

A Triple Play on Tax Law 2003

Now that Congress has debated, deliberated and, most importantly, delivered the new tax laws that are so advantageous to investors, the Schwab Center for Investment Research® (SCIR) helps you to drill down into what this means to you, the individual investor. In this three-part series, Rande Spiegelman, CPA, CFP®, vice president, financial planning at SCIR, discusses the recent tax law and explains ways in which you can use the investor-friendly law to help maximize your after-tax returns.

Part I

2003 Tax Law Pays Big Dividends

Do's and don'ts for individual investors taking advantage of the new rules.

Part II

What's Up With Dividends?

No more double trouble for dividends: The new law reduces the taxes you have to pay.

Part III

Desperately Seeking Yield

Strategies to help that don't include chasing yields.

Part I: 2003 Tax Law Pays Big Dividends

May 23, 2003

The new tax package is good news for investors, and families and small businesses should also benefit. Here are some practical steps you can take to maximize your after-tax wealth in light of the new law.

Let's start with the big news.

Lower taxes on dividends and capital gains

- **The long-term capital gains rate is now 15 percent** for sales on or after May 6, 2003. The old rate was 20 percent.
- **Dividends are now taxed at the new long-term capital gains rate** instead of at your ordinary income tax rate, retroactive to Jan. 1, 2003.
- **For people in or below the 15 percent ordinary income tax bracket**, the new long-term capital gains rate is 5 percent through 2007, and goes to zero in 2008.

Keep in mind this provision is set to expire after 2008, unless Congress extends it or makes it permanent.

Dates to remember

	Effective	Expires*
Long-term capital gains rate of 15% or 5%	Sales on or after May 6, 2003	Dec. 31, 2008 (5% rate becomes 0% for 2008 only)
Dividends taxed at long-term capital gains rate	Jan. 1, 2003	Dec. 31, 2008
Lower income tax rates	Jan. 1, 2003	Dec. 31, 2010 (2003 changes expire in 2006 when same lower rates were previously scheduled to take effect)

*Unless extended or made permanent by Congress.

What do the new dividend and capital gains rules mean for investors?

- **The new long-term capital gains rate bolsters the case** for buying and holding stocks, tax-managed mutual funds and index funds in taxable accounts instead of tax-deferred accounts over the long term (more below).
- **Dividend-paying stocks may now be viable candidates for taxable accounts** vs. tax-deferred accounts. The reason? Withdrawals from tax-deferred accounts (other than Roth IRAs) are taxed at your ordinary income tax rate, which may be higher than the new capital gains rate for dividends. Crunch the numbers to make sure it makes sense for you.
- **Don't switch from taxable bonds to dividend-paying stocks simply for tax reasons.** Investing in stocks carries risk. Make sure the investments you choose suit your goals, asset allocation, income needs and ability to sustain losses.
- **Consider gifting long-term assets to family members age 14 or older.** They'll typically pay only 5 percent in long-term capital gains tax (zero percent in 2008) vs. the 15 percent rate you would likely pay.

Lower income tax brackets

Lower income tax rates were scheduled to phase in over the next few years. But the new law delivers them early—the rate cuts are now retroactive to Jan. 1, 2003 (see chart).

Old law: Phase-in of marginal income tax rate reductions

Pre-2001	15%, 28%, 31%, 36%, 39.6%
2001	15%, 27.5%, 30.5%, 35.5%, 39.1%
2002–2003	10%, 15%, 27%, 30%, 35%, 38.6%
2004–2005	10%, 15%, 26%, 29%, 34%, 37.6%
2006–2010	10%, 15%, 25%, 28%, 33%, 35%
2011 and beyond	Back to pre-2001 law if no action by Congress

New law: 2003 income tax rates

Rate	Single	Married filing jointly
10%	\$7,000 or less	\$14,000 or less
15%	Over \$7,000 but not over \$28,400	Over \$14,000 but not over \$56,800
25%	Over \$28,400 but not over \$68,800	Over \$56,800 but not over \$114,650
28%	Over \$68,800 but not over \$143,500	Over \$114,650 but not over \$174,700
33%	Over \$143,500 but not over \$311,950	Over \$174,700 but not over \$311,950
35%	Over \$311,950	Over \$311,950

Factor in the new rates beginning with this year.

