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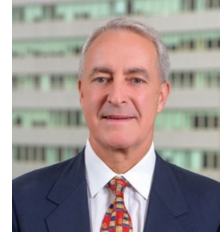
Thoughts for Investors



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Managing Director, Investments

Spring Newsletter to Clients

JUNE 2003

You will notice a difference in this newsletter, aside from the format. From time to time, other members of the team will contribute to the newsletter. Ty Agar wrote this issue and it is especially pertinent as Congress recently passed a significant tax bill, which has major financial planning implications. In this issue, Ty, as our CERTIFIED FINANCIAL PLANNER professional, will provide an update on important aspects of the new law and what people should be doing about them.

About the CFP® designation

Ty has recently been awarded his CERTIFIED FINANCIAL PLANNER designation. This professional accreditation shows a commitment to the financial planning process and is a three-year program that covers a broad and intensive overview of financial planning, including insurance, investment planning, retirement plans and benefits, estate, and tax planning. Certificants must pass education, examination, experience and ethical requirements in order to be awarded the designation.

Financial Planning

The best financial planning is holistic. As a discipline, financial planning should incorporate: cash management, insurance planning, investment planning, tax planning, retirement planning, and estate planning. Our focus is to look at all these areas of your financial life in conjunction with your other trusted advisors to develop recommendations. This process is done in six stages: establishing a dialogue; gathering information and defining goals; analyzing and evaluating your current financial status; presenting recommendations; implementing them; and monitoring and updating the plan.

Some financial advisors' solutions conveniently revolve around their single area of expertise.

For example, to someone that only has a hammer, everything is a nail. Others do an adequate job of carefully creating a plan, yet fall short on the practical implementation of that plan because of lack of expertise and/or licensing. A leather-bound binder of a non-implemented financial plan is worthless if it is sitting on a shelf collecting dust.

Our team has all the pieces to develop a customized plan coupled with the experience and expertise to implement those plans in a cost-effective manner. The correct approach to financial planning is similar to organizing and taking a vacation. Before backing out of the driveway, we need to know:

1) where we are going,
2) how we are going to get there, and
3) how long are we staying.

In that way, we can determine the best way to get there, hopefully even enjoying the trip along the way. It is interesting to note that many people spend more time planning their vacations than planning their future!

Making plans for our future is important. The new tax law presents significant changes that could impact our financial plans and we discuss them below.

The Jobs and Growth Tax Relief Reconciliation Act of 2003

On Wednesday, May 28, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). This $350 billion tax act is the 3rd largest tax cut bill in U.S. history.

As part of JGTRRA, many tax reductions based on the prior tax acts have been accelerated including: marriage penalty relief, an increase in the child tax credit, expansion of the 10% tax bracket, increased depreciation allowances and lower federal income tax rates. Among its new tax provisions, JGTRRA included a reduction of the tax on dividends and capital gains. Few anticipated the capital gains tax cut to accompany the dividend tax cut.

In the past, dividends were taxed as ordinary income, subjecting the cash flow to taxation at the maximum individual tax rate of 38.6%. Now, retroactive to January 1, 2003, dividends are taxed at a maximum rate of 15%, a 61% reduction! Taxpayers in the 10% & 15% tax brackets pay a maximum tax of 5% on dividends. This change presents an opening for more companies (who have the cash flow) to pay dividends to shareholders rather than retain the earnings and hope for stock price appreciation as a way to compensate shareholders.

The law even reduces the capital gains tax, going from 20% to 15% for long term capital gains after May 5, 2003. Moreover, taxpayers in the 10% & 15% tax brackets have the rate reduced from 10% to 5% and to 0% in 2008! These dividend and capital gain tax changes are especially great news, for instance, for investors with tax-free bond holdings, or anyone who has minimum taxable income and will therefore be in this 10% to 15% tax bracket. This is because their dividends and long term gains will only be taxed at 5%!

All these changes revert back to their old levels in 2009, yet there is a strong possibility that the provisions will be extended.

As a result of these changes, here are a few new financial planning strategies to consider:

· Evaluate the location of assets within your portfolio. For instance, investors might obtain a greater benefit from holding dividend-paying stock outside of their retirement accounts to take advantage of the lower taxation rather than holding stock inside the retirement account where it is may be subject to higher ordinary income tax when it comes out.

· Reconsider the desirability of certain investments like annuities, which may be subject to the old higher taxation.

· Review your tax withholding and estimated tax payments since the new tax rates are in effect as of January 1 and you might have already given an interest-free loan to the IRS.

· Consider gifting appreciated assets to a child who will be age 14 or older by 2008 (thereby not taxed at the parents' rate) to sell those assets for a zero capital gain in that year.

· Contemplate converting existing custodial accounts to Section 529 plans, receiving a lower capital gains tax now in exchange for future tax free appreciation!

· Remember that interest expense offsets interest income (which is taxed as ordinary income) so any interest expense incurred to buy stock that pays dividends, create dividend income, which is taxed at a lower rate.

· Examine the actual assets in your portfolio to determine the optimum way to generate overall cash flow, whether by dividends, interest or capital gains in light of your current tax bracket.

As you can see, these changes present many benefits to investors and business owners. We would love the opportunity to help coordinate a strategy that addresses how these tax changes impact your portfolio.

Ty Agar, CFP®
CERTIFIED FINANCIAL PLANNER

Professional

New Tax Rates

Individual tax rates above 15% are lowered across the board and are made retroactive to January 1, 2003.

The tax rates are lowered to: 35% from 38.6%, 33% from 35%, 28% from 30%, 25% from 27%

These rates revert back in 2010. The 10% bracket increases to $14,000 for joint filers and $7,000 for single filers. For 2005, the old thresholds reappear but only temporary. The 15% bracket is unaffected.

Dividends

The maximum tax rate for dividend income for individual shareholders is lowered to 15%. Investors at the 15% tax bracket have a 5% dividend until year-end 2007. Then the rate is zero for 2008. Old rates return in 2009.

Capital Gains

The maximum net capital gains rate is 15%. (Those in the 15% tax bracket will have a 5% max capital gains rate, which turns to zero in 2008). The capital gains rate is in effect for transactions on or after May 6, 2003 through December 31, 2007. On January 1, 2009 the old 20% and 10% rates return.

Child Tax Credit

For 2003 and 2004 the child tax credit is $1,000. It drops to $700 for 2005, then returns to $1,000 in 2010. This child tax credit is phases out at the adjusted gross income rate of $110,000 (married filing jointly) and $75,000 (for single filers).

AMT

The exemption amount for Alternative Minimum Tax rises to $58,000 for married taxpayers and $40,250 for single taxpayers for 2003 and 2004.

Marriage Penalty Relief

In 2003 and 2004 only, the standard deduction for a married couple is increased to double the standard deduction for single taxpayers.

Section 179

Personal property used in a trade or business can be written off up to $100,000.

Items purchased after May 5, 2003 through January 1, 2005 have additional first year bonus depreciation of 50% that can be taken on top of regular depreciation and the Section 179 deduction.

AUDI PARTEM ALTERAM

Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

Thoughts for Investors is a quarterly newsletter written for clients since 1997 by this author. The purpose is two-fold. First, it is meant to help explain the investment philosophy that guides the author's approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.

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