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WHAT'S NEW FOR 2003 - A ROUNDUP OF NON-INFLATION-INDEXING TAX CHANGES EFFECTIVE THIS YEAR

Although automatic inflation-indexing provisions result in numerous tax changes for 2003, many other important tax changes go into effect this year. Some are the result of tax legislation enacted in 1996 through 2002, while others are triggered by the effective date in regulations. Here's a review of the non-indexing changes for 2003 for individuals, businesses, retirement plan and estate and gift tax.

TAX CHANGES FOR INDIVIDUALS

P **Maximum Lifetime Learning Credit is doubled**. Starting in 2003, the Lifetime Learning credit per taxpayer (as opposed to per student) is equal to 20% of up to $10,000 of qualifying higher education expenses, including graduate-level education. The maximum credit is thus $2,000—double the 2002 maximum of $1,000.

P **Lower estimated tax payments for some higher-income taxpayers.** To avoid an estimated tax underpayment penalty for 2003, a taxpayer whose adjusted gross income for 2002 exceeded $150,000 ($75,000 for married persons filing a separate return), must prepay the smaller of (1) 90% of the tax for 2003, or (2) 110% of the tax shown on the 2002 return. This is an easier requirement than the one that applies for 2002, for which the required annual payment for higher-income taxpayers is the smaller of: (1) 90% of the tax bill for 2002, or (2) 112% of the tax shown on the 2001 return.

P **Child and dependent care credit liberalized.** A number of changes are in place for 2003:

- The maximum credit percentage is 35% (up from 30%) reduced (but not below 20%) by 1 percentage point for each $2,000 (or fraction thereof) of AGI above $15,000 (up from $10,000).

- The employment-related expenses against which the credit is applied is up to $3,000 for one qualifying individual or up to $6,000 for two or more qualifying individuals (up from $2,400 and $4,800, respectively.) The amount of income treated as earned by a spouse who is a student or incapable of self-care is $250 a month for one qualifying individual and $500 a month for two or more qualifying individuals (up from $200 and $400 respectively).

- The maximum credit is $1,050 for one qualifying individual (35% of $3,000) or $2,100 for two or more qualifying individuals (35% of $6,000) (up from $720 and $1,440, respectively.)

P **Adoption credit liberalized.** For 2003, taxpayers may claim a $10,160 credit for the adoption of a special-needs child (less expenses paid or incurred in prior years), regardless of actual adoption expenses. (Before 2003, the credit was available only for qualifying adoption expenses actually paid.) Similar rules apply for purposes of the exclusion for employer-provided adoption assistance.

- **No more luxury auto excise tax.** Luxury autos no longer are subject to an excise tax. For 2002, they were subject to an excise tax equal to 3% of the excess of the sale price of the vehicle over $40,000.

TAX CHANGES FOR BUSINESS

- **Boosted annual expensing limit.** The maximum annual expensing amount under Code Sec. 179 is $25,000 (up from $24,000 for 2002). The maximum expensing amount is increased to $60,000 (up from $59,000) for qualifying Liberty Zone property, qualified zone property of an enterprise zone business and qualified renewal property.

- **Self-employed health insurance completely deductible.** Qualifying self-employed taxpayers may deduct 100% of their health insurance premiums, up from 70% for 2002. The 100% deduction also applies to partners and more-than-2% S corporation shareholders.

- **Lower optional mileage allowance deduction.** The optional mileage allowance for owned or leased autos (including vans, pickups or panel trucks) is 36¢ for each mile of business travel (down from 36.5¢ for 2002). The mileage allowance figure also may be used to value personal use of certain employer-provided vehicles. Additionally, record keeping is simplified if an employer reimburses employees who provide their own autos for business use at a rate that doesn't exceed the optional mileage allowance.

- **More reporting chores for non-statutory stock options.** Employers must report compensation from the exercise of non-statutory stock options in box 12 of Form W-2, using Code V, on Forms W-2 issued for 2003 and later years. The compensation element is the “spread”—the fair market value of the stock purchased less the exercise price under the option. Before 2003, the employer had to report compensation from the exercise of non-statutory options on Form W-2 as part of the employee's wages in boxes 1, 3 (up to the social security wage base), and 5, but did not have to show the spread separately. The new reporting requirement does not apply to exercises of statutory options (incentive stock options or employee stock purchase plan options), which aren't subject to FICA, FUTA or income tax withholding either on option exercise or on disposition of the option stock.

- **New tax shelter disclosure regs in place.** New temporary tax shelter disclosure regs are effective for transactions entered into after 2002. Additionally, revised list-maintenance temporary regs apply to potentially abusive tax shelters entered into or acquired after 2002 (and to any transaction entered into or acquired after February 28, 2000, that becomes a listed transaction subject to disclosure under regulations.

