MONEY MATTERS

How Does The 2003 Tax Act Impact Equity Investments?

(NAPSA)—The Jobs and Growth Tax Relief Reconciliation Act of 2003 includes several provisions that affect individual investors. The most important are a lowering of tax rates for ordinary income and long-term capital gains and a change in the tax treatment of qualifying dividend income.

For ordinary income, the former 38.6 percent peak tax rate is reduced to 35 percent, and the former 35 percent, 30 percent and 27 percent tax rates are reduced by 2 percent each. Net long-term capital gains, formerly taxed at 20 percent, are now taxed at 15 percent.

The biggest change for equity investors is that qualifying dividend income is now taxed at much lower rates than other investment income and short-term gains (maximum rate of 15 percent vs. 35 percent) and on par with realized long-term gains. The spread between short-term and long-term capital gains tax rates has also increased.

The revised tax treatment applies to income received in 2003 and thereafter, and to capital gains realized on sales or exchanges after May 5, 2003. Unless legislation to extend the new tax provisions is enacted, the taxation of dividend income and long-term capital gains will revert in 2009 to the previous treatment and ordinary income tax rates will revert to the pre-2001 rates (maximum of 39.6 percent) in 2011.

In managing taxable funds and accounts, these changes increase the importance of achieving a mix of returns that emphasizes long-term gains and qualifying dividends over less favorably taxed short-term gains and non-qualifying dividends and other investment income. Deferring taxes on long-term gains continues to be of significant value, particularly for investors with longer time horizons and for assets earmarked for inheritance.

New legislation is lowering the tax rate on income derived from investments.

"The new tax rules open up the opportunity to generate tax-advantaged income from dividend-paying stocks," observed Thomas E. Faust, Jr., chief investment officer, Eaton Vance Management. "Because the rules that apply to dividend income are complicated and because many dividends do not qualify for favorable tax treatment, equity income investors must be particularly mindful of tax effects in constructing and managing their portfolios."

Even with the lower tax rates, taxes remain the biggest drag on the long-term performance of equity funds and accounts held by high bracket taxpayers and are generally far more burdensome than management fees, trading costs or sales commission. This is particularly true when state and local income taxes are taken into account.

Investments held in 401(k)s, IRAs (other than Roth IRAs), other types of qualified retirement plans and variable annuities generally are tax-free until the investor makes a withdrawal, at which time the growth in account value is taxed as ordinary income. Qualified plans and variable annuities offer the benefit of tax deferral, but at the price of converting long-term gains and qualifying dividends earned on the underlying investments into ordinary income. To minimize this income conversion cost, investors may wish to consider an asset allocation that uses qualified plans and variable annuities primarily to hold income and short-term-gain-generating assets, and to hold equity investments generating qualifying dividends and long-term capital gains primarily in taxable accounts.

"Even with today's lower tax rates, taxes continue to be the single largest cost borne by long-term equity investors," said Faust. "Strategies to minimize tax effects can add substantial value to taxable accounts, without sacrificing performance or adding to portfolio risk."

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