Sather Financial Group, Inc.
Registered Investment Advisor

# 2003 Tax Cut Overview

After months of political posturing, our elected leaders have finally decided upon a tax reduction package, which includes relief for investors, married couples and parents. Unfortunately, like the tax package passed in 2001, this round of cuts will provide only temporary relief. The cuts phase out by 2011, if not earlier. Nevertheless, most taxpayers can expect to keep more of their earnings for at least a year or two.

## Income Taxes

The most sweeping change is an immediate reduction of the marginal tax brackets. Individuals whose adjusted gross income exceeds $28,400, and married couples who file jointly with an AGI of at least $47,450, will get a break.

The highest income producers (individuals and married couples whose AGI tops $311,950) now pay tax rates up to 38.6%. That rate would be cut to 35%.

Those who currently fall under the 35% bracket (single filers with incomes over $143,500 and joint filers with incomes over $174,700) will have their tax rate trimmed to 33%.

Taxpayers in the 30% bracket will have their rate reduced to 28%. (That includes singles with an AGI of $68,800 to $143,500 and married couples with an AGI of $114,650 to $174,700.)

And those in the 27% bracket will pay no more than 25%. (Again, this applies to singles with incomes from $28,400 to $68,800 and married couples filing joint returns with an AGI between $47,450 and $114,650.)

Meanwhile, lower-income earners in the 10% and 15% tax brackets won't get a cut. However, they do get some relief because more of their earnings would be taxed at the lowest 10% rate.

## Relief for Investors

Much of the controversy of this compromise has centered around the taxation of dividends and capital gains. Currently, investors who owe dividend taxes must pay their marginal tax rates, or as much as 38.6%. But the tax package would freeze the dividend tax at 15% for anyone in the top four tax brackets. The cut would start this year and run through 2008. In 2009, the dividend tax would revert to marginal tax rates. Those in the 10% or 15% brackets would pay 5% taxes on dividends, starting this year. In 2008, they'd pay nothing. In 2009, the tax owed on dividends would revert back to 10% and 15%.

Meanwhile, the long-term capital gains tax rate would fall to 15%, down from 20%. For investors in the 10% and 15% bracket, the tax would drop to 5%, down from 10%.

The new cuts would apply to investment transactions made on or after May 6, 2003 and, of course only to investments owned for one year or more. Short-term capital gains rates would remain the same -- that is, your regular income tax rate.

## Bigger Breaks for Parents

Depending on your income, you can expect as much as $400 more from Uncle Sam for dependent children. That's because the tax package would immediately boost the child tax credit to $1,000, up from a current $600.

However, not everyone will qualify for this credit. The child tax credit isn't as generous, and may not even be available, for those who "earn too much." In the eyes of Uncle Sam, that's singles with an AGI over $75,000 and married couples with an AGI exceeding $110,000. If you do qualify for the full credit, be aware that it drops back to $700 in 2005 and $500 in 2011.

## Leveling the Playing Field for Married Couples

If you're married you know all about the tax marriage penalty. Starting this year, married couples filing a joint return would be able to earn up to $56,800 and remain in the 15% bracket. That's twice as much as what singles can currently earn and remain in this bracket. Currently, married couples whose AGI tops $47,450 are bumped out of the 15% range.

At the same time, the so-called standard deduction (taken by taxpayers who don't itemize deductions) would be raised for married couples to $9,500 (double the $4,750 break that single filers get). Once again, the marriage penalty relief is short-lived and will expire in 2005.

## Small Business Opportunity

Small business, which is a primary driver of US Gross Domestic Product, was also given a boost by expanding depreciation schedules from 30% to 50% for investments made in their first year. Unfortunately, this depreciation bonus will only last through 2004. Businesses were also given an increase in expensing from the current $25,000 up to $100,000. This is provision is set to terminate at the end of 2005.

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## Strategy Points

From its inception the Sather Financial Group has managed stock market assets with a Warren Buffett inspired "value" style. This has meant a focus on blue chip companies with sizable, and ever increasing, earnings and dividends. Congress, for once, has done us, and our clients, a large favor with the current tax package given our investment mentality and structure.

Knowing this, the need to own good companies and manage the taxation issues associated with a given portfolio has never been more important.

Currently, ***an individual in the top marginal tax bracket is subject to a 35% tax rate***. If this investor buys an asset and sells it in less than one year they will incur ***short term capital gains taxation of 35%***. However, if an investor can make more astute and disciplined decisions and hold onto their investments for at least one year or longer they will qualify for long term capital gains taxation. This is a very important distinction because ***long term capital gains are now a maximum of only 15%***. As such, the less patient investor will increase their tax bill by 133% (the difference between 15% and 35%).

Furthermore, assume a stock pays a dividend of $1.00 per share annually. Under the previous tax structure investors may give up as much as 38.6% of this $1 in the form of taxes. Now, however, ***the tax rate on dividends has been dropped to only 15%***. Given this, investors used to pay up to 157% more in taxes on their dividends. This has made blue chip value investing more attractive now than any time in recent memory mainly by allowing investors to keep a substantial amount more of their long term gains and dividends.

Sadly, the mutual fund industry continues to be an inefficient structure by which to manage investments. The typical mutual fund has very high buying and selling (turnover) each year. This ***turnover creates a tremendous amount of short term capital gains which are still taxed at an investors marginal bracket (up to 35%)***. Worse yet, a mutual fund investor has no control over the amount of turnover within a fund. In contrast, a patient investor who owns individual securities (as opposed to a mutual fund) can defer the taxation of gains indefinitely and wait for long term gains which will be taxed at a maximum of 15% when the time to sell is appropriate.

Many mutual funds also own dividend paying stocks, which given the recent change should be a good thing for investors. Unfortunately, ***another flaw in the mutual fund structure precludes the full benefit from being passed on to investors***. As stated above, if an investor receives a $1 dividend from an individual stock they own they pay a maximum of 15% in taxes. If the same investor owns a mutual fund, which receives a $1 dividend, the individual investor receives the $1 but also has management fees and operating fees subtracted out before it is paid out. As such, ***the after tax benefit to the individual mutual fund owner is far less than the investor who receives the same dividend amount, but from an individual stock***. Once again the flawed structure of the mutual fund industry hurts individual investors.

Another loser in the recent tax bill is the traditional fixed income investor. The ***attractiveness of traditional fixed income investments has been reduced since it continues to be taxed at the investors marginal tax bracket (up to 35%)***. Therefore, an individual who buys a ten year US Treasury will receive a before tax interest payment of 3.4% which will yield as little as 2.2% after taxes.

In comparison, a stock that pays a 3% dividend will pay an investor more, even after considering taxes than the US Treasury due again to the tax bracket differential. Furthermore, one must not forget that dividends have the ability to grow over time whereas a Treasury note will never change its rate once you have bought that investment.

Additionally, the proposition of being a fixed income investor may become even more challenging given that the Federal Reserve has already hinted that they may lower short term interest rates at their June meeting. While this creates a terrific situation under which to borrow money it is the worst time in the past fifty years to be a fixed income investor.

Finally, ***all investors must remember that it is not a matter of what an investor makes—it is a matter of what an investor keeps net of taxes***. Understanding this, long term investors in consistent, high quality blue chip stocks that pay ever increasing dividends, have the most potential to benefit from the new tax relief package.

Please call or stop by to further discuss the new tax relief package and its impact upon your investments.

Sincerely,

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™