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PLANNER RESOURCES

DON'T LET NEW TAX ACT DISTRACT FROM INVESTING BASICS, SAY FINANCIAL PLANNERS

The new tax act presents challenges and opportunities for investors. But don't let the new act distract you from sticking with the fundamentals of investing, say financial planners. Here are some of the highlights and possible investing implications of the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Lower capital gains rate. The new act lowers the maximum regular capital gains tax rate from 20 percent to 15 percent. For lower-income taxpayers, the rate falls from 10 percent to 5 percent, and all the way to zero in 2008—for one year. The new rates apply only to investment assets held at least one year and sold on or after May 6, 2003 (short-term gains are still taxed at your ordinary income tax rate). To complicate matters, the lower capital gains rates, as well as the lower rates on dividends, expire on January 1, 2009.

Lower dividend rates. “Qualified” dividends will be taxed at the investor's regular capital gains rate. This is a dramatic cut, especially for high-income investors. Like the capital gains provision, the tax on dividends disappears in 2008 for lower-income investors, and the entire provision expires in 2009, returning to the pre-act rates. Unlike capital gains, however, the lower dividend rate goes into effect retroactive to January 1, 2003.

There remains considerable confusion as to what constitutes “qualified” dividends. Generally, these are dividends paid out from profits that have already been taxed at the corporate level. What sometimes is reported as “dividends” from mutual fund money markets and bond funds is actually interest, and will not qualify. Some dividends from stock mutual funds won't qualify for the lower rate, either, and neither will most dividends paid from real estate investment trusts (REITs).

Beyond these specific investment tax changes, the broader question is, what does all this mean for investors? What changes should investors make, if any, in their portfolios, in how and where they invest? The only thing certain at this point is that investment experts disagree on many of the implications of the new law.

For example, some experts argue that variable annuities, whose earnings grow tax deferred, lose some of their luster with the new act. They say that VAs have higher fees compared with a taxable mutual fund, and that when taxable withdrawals are made from annuities investors pay taxes on the earnings at their ordinary income tax rate instead of the lower capital gains and dividends rates they would pay on withdrawals from taxable mutual funds. Defenders dismiss the notion that VAs will suffer much because they offer other benefits, or can be used to invest in assets that won't benefit from the tax act, such as REITs.

The same argument is being debated regarding 529 college savings plans, which are state-run mutual-fund-type programs whose earnings grow tax deferred and remain free of tax entirely if used for qualified education expenses. Again, critics think investors may be better off investing in tax-managed stock index funds, for example, which have lower fees and whose after-tax, after-expense return in light of the new investment-tax rates may actually be better than the after-expense return of 529 plans.

Another education-funding alternative, suggest some, is to pass ownership of taxable assets on to your college-bound child so he or she can sell them in 2008, when capital gains rates drop to zero for low-income taxpayers.

Some experts think individual stocks paying higher dividends, such as utilities, will become more attractive, as will income-oriented stock mutual funds. And for investors in the highest income tax bracket, the spread between their new ordinary income tax bracket (35 percent) and the new capital gains rate is greater than the spread before the act, making capital gain income even more valuable to them.

The implications of the new tax provisions will take a while to examine thoroughly. While some investment changes might be advisable now or in the future, many financial planners advise investors not to make radical changes to their portfolios based only on the new tax act. Instead, they should keep their eyes on the prize (achieving personal financial goals) and stick to the dependable: investing regularly in a diversified portfolio that's designed for their needs and regularly reviewed.

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