

## THE TAX CLIENT NEWSLETTER

### **Fall/Winter 2004**

The Fall/Winter 2004 Tax Client Newsletter brings you up-to-date on a number of important tax law changes for 2004. As a result of 2004 tax legislation, there are a number of significant tax law changes affecting you this year and right now.

You may be aware through media attention that many of the important tax law changes are scheduled to “sunset” (go away) at various dates — some sooner rather than later. You should think of the “sunset” issue as a future concern and take advantage of the opportunities that you have today.

If you have any questions concerning any of the information being reported on in the Tax Client Newsletter, please contact my office to schedule an appointment.

### **2004 Tax Law Changes**

With the stroke of his pen, President George Bush signed into law two significant and separate tax bills this year: The Working Families Tax Relief Act (October 4) and The American Jobs Creation Act of 2004 (October 22). In this Tax Client Newsletter, the new tax laws will be referred to as 2004 Tax Act! and 2004 Tax Act 2.

In reviewing the 2004 Tax Bills it will be important to refresh your knowledge of the 2003 Tax Act known as the Jobs and Growth Tax Relief Reconciliation Act of 2003. This Newsletter will refer to the 2003 tax legislation as the 2003 Tax Act.

As you will read below, the 2004 and 2003 Tax Acts offer tax benefits and challenges for many taxpayers.

### **Are There Things That! Should Be Thinking About Now?**

One of the most complicated aspects of any tax legislation is reviewing the wide range of effective dates that apply. Some of the tax breaks are retroactive to January 1, 2004, or take effect at other times during the year. Other provisions become effective after 2004 a: some immediately after President Bush signed the Acts into law.

### **Deduction for Educator Expenses**

In the 2004 Tax Act 1, Congress and the President agreed to restore the special tax deduction available to elementary and secondary school teachers, administrators, counselors and aides. The deduction (maximum \$250) for out-of-pocket expenses expired on December 31, 2003. The good news is that the above-the-line deduction is back and it was restored for all of 2004 and 2005. Message to teachers — save those receipts!

The National Education Association estimates that the average teacher spends about \$450 per year on out-of-pocket classroom related expenses. Note that any qualifying expenses above the \$250 maximum may be deducted as unreimbursed employee business expense of Schedule A (as an itemized deduction). Unfortunately, Schedule A requires that the additional deductible expenses be greater than 2% of the taxpayer's Adjusted Gross Income.

### **Vehicle Donations**

2004 Tax Bill 2 significantly changes the rules regarding the donation of vehicles to a charity. Under the new rules (effective January 1, 2005) the donation of a car to a charity can result in a much lower deduction since the amount of the deduction (in most cases) will be "limited" to the amount that the donated vehicle sells for at auction. There are exceptions where the charity uses the vehicle or substantially improves the vehicle.

Since the new rules are effective starting with the 2005 tax year — contributions of vehicles up to December 31, 2004 are governed by the old more favorable tax rules. The old rules permitted a deduction of the vehicle's fair market (blue book) value. This is one area of the tax laws that has been subject to abuse on issues of valuation — therefore the decision to tighten the rules starting January 1, 2005.

### **The SUV Tax Loophole**

You probably are aware from newspaper articles and other publications that the 2003 Tax Act created what was called the SUV loophole. The so-called loophole allowed certain business taxpayers to immediately expense (up to \$100,000) the cost of a business vehicle weighing more than 6,000 pounds. Published reports during the past year and a half have suggested that doctors, lawyers and other business professionals were out buying the large SUVs and getting the maximum tax write-off in 2003 and 2004.

Tax Act 2 closes the loophole by requiring a vehicle weight of more than 14,000 pounds to qualify for the maximum expensing opportunity. The 2004 Tax Act reduces to \$25,000 the expensing available to qualifying vehicles weighing over 6,000 pounds (traditional SUV5). The effective date for the change is for purchases made after October 22, 2004— the day President Bush signed the 2004 Tax Act 2 into law.

If you have a profitable business and have been contemplating purchasing a new vehicle be sure to contact this office ASAP to review your choices. The 2003 Tax Act added a special 50% bonus depreciation (but it expires on December 31, 2004) which when combined with the new 2004 \$25,000 expensing limits might make the decision to buy this year more attractive than a delayed purchase in 2005.

