

Tax Tidbits

2003 - A Year of Savings For The Taxpayer

Another tax season is upon us and thanks to the third-largest tax cut in U.S. history taxpayers may actually feel some relief this year. **The Jobs and Growth Tax Relief Reconciliation Act of 2003** was passed on May 28, 2003 and includes significant overall relief for individual taxpayers, specific tax breaks for investors and increased first-year deductions for businesses that purchase new machinery and equipment.

Much of this relief was set forth in the Economic **Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)**, which essentially served as the precursor to the Jobs and Growth Act. Some of the highlights of the EGTRRA include establishment of a 10% tax bracket, increased annual contribution limits for retirement accounts, education savings accounts, and increased federal estate tax exemptions coupled with decreased estate tax rates. These provisions still apply. In addition, the EGTRRA contained various provisions scheduled to become effective over the next three to five years, including decreases in overall tax rates, expansion of the 10% tax bracket, and reduction of the marriage penalty for married taxpayers filing jointly.

However, because the economy is still in need of a little encouragement, taxpayers will reap the benefits of these provisions sooner

rather than later. In an effort to put more money in taxpayers' pockets, the Act of 2003 provides immediate and widespread savings by accelerating some of the 2001 Act provisions. For example, the reduction of regular income tax rates above the 15% tax bracket originally scheduled to be effective in 2006 is accelerated to 2003. Likewise, the upper level of the 10% tax bracket is expanded in 2003, rather than 2008. This means that more income will be taxed at lower rates, resulting in direct savings for all taxpayers except those in the lowest tax bracket. In addition, the 2003 Act contained provisions especially beneficial to investors. The maximum tax on capital gains is reduced from 20% to 15%, and dividends, which used to be taxed at ordinary income tax rates, are now taxed at a maximum of 15%. This is all good news indeed!

Unfortunately, all good things must come to an end. Many of these tax breaks are only temporary, so unless the rules are changed again, some tax breaks for individuals will be diminished and some will disappear completely after 2004. In addition, more people may find themselves in alternative minimum tax as a result of these changes. However, let's not dwell on the negative, but rather focus on the positive and enjoy the reprieve while we can!

Volume 3, Issue 1
December 5, 2003



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Valicenti Advisory Tax Services

We would like to take this opportunity to introduce three new members of the Valicenti Advisory Tax Services team. Paul Hornbuckle, Sandy Cook, and Kathleen O'Herron have recently joined our firm and will be responsible for preparing all tax returns for the 2003 tax year. Together they will provide us with the knowledge and expertise necessary for proficient preparation of your tax return.

Now is a good time to start thinking about what information you'll need to prepare your 2003 tax return. You will most likely start receiving tax information in January. This is a reminder to get together all of your income information as provided by W-2s, 1099s and K-1s, etc. Gather your deduction information

including mortgage interest, real estate taxes, charitable contributions, and unreimbursed employee expenses. Take a minute to review your tax return from 2002 to make sure you're not forgetting anything. If you have any questions regarding your tax information or the tax preparation process, please contact Kathleen O'Herron at 734-2665 ext.115.

Please schedule an appointment to have your taxes prepared sooner rather than later. We want to ensure that all returns are prepared in a timely manner and the closer the calendar gets to April 15th the busier the tax team will be. We appreciate your cooperation in advance!

Inside this issue:

- *The 2003 Jobs and Growth Act* 2
- *What Does Alternative Minimum Tax Mean to Me?* 3
- *Tax Relief for Education* 3
- *Retirement Contributions* 4
- *More Tidbits* 4

The 2003 Jobs and Growth Act – A Closer Look

New Rules for Capital Gains

The Jobs and Growth Act of 2003 brings significant tax savings to investors by lowering the amount of tax paid on long-term capital gains. For investors in the 10% or 15% tax brackets, capital gains will now be taxed at 5%; for those in the 25% tax bracket or above, capital gains will now be taxed at 15%. But, since no tax rule is that simple, here are some caveats to be aware of:

- The new rules only apply to assets sold *after* May 5, 2003. Any sales prior to May 6, 2003 will be taxed at the old rates.
- Gain from an installment sale that would have qualified for the 10%/20% rates will now qualify for the 5%/15% rates, but the new rates will only apply to payments received after May 5, 2003.
- The lower rates are available under both the regular tax and AMT systems.
- In 2008, capital gains normally taxed at the 5% rate will be *tax free*, but only for that year.
- Barring any further legislation, after 2008 the pre-2003 Act capital gains rates of 10% and 20% will again apply.

Dividends Follow Capital Gains

Dividends received by an individual shareholder will be taxed at the same rates as long-term capital gains. Therefore, dividend rates are 5% (0% in 2008) for taxpayers in the 10% or 15% tax brackets and 15% for higher bracket taxpayers. However, unlike the capital gains rates, the new dividend rates are effective for all of 2003. A special holding period is required in order to receive the new lower rates. The stock must be held for at least 61 days and the holding period must include the last day before the ex-dividend date. The new lower dividend tax rates are applicable under both the regular tax and alternative minimum tax systems as well. Note that dividends are only treated as capital gains for the purpose of determining the tax rate that applies to them. Thus, they are not eligible to offset capital losses to any greater extent than other types of non-capital gain income.

Reduction in Tax Rates

The 2001 Tax Act included a series of tax rate reductions that were scheduled to take place over the period 2001-2006. The Act of 2003 accelerated these reductions, making the 2006 rates effective in 2003. The following table shows the rates before the law change and the new 2003 rates.

Prior 2003 rates	27%	30%	35%	38.6%
Reduced rates	25%	28%	33%	35%

These rate reductions will benefit all taxpayers whose taxable income is large enough to be taxed at rates above 15%. For 2003, this applies to taxable incomes above the following amounts:

Single	\$28,400
Married Filing Jointly	\$56,800
Head of Household	\$38,050
Married Filing Separately	\$28,400

The new rates are scheduled to last through 2010. Unless the law is changed, the rates in 2011 will revert back to the pre-2001 Act rates, which were 28%, 31%, 36% and 39.6%.

Expanded 10% Bracket

The Act of 2003 also accelerated the expansion of the 10% tax bracket originally scheduled for 2008. This means that more money will be taxed at lower rates, resulting in immediate savings for most taxpayers. For single taxpayers and married taxpayers filing separately, the first \$7,000 of income will be taxed at 10% (up from \$6,000). For married taxpayers filing jointly and qualifying widowers, the first \$14,000 of income will be taxed at 10% (up from \$12,000). There is no change for head of household taxpayers. Unfortunately, this savings will only last for 2003 and 2004. After 2004, pre-2003 Act law applies. But sit tight—the 10% bracket will once again expand in 2008 and will stay that way through 2010.

Marriage Penalty Relief

A “marriage penalty” occurs when married taxpayers pay more tax than they would if they were single. For example, in 2002, the standard deduction for single taxpayers was \$4,700, where the standard deduction for married taxpayers filing jointly was only \$7,850, resulting in a higher taxable income for these taxpayers simply because they are married. The Act of 2003 softens the marriage penalty by making the standard deduction for married taxpayers filing jointly exactly double that of single taxpayers; therefore, each taxpayer gets his or her full individual standard deduction. In addition, the income levels for the 10% and 15% tax brackets for married taxpayers filing jointly will be expanded to double that of single taxpayers. These amounts will be in flux for some time because in 2005 they go back to the 2001 Act amounts, only to gradually increase each year until 2009, when they will once again be at the 2003 amounts.

What Does the Alternative Minimum Tax Mean to Me?

