains run at least one year to receive the lower long-term tax rates. Short-term gains will continue to be taxed at ordinary income tax rates.

### DIVIDEND RATE REDUCTION

Between 2003 and 2008, dividends will be taxed at 15%, down from being taxed at ordinary income tax rates. For taxpayers in the 10% and 15% tax brackets, dividend rates will drop to 5% between 2003 and 2008, and will drop to zero in 2008.

- Consider transferring high-dividend-paying stocks to the same children age 14 and over.
- Closely-held corporations may consider increasing dividends; this could be a one-time opportunity to distribute low-tax income to owners.
- Borrowing money to buy dividend-paying stocks may no longer be a good strategy. Investment interest can be deducted only to the extent of investment income. Using a margin account in a taxable portfolio may nullify this tax relief benefit.
- This new tax treatment of dividends and capital gains could lead to lower level of corporate debt in companies' capital structures as stocks become more attractive than bonds—a welcome change.

### RETIREMENT PLANS

In light of better personal tax treatment of capital gains and dividends, the new tax law favors purchasing and holding stocks in investors' tax-

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able accounts, and purchasing bonds in IRAs, 401(k)s, and other tax-advantaged retirement plans.

- Since lower capital gains rates apply only to long-term holdings, consider owning short-term stock holdings and heavy-turnover mutual funds in your tax-free retirement accounts.
- Consider owning stocks in your taxable accounts, and owning bonds, especially high-yield ones, and real estate investment trusts (REITs) in your tax-free retirement plans.
- If you have a choice between putting money into a tax-deferred account and your taxable one, the taxable account may now be a better choice. There is still an advantage, however, to deductible IRAs and pre-tax 401(k)s, especially those with an employer match.
- Variable annuities are less attractive now as it makes little sense to draw funds from an annuity at ordinary income tax rates, when the alternative is 15% for dividends and capital gains taxes.

**CHILD TAX CREDIT**

- The Senate and House have vastly different versions of the child tax credit. The issue remains to be resolved in conference committee.

**ALTERNATIVE MINIMUM TAX (AMT)**

- The new tax law will bring out higher allowances in AMT for the years 2003 and 2004. However, a report by the Joint Committee on Taxation shows that the number of people with AMT liability should grow from an estimated 2.4 million this year to 11.3 million in 2005, and 30 million in 2010, unless Congress overhauls the law.

To close, given the many changes in the new tax law, keep the following in mind:

- Take advantage of more favorable tax treatments when appropriate, but investment decisions should continue to be made for investment reasons and *not* solely for tax reasons.
- As investment counselors, we are familiar with the recent tax law changes, but we are not accountants. We encourage you to obtain **your accountant's blessing** *prior* to implementing any structural changes we may recommend, as there may be specifics in the law which may make those changes more or less attractive in your individual case.

# Saving for College Just Got Easier

*By David Andrew*

Selecting a college savings plan has been almost as difficult as selecting a college. There are several popular saving plans available and each has its own unique advantages and disadvantages. Many families who plan ahead for college currently use at least one of the following types of plans to accumulate funds for college:

1. Custodial accounts (Uniform Transfer to Minors Act or Uniform Gift to Minors Act)
2. 529 Plans (Prepaid Tuition Plans and College Savings Plans)
3. Coverdell Education Savings Accounts (sometimes called an Education IRA)

While all of these plans are considered tax-favored savings accounts, the new tax law changes (which become effective this year) should make the college savings plan decision a little easier.

Prior to the recent tax law changes, 529 Plans were growing in popularity since any withdrawals for qualified higher education costs were tax-free until 2011. The new rules now make some of the advantages of 529 Plans less compelling. The new tax law shifts some additional tax advantages to custodial accounts for a limited period of time by lowering the capital-gains rate of people in the two lowest income-tax brackets of 10% and 15%. Under the new rules, people in these brackets, which is where kids over 13 years old tend to fall, will be able to sell stock at a 5% capital-gains rate between now and 2007, and at a 0% in 2008.

This change will benefit custodial accounts because they are the primary vehicles used to transfer securities to children. You cannot transfer securities to a 529 Plan. But like all things tax-related,

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**_Principals:_**

Maye Albanez, CFA

David Andrew

Peter Boyle, CFA

Ken Dike, Esq., CPA

Jim Fox

Terry Price

Ralph Weil, CFA

Bruce White

Randy Zaharia, CFA

**_Offices:_**

Pasadena,
California
(626) 792-2228

Huntington Beach,
California
(714) 846-2851

Evergreen,
Colorado
(720) 746-1244

**_Website:_**

www.clifford1915.com

there are a number of restrictions on who can qualify for the lower capital gains rate. Parents should make sure their child meets a number of prerequisites to benefit from the new tax law. Stock transfers must be made to children 14 and over to take advantage of the lower 5% and 0% tax rates. Children under 14 are subject to the so-called kiddie tax, which means that they pay taxes at their parents' rate. Also, keep in mind that the first $750 in earnings in a custodial account is tax-exempt. The new tax law also reduces the top tax rate on most dividends from 38.6% to 15%, the lowest since 1916. Parents should make sure that any stock sales do not push the child's income above the 15% bracket, which peaks at about $28,400, or the lowered rates will not apply.

Even with these new tax changes, parents still need to carefully evaluate all of the pros and cons of each college savings plan. Some of the more important factors to consider are: age, control of the account, withdrawal restrictions, state income-tax benefits, flexibility, investment costs, qualifying for financial aid, investment performance, and annual contribution amounts. Also, watch for further changes to these college savings plans and remember to seek the advice of a qualified tax preparer for your tax questions.

# Market Comment

*By Ralph Weil*

The equity market has risen more than 20% since its lows in mid March. These gains are impressive, and we are happy to report that many of our individual holdings had similar increases. While small capitalization companies as an asset class rose substantially more during the same time frame, some are once again selling at ridiculous valuations and are generally not found in Clifford portfolios. It would appear that a lot of market participants have quickly forgotten the ravages of the last three years.

Recoveries from major market bottoms are characterized by large percentage increases in prices for small companies that have managed to survive the down turn in the economy and equity market. It should be remembered that these companies had their market values cut by 80% or more in the downturn. While the move in these stocks does not surprise us, the question is will these companies' share prices continue to lead the market going forward? We do not believe that will be the case. The strong upward movement in their prices really represents a survivor effect, meaning that at the bottom of the market those stocks were being priced as if the company was going out of business. The real test for those companies will come if the economy resumes its downturn.

We believe that the chance of another downturn in the economy, at this time, is remote. We also believe that we may witness a small pull back in the market and then see a trading range that favors the larger capitalization companies that are represented in Clifford portfolios. As for the fixed income markets, we believe we have seen the low in rates for this cycle. Interest rates should start to rise as the economy improves.