### **Extending Tax Benefits**

One of the most important features of 2004 Tax Act I is the decision to extend for a period of several years certain tax benefits that were soon to be expired. The big three include: (1) the 10%

tax bracket, (2) the \$1,000 child tax credit, and (3) marriage penalty relief.

### **Tax Brackets Reduced**

One of the most significant features of the recent tax law changes was the lowering of income tax brackets. The 2001 Economic Growth and Tax Relief Reconciliation Act provided that individual marginal tax rates gradually decline over several years. The 2003 Tax Act accelerated the reductions. The new tax rates/brackets are:

| Now | Was             |
|-----|-----------------|
| 35% | 38.6%           |
| 33% | 35%             |
| 28% | 30%             |
| 25% | 27%             |
| 15% | 15% (no change) |
| 10% | 10% (no change) |

Note: New rates are retroactive to January 1, 2003.

### **10% Bracket Expanded and Extended**

The 10% rate for taxable income up to \$14,000 (married taxpayers) and \$7,000 (single taxpayers) had been set to decline to \$12,000 and \$6,000 respectively. 2004 Tax Act 1 retains the higher amounts (and they are adjusted for inflation) through 2010.

### **Marriage Penalty Relief Extended**

The 2003 Tax Act changed the so-called “marriage penalty” rules of the tax code. The marriage penalty is a feature of the tax code that, in some cases, leaves two working spouses worse off taxwise than they would be as singles. The marriage penalty comes about because some features of the tax laws don’t always double for married couples. The 2003 Tax Act addressed the “marriage penalty” by 1) making the standard deduction for married couples filing jointly twice the amount available to single taxpayer and 2) making the amount of taxable income in the 15% tax bracket for married couples filing jointly double the amount available to single taxpayers.

2004 Tax Act 1 extends through 2010 the two tax breaks that otherwise would have expire’ at the end of 2004.

### **Investors Win: Lower Capital Gains Taxed at 15% or 5%**

Investors came out a very big winner under the 2003 Tax Act The top capital gains rate was lowered from 20% to 15%. The lowest capital gains rate decreased to 5% from 10%. Note that the lower rates were effective for transactions after May 5, 2003. The lower rates are scheduled to expire after 2008.

The paperwork on capital gains for 2003 proved to be a nightmare as taxpayers struggled with timing issues. Long-term gains on sales made through May 5, 2003 were taxed at up to 20% or

10% while sales made after May 5, 2003 are taxed at 15% or 5%. There was no increase in the \$3,000 annual limitation on deducting excess capital losses.

For 2004 and 2005, the rates are 15% or 5% respectively.

Taxpayers in the lowest two brackets (10% and 15%) will get a one-year bonus in 2008 when they will pay no federal taxes on capital gains. The tax is reinstated after 2008.

### **Investors Win: Dividends Taxed at 15% or 5%**

Historically, dividend income was taxed as ordinary income. Under the 2003 tax legislation the top dividend rate was lowered to 15%. Taxpayers in the lowest two tax brackets pay 5%. This is a very significant change when you consider the fact that the top rate for dividends was 38.6%. The new lower rates are effective for “qualified” dividends received after December 31, 2002. That’s right — all “qualifying dividends” received in 2003 were taxed at the lower rates of 15% and 5% respectively.

For 2004 and 2005, the tax rates are 15% and 5% respectively.

The IRS reported that there was significant confusion on the part of companies and brokers in reporting whether the dividends were “qualified” for the lower rates. The problem resulted from a special holding period that Congress created. According to the IRS, at least 9% of dividend forms (1099-Div) sent to taxpayers in 2004 contained errors. The tax professional community anticipated this problem and warned the IRS that the rules were far too complicated for the average taxpayer to deal with. The IRS has recently taken steps to clarify the “qualifying dividends” rules — the changes are pro-taxpayer. Note that not all dividends you received qualify for the lower rate. There is a special (more than 60 days in a 120 day period surrounding the ex-dividend date) Holding period. This becomes a very complicated issue when the dividends are being paid out by mutual funds.

Taxpayers in the lowest two brackets will get a one-year bonus in 2008 when they will pay no tax on dividend income. The tax is reinstated after 2008.

### **Selling Losers**

Investors are advised to take a fresh look at their investments. If you are thinking about getting rid of some stocks you bought years ago that are now selling for less than you paid the end of the year could be as good a time as ever to “pull the trigger.” Capital losses can help to cut your tax bill. Investors can use losses to soak up gains. If losses exceed gain, investors can deduct as much as \$3,000 a year of those losses against other income. Excess losses can be carried forward to future years.