Alternative minimum tax, a.k.a. AMT, was devised to ensure that high-income taxpayers don't escape taxation by making generous use of certain tax deductions, exclusions, and credits. AMT is a parallel tax system with its own set of rules. Both the regular tax rules and the AMT rules are applied to every taxpayer's situation, and whichever set of rules results in a higher tax is the one that must be used.

AMT is calculated beginning with adjusted gross income (AGI) minus itemized deductions. This amount is then increased by various items, known as preferences, to arrive at alternative minimum taxable income (AMTI). For most taxpayers, these preferences consist of itemized deductions disallowed under the AMT system. For example, state and lo-

cal taxes cannot be deducted for AMT purposes. Medical expenses can only be deducted if they are over 10% of AGI (versus 7.5% under the regular tax system). None of the miscellaneous itemized deductions subject to the 2% of AGI limitation (such as unreimbursed employee business expenses and tax preparation fees) are allowed under the AMT system. In addition, no deduction is allowed for personal exemptions.

A specified amount of AMT income is exempt from the alternative minimum tax and varies according to the taxpayer's filing status. The Jobs and Growth Act of 2003 increases the AMT exemption amounts for 2003 and 2004 to \$58,000 for married filing joint taxpayers and to \$40,250 for all other taxpayers. After 2004, the exemptions revert back to the

pre-2001 Act amounts. Like most exemptions, AMT exemptions are phased-out for taxpayers with high AMTI. The AMT system has two tax rates, 26% and 28%, depending on filing status and income levels.

The lower tax rates established by the Act of 2003 may force many more taxpayers into AMT than ever before. Although the AMT rules were established with higher-income taxpayers in mind, middle-income taxpayers with significant deductions and exemptions will find that they too must beware of the alternative minimum tax. Since both the regular tax rules and the AMT rules must be applied to each taxpayer, we're very thankful for our software, which does the computations for us!

Tax Relief for Education

Save! Save! Save!

The IRS continues to provide incentives for taxpayers to save for the enormous cost of higher education. Using either a 529 College Savings Plan or an Education Savings Account (ESA), taxpayers can create tax-free savings to fund future education expenses. Contributions are not tax-deductible, but both plans allow for tax-free growth. Distributions will be tax-free as long as they are used to pay for qualified education expenses. The maximum annual contribution limit for each plan is \$2,000. Your 529 Plan contribution may qualify for the \$11,000 annual gift tax exclusion (\$22,000) for married couples, which would significantly increase your savings potential.

Education Credits

Once education expenses are paid, the Hope Credit and the Lifetime Learning Credit are available to help taxpayers reclaim some of the money spent on education expenses. To qualify for the Hope Credit, a student must be in the first two years of a post-secondary degree pro-

gram. The maximum available Hope Credit is \$1,500. The Lifetime Learning Credit is available to students who are either in a degree program or who are taking classes to improve job-related skills. There is no limit to the number of years a person can take the Lifetime Learning Credit. The maximum amount of qualified education expenses for which a lifetime learning credit may be claimed is doubled to \$10,000 for 2003 (up from \$5,000 in 2002), increasing the maximum credit available to \$2,000 (up from \$1,000 in 2002). The bad news is, both credits are subject to AGI phase-outs beginning at \$41,000 for single taxpayers and \$83,000 for married taxpayers filing jointly. The credits are completely phased out for single taxpayers with AGI over \$51,000 and for married taxpayers with AGI over \$103,000.

Tuition and Fees Deduction

Taxpayers whose AGI is less than \$65,000 may deduct up to \$3,000 for qualified tuition and course-related expenses for the taxpayer, spouse, or de-

pendents. The deduction is taken "above the line" and therefore reduces the taxpayer's AGI. The courses do not have to be degree or job related to qualify, so take that art class you've always been interested in!