- **Income averaging changes for farmers.** A landlord is engaged in a farming business for Code Sec. 1301 income averaging purposes for rental income that is based on a share of production from a tenant's farming business and, for amounts received after 2002, is determined under a written agreement entered into before the tenant begins significant activities on the land. However, a landlord is not engaged in a farming business with respect to (1) fixed rent, or (2) rental income received after 2002 based on a share of a tenant's production determined under an unwritten agreement or a written agreement entered into after the tenant begins significant activities on the land.

- **Foreign tax credit changes.** Statutory changes to the foreign tax credit rules that were enacted as part of the '97 TRA apply for the first time for tax years beginning after 2002. The changes significantly reform the treatment for foreign tax credit purposes of dividends paid by certain foreign corporations with U.S. ownership (so-called "10/50 corporations"). The '97 Act eliminated the separate foreign tax credit baskets for dividends from each 10/50 corporation and instead provide "look-through" treatment for dividends paid by a 10/50 corporation out of earnings and profits accumulated in post-2002 tax years.

- **Many changes in non-penalty excise tax rates.** Numerous non-penalty excise tax rate changes are effective after 2002, including increases in the taxes on use of international air travel facilities, and on gasohol and ethanol.

TAX CHANGES FOR RETIREMENT PLANNING

- **First opportunity for earnings from Roth IRAs to be withdrawn tax-free.** A distribution of earnings from a Roth IRA is tax-free if made: (1) after the five-tax-year period that begins with the first tax year for which the taxpayer makes a contribution to a Roth IRA; and (2) on or after the taxpayer's attainment of age 59-1/2, disability, death or for qualifying first-home expenses. The first year for which Roth IRA contributions could be made was 1998; so 2003 is the first year in which condition (1) can be satisfied. Thus, for example, an individual who made a Roth IRA contribution in 1998, and is now age 59-1/2 or older, can make tax-free withdrawals of earnings from any of his Roth IRAs.

- **Final regs on required minimum distributions are in effect.** The final regs on required minimum distributions (RMDs) must be used for determining RMDs for 2003 and later years (although taxpayers could rely on them for the 2002 year). These final regs carry more favorable life expectancy tables than earlier guidance and thus allow RMDs to be paid out over a longer period, liberalize the RMD rules that apply where an IRA owner dies on or after his required beginning date (generally, April 1st of the year following the year in which he attains age 70-1/2), and leave less time under some circumstances to perform post-mortem planning.

- **New RMD information reporting requirements apply for custodians and trustees of IRAs.** If a required minimum distribution (RMD) is required from an IRA for a calendar year after 2002 and the IRA owner is alive at the beginning of the year, the trustee that held the IRA as of December 31st of the prior year must provide a statement to the IRA owner by January 31st of the calendar year regarding the RMD for the year. The trustee can meet this requirement by providing either:

  - a statement indicating the RMD amount and the date by which it must be distributed, or

  - a statement informing the IRA owner that an RMD is required for the calendar year and the date by which it must be distributed, accompanied by an offer to furnish, on request, a calculation of the RMD amount.

The statement used must be provided to the IRA owner by January 31st of each calendar year for which an RMD is required. Thus, the first statement must be provided by January 31st of the calendar year in which the IRA owner reaches age 70-1/2 since an RMD is required for that calendar year even though it doesn't have to be made until April 1st of the following year.

P **Voluntary employee contribution to deemed IRAs.** For plan years beginning after 2002, a qualified retirement plan may allow employees to make voluntary employee contributions to separate IRA or Roth IRA accounts or annuities.

P **Boosted dollar limits for elective deferrals and catch-up contributions**. The following limits all increase by statute for 2003:

- *Elective deferrals*. The limit on the exclusion for elective deferrals for 401(k) plans, 403(b) annuities, SEPs and the federal government's Thrift Savings Plan, increases from $11,000 to $12,000. The same increase applies to the limit on deferrals for deferred compensation plans of state and local governments and tax-exempt organizations.

- *SIMPLE salary deferral.* The maximum amount of compensation an employee may elect to defer for a SIMPLE plan increases from $7,000 to $8,000.

- *Catch-up contributions for those age 50 or over.* The dollar limit for 2003 catch-up contributions to an applicable employer plan (other than SIMPLE 401(k) and regular SIMPLE plans) for individuals aged 50 or over increases from $1,000 to $2,000. For SIMPLE 401(k) or regular SIMPLE plans, the catch-up amount for individuals aged 50 or over increases from $500 to $1,000.

ESTATE AND GIFT TAX CHANGES

P **Lower maximum transfer-tax rate**. The top estate and gift rate and the flat GST (generation-skipping transfer tax) rate is 49% for estates of individuals dying and gifts made in 2003 (down from 50% for estates of individuals dying and gifts made in 2002).

P **Smaller state death tax credit**. For individuals dying in 2003, the state death tax credit can't exceed the credit determined under the table in Code Sec. 2011(b)(1) multiplied by 50% (down from 75% for 2002 deaths).