If you are really in love with the stock you are selling at a loss, you can buy it back after 31 days to avoid the wash-sale rules. If you are in love with a particular industry you can buy another stock within the industry.

### **Families Win: Child Tax Credit Increased to \$1,000**

For 2003 and 2004, the child tax credit was increased from \$600 to \$1,000. As a result some 24.4 million families were eligible to receive a \$400 rebate check in the summer of 2003. The Treasury Department and the IRS relied on data in the system from 2002 tax returns. Taxpayers and their tax professionals were not required to take any additional steps to receive the checks. Since the immediate increase in the child tax credit was in 2003, the government did not issue any advance rebate checks in 2004.

As a result of 2004 Tax Act 1, the credit for a dependent child under age 17 will remain at \$1,000 through 2009.

The refundable credit, payable to low-income taxpayers, has been increased to 15% (up from 10%). The refund is 15% of earned income over \$10,750 in 2004 and \$11,000 in 2005.

Military personnel can elect in 2004 and 2005 to include tax-free combat pay as earned income for the purpose of figuring the Child Tax Credit as well as the Earned Income Tax Credit.

### **Health Savings Accounts Have Arrived**

One of the most significant tax law changes for 2004 is the introduction of Health Savings Accounts (HSAs). The HSAs were created in the Medicare Prescription Drug Improvement and Modernization Act of 2003. Effective January 1, 2004, HSAs allow deductible contributions to be set aside to cover medical expenses that are not covered by a high-deductible medical plan in which the taxpayer – employee participates.

The contributor to the HSA — either the employee or the employer — gets a tax deduction for the contributions going into the HSA, and then the employee is allowed to withdraw the funds tax-free in the same year or in a future year to cover their unreimbursed medical expenses. Contributions that are not used in any tax year may be rolled over for future use. Upon reaching the age of 65, accumulated funds in an HSA can be withdrawn tax-free to cover medical expenses or they can be withdrawn penalty-free (but not tax-free) for any purpose.

### **New Itemized Deduction for State Sales Taxes (2004 & 2005)**

2004 Tax Act 2 creates a new itemized deduction for state sales taxes. While the deduction can only be taken on Schedule A (itemized deductions) it will be a benefit to taxpayers who live in states that do not have a state income tax. Those states include: Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington and Wyoming. Tennessee's state income tax is limited to dividends and interest income. New Hampshire has no income or sales tax. While Alaska does not have a sales tax, there are some local taxes.

The deduction is available to all taxpayers. It is not taken in addition to your state income taxes but in place of such. It is not likely that taxpayers in the remaining states with a state income tax will find this an attractive alternative.

Taxpayers electing to deduct state sales taxes may rely on their actual receipts or make use of state sales tax tables that the IRS will be releasing soon. In some cases additional state sales taxes for expensive purchases may be added to the IRS tables.

The bottom line here is that many more taxpayers will qualify to itemize their deductions, rather than using the standard deduction.

### **Tax Deduction for Tuition and Fees: Increases for 2004 & 2005**

The above-the-line deduction for higher education expenses increases this year based on the 2001 Tax Act. The maximum deduction increases to \$4,000 for 2004 and 2005 (was \$3,000). In addition, some taxpayers who were not eligible for the deduction based on their adjusted gross income are now eligible for a maximum \$2,000 deduction. Unless Congress acts, the popular deduction for higher education expenses will expire at the end of 2005.

### **IRA Contributions**

One of the tax law adjustments for 2004 relates to a schedule that Congress created in the Taxpayer Relief Act of 1997. The income eligibility limits for a deductible IRA contribution increases to a range of \$45,000 to \$55,000 (was \$40,000 to \$50,000) for single taxpayers and \$65,000 to \$75,000 (was \$60,000 to \$70,000) for a married couple filing jointly.

The maximum IRA contribution for 2004 is \$3,000 and an additional \$500 for taxpayers who are 50 years of age or older in 2004. Note that the contribution limits in 2005 will be increased to \$4,000 and the additional \$500 for catching-up.

Roth ERAs continue to be an attractive investment option. The generous AGE test (\$95,001 - \$110,000 for singles and \$190,000 - \$220,000 for married couples) makes this form of retirement savings available to many taxpayers. Unlike the traditional deductible IRA, the Roth IRA does not provide a current tax deduction but does provide future tax-free growth. Two other benefits to the Roth IRA are 1) there are no minimum mandatory distribution rules and 2) you can contribute to a Roth as long as you are working — no age limits.