Student Loan Interest Deduction

A taxpayer may also deduct up to \$2,500 of qualified student loan interest paid for the year. The loan must be used to pay qualified education expenses, which include tuition and fees, all required books, room and board, transportation and all other necessary expenses. Most types of loan interest qualify, including interest on a credit card used *exclusively* to pay qualified expenses. Like other credits and deductions, the student loan interest deduction is also subject to AGI phase-outs, which begin at \$55,000 for singles and \$100,000 for married taxpayers filing jointly.



Retirement Contributions Available for 2003 and Beyond

Planning now for your retirement is one of the best gifts you can give yourself. Last year, the government gave taxpayers increased incentive to save for retirement by increasing the annual contribution limits for most retirement vehicles. Taxpayers can now contribute more to their retirement accounts than ever before and consequently defer even more taxes to the future. Taxpayers age 50 and over can make up for lost time by making “catch-up” contributions, which allow them to contribute more to their retirement accounts than those under age 50. See the chart below for the annual contribution limits for both individual and employer-sponsored retirement accounts.

Year	401(k)s, 403(b)s, 457s, and SEPs	401(k)s, 403(b)s, 457s, and SEPs for Taxpayers 50 and Over	Traditional and Roth IRAs	Traditional and Roth IRAs for Taxpayers 50 and Over	SIMPLEs	SIMPLEs for Taxpayers 50 and Over
2003	\$12,000	\$14,000	\$3,000	\$3,500	\$8,000	\$9,000
2004	\$13,000	\$16,000	\$3,000	\$3,500	\$9,000	\$10,500
2005	\$14,000	\$18,000	\$4,000	\$4,500	\$10,000	\$12,000
2006	\$15,000	\$20,000	\$4,000	\$5,000	\$10,000	\$12,500
2007	\$15,000	\$20,000	\$4,000	\$5,000	\$10,000	\$12,500
2008	\$15,000	\$20,000	\$5,000	\$6,000	\$10,000	\$12,500

Source: U.S. Internal Revenue Code

Qualified lower- and middle-income taxpayers who make retirement plan contributions may be eligible for a nonrefundable credit, known as the “saver’s credit”, in addition to any allowed deduction. This is one of the very few situations where a double benefit may be claimed. The “saver’s credit” is not available to taxpayers who were born after January 1, 1985, claimed as a dependent on another person’s tax return, or who were full-time students during any part of five months of the tax year. For more information about planning for your retirement, contact Ralph Roberts or Michael Valicenti at 734-2665.

More Tidbits...

Self-Employed Health Insurance

The percentage of health insurance premiums that may be deducted by self-employed taxpayers is 100% beginning in 2003, up from 70% in 2002. The deduction is taken “above-the-line” and therefore reduces the taxpayer’s AGI, which in turn will benefit AGI-sensitive deductions.

Social Security and Self-Employment Tax

Working taxpayers will now pay more social security tax as the wage and earnings base for 2003 is \$87,000, up from \$84,000 in 2002. The maximum social security tax for employees is \$5,394 (6.2% of \$87,000) and the maximum

self-employment tax is \$10,788 (12.4% of \$87,000).

Child Tax Credit

The Act of 2003 increased the Child Tax Credit from \$600 to \$1,000 for 2003 and 2004. The credit will be phased out for taxpayers whose modified AGI is above \$110,000 for married filing jointly or \$75,000 for single, head of household, or qualifying widower. After 2004, the credit will fall to \$700, as determined by the 2001 Act.

Child and Dependent Care Credit

In 2003, the Child and Dependent Care Credit was expanded for the first time in many years. Both the income levels and the credit percentages were increased.

The amount of eligible expenses increased to \$3,000 for one child and \$6,000 for two children (up from \$2,400 and \$4,800 respectively.)

Standard Mileage Rates

As gas prices rise, mileage rates go down. The Act of 2003 decreased the standard business mileage rate from 36.5 cents in 2002, to 36 cents beginning in 2003. The mileage rates for moving expenses and medical expenses are 12 cents per mile for 2003, down from 13 cents for 2002. The rate for volunteer mileage remains at 14 cents per mile.