- **Re-run your 2003 tax projections** to see if the new withholding rates make sense for you. If you make quarterly estimated tax payments, revisit your payment schedule—you may be due a bigger refund.
- **Reevaluate your strategy if you were planning to defer income** into next year based on the now-implemented 2004 rate reductions.
- **Does it still make sense to hold municipal bonds instead of taxable bonds in your taxable accounts?** It might, especially if you have in-state bonds and your state raised (or plans to raise) its marginal income tax rate.
- As mentioned above, **taxpayers in higher brackets should still benefit from holding tax-efficient stocks and mutual funds in taxable accounts** if they plan to hold them for the long term. That now goes for dividend-paying stocks as well. Likewise, it still makes sense to put less tax-efficient investments—taxable bonds, stocks you hold for one year or less, and actively managed mutual funds—in tax-deferred accounts.

The significant factor here is that the difference between the long-term capital gains rate and income tax rates hasn't changed significantly. For example:

- Pre-2002, the highest ordinary federal rate was 39.6 percent and the long-term capital gains rate was 20 percent—a difference of 19.6 percent.
- Now, the highest ordinary federal rate is 35 percent and the long-term capital gains rate is 15 percent—a difference of 20 percent, virtually the same as before.

Remember, the old “sunset” provision from the 2001 tax law is still out there. That means in 2011 we go back to pre-2001 income tax rates unless Congress passes an extension or makes the changes permanent.

Other important changes:

- **Alternative Minimum Tax relief.** The exemption is a bit higher to help prevent more taxpayers from inadvertently entering the AMT ranks, at least for 2003–2004.
- **Family-friendly changes.** The standard deduction is increased and the 15 percent bracket expanded for married taxpayers filing jointly for 2003–2004, providing some “marriage penalty” relief. Additionally, the child tax credit is increased to \$1,000 per child for the same period.
- **Small business relief.** Section 179 of the Internal Revenue Code may not mean much to you as an individual, but if you own a small business it could be a big deal. This section of the Code lets small business owners expense a portion of the purchase cost for capital equipment put into service during the year, instead of having to depreciate it more slowly over a period of years. The new section 179 limit has been raised to \$100,000 through 2005 in the hope of providing a shot in the arm for the economy. Bonus depreciation is also increased from 30 percent to 50 percent through 2004.
- **State aid.** The tax package includes \$20 billion in aid to state and local governments in 2003 and 2004. That may keep local income taxes from rising more than they otherwise might.

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Part II: What's Up With Dividends?

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All dividends are not created equal

"Qualified" stock dividends—which include nearly all common stock dividends—are eligible for the new 15 percent rate. Your 2003 Form 1099 should categorize your investment income properly.

However, for planning purposes, here's a list of dividends that DON'T qualify for the new rate—they're taxable as ordinary income.

- **Certain preferred stock dividends.** Most preferred stock is structured as debt to receive an interest expense deduction at the corporate level. However, many companies are expected to restructure their preferred stock or issue new preferred stock to qualify for the 15 percent dividend tax. Check with your broker on a company-by-company basis.
- **Real estate investment trust dividends.** Because REITs are typically tax exempt at the corporate level, the dividends they pay generally won't qualify. Distributions in the form of long-term capital gains, however, will receive the 15 percent rate.
- **Certain foreign stock dividends.** Dividends from foreign stocks traded as American Depositary Receipts on a U.S. exchange will qualify. The 15 percent rate should also apply to foreign companies based in U.S. territories (such as Puerto Rico or Guam), as well as to companies traded in a foreign country that has an established tax treaty with the United States. Other foreign stock dividends will be subject to ordinary income tax.

What about mutual fund dividends?

Mutual funds call all sorts of things "dividends," including interest income from bonds and money market funds. Going forward, mutual fund companies will likely use these three categories to report your investment income on Form 1099:

1. **Ordinary dividends.** Ordinary dividends are taxed at your regular income tax rate. These include interest dividends from bonds and money markets, non-qualified stock dividends, most REIT dividends, and short-term capital gains.
2. **Qualified dividends.** Qualified stock dividends will be taxed at 15 percent or 5 percent, depending on your tax bracket.

3. **Capital gains distributions.** Long-term capital gains distributions will be taxed at 15 percent or 5 percent, depending on your tax bracket.