### **Estate and Gift Tax Rules: Update**

Changes in the area of estate taxation have produced an increase in the lifetime exclusion from \$1 million to \$1.5 million for 2004. The maximum tax rate for estate and gift tax is now 48%. The gift tax lifetime exclusion remains at \$1 million as does the annual \$11,000 per recipient (donee) tax-free gifts rule. The \$11,000 is doubled to \$22,000 in the case of joint gifts from a married couple.

The 529 College Savings Plan rules permit five years worth of gift giving at one time. An individual can contribute \$55,000 to a 529 Plan and a married couple can contribute \$110,000 to a 529 Plan without any federal gift tax implications.

## **Tax Breaks for Businesses**

Continuing with the theme that the Jobs and Growth Tax Relief Reconciliation Act of 2003 offers something for almost everyone, the law increased the amount that businesses can “expense” or immediately write off, from \$25,000 to \$100,000. For 2003 through 2005, firms that put less than \$400,000 of assets in use in a year can expense up to \$100,000 of cost in lieu of depreciation. The trigger point of the investment limitation phase-out increased from \$200,000 to \$400,000. The dollar limitations are indexed for inflation: 2004 (\$102,000); 2005 (\$105,000).

The increase in the so-called expensing deduction has the potential to assist businesses while also serving to stimulate the economy. The business community can be expected to leverage the available tax incentive.

Bonus depreciation is increased from 30% to 50% for post-May 5, 2003 acquisitions. The type of property that qualifies for this special allowance is unchanged from existing law. For the 50% allowance to apply, the property must be acquired after May 5, 2003, and before January 1, 2005. Note that if a binding contract to acquire the property was in effect before May 6, 2003, the property does not qualify for the 50% bonus depreciation (30% may be available). Taxpayers may elect out of bonus depreciation.

The standard mileage rate allowance for business use has increased to 37.5 cents for 2004 (up from 36 cents); the mileage rate related to medical and moving expenses increased from 12 cents to 14 cents per mile. The mileage rate for work related to a charity is 14 cents per mile in 2004. 2005 mileage rates will be announced before the end of the year.

## **IRS Permitted to Use Private Debt Collectors**

2004 Tax Act 2 authorizes the IRS to make use of private debt collectors. Congress has expressed concern with the agency’s collections efforts. The new law requires that any private companies used by the IRS follow the Fair Debt Collections Practices Act.

## **Conclusions**

The 2004 Tax Acts provide tax benefits for millions of taxpayers. While the bulk of the 2004 Tax Act 1 is a series of tax cut extensions, the Act does restore the special deduction for teachers for 2004 and 2005.

2004 Tax Act 2 is substantially a corporations/manufacturers Act. 2004 Tax Act 2 changes the rules for certain vehicle donations (effective 2005), closes the so-called SUV loophole (effective October 22, 2004), and creates a new itemized deduction for state sales taxes for 2004 and 2005.

The 2003 Tax Act has been described as a bumpy series of starts and stops — in some cases accelerating for brief periods some provisions of the 2001 Tax Act, providing short-term business investment incentives, and dramatically reducing income tax rates on capital gain and dividends for a short period of time.

Looking into the crystal ball — 2005 will bring a national debate over the subject of tax reform and proposals ranging from abolishing the tax code and replacing it with a national sales tax, consumption tax or flat tax. Each of the options will require careful study and debate. The idea of making the 2001 tax cuts permanent will be under consideration.

It is not likely that the favorable tax rates on capital gains or dividends will be changed in any negative way during 2005.

Social Security reform appears to be high on President Bush's 2005 economic agenda. President Bush has endorsed the idea of establishing "limited" private accounts out of Social Security savings.

The 2005 FICA wage base is \$90,000, the COLA adjustment is 2.7% and the cost of Medicare Part B premiums for 2005 is up 18%. The Social Security system appears headed for a future financial crisis unless some meaningful changes are made.

As always your individual focus should be on how the tax law changes affect you and how the tax law changes may benefit you.

Thank you for reviewing the Fall/Winter 2004 Tax Client Newsletter and for the opportunity to serve as your tax professional.

Best Wishes

*Michael Price*