The fine print

- To qualify for the special tax rate, you or your mutual fund must have held the stock for more than 60 of the 121 days surrounding the "ex-dividend" date. The 121-day period starts 60 days before the stock goes ex-dividend.
- Qualified dividends that receive the 15 percent rate aren't considered "investment income" for purposes of the investment interest expense deduction (although you can elect to treat them as ordinary income to offset the interest expense).
- If you borrow to buy stocks on margin and your broker lends out your stock, you don't really receive dividends, you receive "payment in lieu of dividends." Such payments are treated as ordinary income and aren't eligible for the lower rate.

Should you change your strategy?

In light of the new tax rates, what, if anything, should you do differently? First, don't let the tax tail wag the dog—there's likely no reason to dramatically change your portfolio. For many, the new rates simply mean your overall tax bill goes down.

That said, here are a few situations to watch for:

Bonds or dividend-paying stocks?

Considering a switch from bonds to dividend-paying stocks? Be careful—stocks are an entirely different asset class and carry their own risks.

However, if you find you have more bonds than you'd like in taxable accounts, you might consider selling some and using the proceeds to buy a diversified group of highly-rated, dividend-paying stocks. For example, at the highest ordinary income tax bracket, a high-quality taxable bond paying 4 percent would leave you with only 2.6 percent after taxes. But a mix of highly rated stocks, or mutual funds paying an average, current qualified dividend yield of 4 percent would leave you with 3.4 percent after taxes.

Evaluate your decision in the context of your investing goals, asset allocation and ability to sustain losses.

Gifting

If you have a family member who's 14 or older, think about gifting securities that you've held over a year (up to \$11,000 per year, or \$22,000 for spouses "splitting" gifts with no gift tax, as of 2003). Under the "kiddie tax" rules, kids 14 and older are taxed at their own rate, not yours. If they're in the 15 percent ordinary income bracket or lower, they'll pay only 5 percent in long-term capital gains tax vs. the 15 percent you would pay if you sold the securities and gave them the cash.

Likewise, dividend-paying stocks held for income could make tax-smart gifts. If a child 14 or older holds the stock and receives the dividends, he or she will likely pay only 5 percent on the income. What's more, that 5 percent rate goes to zero in 2008 for both long-term gains and dividends.¹

Dividends in taxable vs. tax-deferred accounts

The lower capital gains and dividend rate makes managing investments for tax efficiency even more advantageous. Here's why: If you hold long-term investments in taxable accounts, you'll typically pay long-term capital gains tax when you sell. But if you hold those same investments in a tax-deferred account, such as a traditional IRA, any gain will eventually be taxed as ordinary income—typically a higher rate.

The new law doesn't significantly change this tax-smart strategy for investors in top tax brackets, while middle-income investors gain more of an edge:

The spread between ordinary tax rates and capital gains rates is little-changed

	Pre-2001	New law
Top income tax rate	39.6%	35%
Long-term capital gains rate	20%	15%
Difference	19.6%	20%
Middle income tax rate	28%	25%
Long-term capital gains rate	20%	15%
Difference	8%	10%

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But here's the big news: **The spread between ordinary rates and the new dividend rate is significant for just about everybody.**

Previously, it might have made sense to hold dividend-paying stocks in your IRA instead of your taxable accounts, because the dividends were taxed at your ordinary income tax rate anyway. Now, with dividends taxed at 15 percent, (or 5 percent, depending on your bracket) the value of putting dividend-paying stocks in taxable accounts has grown tremendously.

Dividend tax has changed significantly

	Dividend tax pre-2001	Dividend tax now	Difference
Investor in highest tax bracket	39.6%	15%	24.6%
Investor in middle tax bracket	28%	15%	13%

Do the new rules make tax-deferred accounts unattractive? Absolutely not! It simply means that where you place your investments is more important than ever.

Where tax-smart investors put their investments

Taxable accounts	Tax-deferred accounts such as traditional IRAs, 401(k)s and deferred annuities
• Individual stocks held over one year	• Individual stocks held one year or less (when sold for a gain)
• Tax-managed stock funds, index funds, low-turnover stock funds	• Actively managed funds that generate significant short-term capital gains
• Stocks or mutual funds that pay "qualified" stock dividends ²	• Taxable bond funds, zero-coupon or TIP Treasury bond funds, ⁴ high-yield bond funds
• Municipal bonds ³	• REITs

Remember, at the end of the day, it's after-tax dollars that count. Be a tax-smart investor and take advantage of the new tax law. Be sure to consult an investment professional to find out what makes sense for you before you take action.

¹A special 5 percent long-term capital gains and dividend tax rate applies to taxpayers below the 25 percent bracket, with that rate going to zero in 2008. Unless Congress extends the law, all new rates expire after 2008 and the previous law will apply.

²All things being equal with respect to turnover and assuming an ordinary tax bracket of 25 percent or higher.

³For those in higher ordinary income tax brackets, depending on tax-equivalent yield comparisons.

⁴Treasury securities are exempt from state income tax.

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Part III: Desperately Seeking Yield?

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Unless you've been vacationing on the moon lately, you're aware the tax rate on "qualified" dividend income has dropped to 15 percent (the same rate that now applies to long-term capital gains) thanks to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

Now that the Fed has lowered rates yet again, let's explore dividend strategies for investors seeking current portfolio income in a low-rate environment.

Whether or not you find yourself with more bonds in your portfolio than you'd like, highly rated stocks paying solid, "qualified" dividends might deserve a closer look for your taxable accounts in light of the new tax law. Why? If you're in the 33 percent federal income tax bracket or higher, you'll keep only two-thirds or less of your bond coupon after the IRS is through with you. But 85 percent of your qualified dividends will find their way into your after-tax pocket. (State and local taxes may also apply.)

Here's how some average market interest rates¹ compare to various hypothetical dividend yields as of this writing, in order from lowest to highest based on federal after-tax yields.

Interest rates vs. dividend yields: after-tax

	5-year Treasury	5-year, AAA-rated corporate	Qualified dividend	5-year, AAA-rated municipal	Qualified dividend	Qualified dividend
Pre-tax	2.29%	2.36%	2.00%	1.84%	3.00%	4.00%
After-tax						
35% bracket	1.49%	1.53%	1.70%	1.84%	2.55%	3.40%
33% bracket	1.53%	1.58%	1.70%	1.84%	2.55%	3.40%
28% bracket	1.65%	1.70%	1.70%	1.84%	2.55%	3.40%

Of course, stocks aren't bonds—what about risk?

- With interest rates at, or at least approaching, what many might consider a long-term nadir—and the possibility of rising rates in the future—you have to ask yourself which asset has the greater potential to rise in value vs. go down in value over the next five years: a diversified group of highly rated stocks of low to average volatility that pay qualified dividends, or a 5-year note currently paying close to 2 percent? Remember, when interest rates rise, bond prices fall.
- You can log in to Schwab's Stock Screener to select dividend-paying stocks that fit your goals and circumstances. For example, we found 31 stocks (as of June 25, 2003) using the following simple criteria (you'll likely want to dig a little deeper):
 - Stocks rated "B" or higher by Schwab Equity Ratings™
 - Stocks with a beta, or volatility, of "0 to 1.0" (a beta of 1.0 equals "the market" as a whole)
 - Stocks with a dividend yield of "4% or more"
- The advice "don't chase yield" applies as much to dividend-paying stocks as it does to bonds. As the yield gets north of 5 percent (vs. the current broad market dividend yield of around 1.6 percent), your concern should be rising as well. The dividend yield for a particular company could be abnormally high because of a depressed stock price, and that price might be depressed for a reason. You should evaluate the company in light of the potential for its stock to rise as well as the company's ability to maintain its dividend.

¹Composite rates, as of June 25, 2003. Data obtained from third-party sources we believe to be reliable, but not guaranteed as to accuracy. Market rates are subject to change.

For example, you can see below that the percentage of A- and B-rated stocks relative to the entire universe of stocks drops significantly as the dividend yield rises (which suggests that a high dividend yield and a high stock rating don't usually go hand in hand):

As dividend yield goes up, the number of highly rated, dividend-paying stocks goes down

Dividend yield as of 6/25/03	Total stocks	Stocks rated A or B	A and B as a % of total
≥ 2%	1,385	217	16%
≥ 4%	518	31	6%
≥ 5%	367	8	2%

As always, evaluate any changes to your portfolio within the context of your specific circumstances and long-term asset allocation. Consider your unique goals, objectives and ability to tolerate risk before you take action. And get some help if you need it. Happy dividend hunting!

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