

TAX NEWS

DARNALL
Accounting & Tax Service, Inc.
425-771-9120

Summer 2005

TAX CLIENT NEWSLETTER

The Summer 2005 Tax Client Newsletter brings you up-to-date on a number of important tax law changes for 2005. As a result of tax legislation over the past few years, 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 available to you now.

The focus in Washington these days is on Social Security Reform. Congress, it appears, has placed tax law legislation on the post-Labor Day agenda. Only time will tell what, if any, tax law changes will be enacted in 2005. If you recall, this is exactly what happened last year and in the Fall of 2004, Congress passed and President Bush signed into law two significant pieces of tax legislation: *The Working Families Tax Relief Act of 2004 and the American Jobs Creation Act of 2004.*

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

2004 Tax Legislation

The 2004 Tax Acts (721 pages and 755 amendments to the Internal Revenue Code) affects a significant number of taxpayers and in a number of ways. In this issue of the Tax Client Newsletter we will review some of the most important changes for 2005.

The Definition of a "Qualifying" Child:

Child-related tax benefits frequently depend on the existence of a "qualifying" child. Among the items impacted by the definition are: is the taxpayer entitled to a dependency exemption, head-of-household filing status, the child tax credit, the earned income tax credit, or the dependent care credit? Prior to the 2004 tax legislation, each of the above items came with its own definition of a "qualifying" child. Talk about confusion.

Beginning in 2005, one set of dependency tests applies to the taxpayer's "qualifying" children and another test will be used for "qualifying" relatives. To be a "qualifying" child and eligible for the dependency exemption, the child:

1. Must be under the age of 19 at the end of the year or a full-time student under age 24.
2. Must share a home with the taxpayer for more than half the year.

3. Must not provide more than half of his/her support.

4. Must be the taxpayer's child, grandchild, brother, sister, niece or nephew.

Under a new, uniform definition of a child, a taxpayer's children include the taxpayer's natural children, stepchildren, adopted children and eligible foster children. This new, uniform definition will be used for other child-related tax benefits.

Alert: If a child satisfies the test for more than one taxpayer there are rules in place that favor parents first. This issue can become tricky and we are available to work you through this.

Child Tax Credit Increase is Extended:

The child tax credit which was scheduled to decrease to \$700 in 2005 will stay at \$1,000 per child through 2010. Keep in mind that the available child tax credit is reduced (and in some cases eliminated altogether) if the taxpayer's modified adjusted gross income is greater than certain amounts. Note that the new, uniform definition of a child (see above) did not increase the age at which the child tax credit is available. The child tax credit is only available for children under the age of 17 at the end of the tax year.

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 Jobs and Growth Tax Reconciliation Act of 2003 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: Rates were retroactive to January 1, 2003.

10% Tax Bracket Increased and Extended:

Both single taxpayers and joint filers will benefit from an extension of the 10% tax bracket. For tax years through 2010, the 10% tax bracket applies to the first \$7,000 of taxable income (single filers) and the first \$14,000 (married joint filers). The 10% tax bracket amounts are adjusted for inflation (started in 2003). Under the old law, the amounts would have been adjusted for inflation only in 2004, 2009 and 2010.

For 2005, the 10% tax bracket applies to the first \$7,300 of taxable income for single taxpayers (also for married taxpayers filing separate) and \$14,600 for married taxpayers filing jointly.

Marriage Penalty Relief Extended:

The 2003 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 tax-wise 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 2004 Act extends the 2003 marriage penalty relief by continuing to increase the standard deduction available to married couples to twice the standard deduction available to single taxpayers. The 2004 Act extends this relief through 2010.

The 2003 Act expanded the 15% tax bracket for married couples filing jointly to double that of single taxpayers. The 2004 Act extends this relief through 2010.

Lower Capital Gains Rates

Investors came out a very big winner under the 2003 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.

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.

Dividends Taxed at 15%

Historically, dividend income was taxed as ordinary income. Under the 2003 Act, 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. The reduced rates are the same rates that apply to capital gains. With up to a 20 percentage

point difference between the highest income tax rate (35%) and the highest dividend rate (15%), determining what a "qualifying" dividend is can make a big difference. To be a "qualified" dividend, the stock must be held for more than 60 days during a 120 day period starting 60 days before the ex-dividend date. If this sounds complicated - it is. Many companies have experienced difficulty in properly reporting this information to their shareholders. The lower rates are scheduled to expire after 2008.

Out of favor for years, dividends on stock have surged back. The 2003 dividend-tax cut has prompted companies to pay out an increasing share of their profits rather than stash the cash or reinvest it. Some companies, notably Microsoft, have started paying dividends for the first time. In 2004, U.S. companies paid out a record \$181 billion in dividends.

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.

Electric Vehicle Credit and Clean Fuels Tax Deduction

Taxpayers, who purchase a "qualified electric vehicle" in 2004 or 2005, are allowed a nonrefundable tax credit for 10% of the costs. The maximum tax credit is \$4,000. Note that for vehicles placed in service in 2006, the amount of the allowed credit is reduced by 75% and then eliminated for vehicles placed in service after 2006.

Taxpayers who purchase a "qualified clean-fuel vehicle" in 2004 or 2005 are eligible for a deduction of up to \$2,000. For clean-fuel vehicles placed in service in 2006, the deduction will be reduced by 75% and then eliminated for vehicles placed in service after 2006.

The IRS is, on an ongoing basis, “certifying” vehicles. The most recent vehicle “certified” is the 2006 Toyota Highlander hybrid. Please be sure that the vehicle “qualifies” before making the purchase.

State Sales Tax Deduction:

One of the most exciting developments (maybe not for all taxpayers) in the 2004 Jobs Act was a provision to allow taxpayers to deduct state and local sales taxes in place of (not in addition to) state and local income taxes. This election is available for tax years 2004 and 2005. This new deduction is most popular among taxpayers from states (there are nine) that do not have a state income tax.

Taxpayers who elect to deduct state and local sales taxes have two options for determining the deductible amount. Taxpayers may deduct the actual amount of taxes paid (keep those receipts) or they may deduct the appropriate amount from tables provided by the IRS.

If you pay state income tax, the chances are you’ll come out ahead with the state income tax deduction. But there are exceptions. Big spenders should run the numbers. So should residents of states, including Illinois and Michigan, where income tax rates are lower than the state sales tax rate.

Alert:

The Alternative Minimum Tax (AMT) may eliminate any benefit provided by the new sales tax deduction.

States With No Income Tax:

Alaska

Florida

Nevada

*New Hampshire

South Dakota

*Tennessee

Texas

Washington

Wyoming

*New Hampshire and Tennessee have a state income tax limited to interest and dividends.

States With No Sales Tax:

* Alaska Delaware Montana

New Hampshire Oregon

*There are some local jurisdictions in Alaska that impose a local sales tax.

Charitable Contributions of Cars and Other Vehicles:

Concerned that too many taxpayers were taking much larger tax deductions for donated automobiles than the amount the charities were receiving when the cars were sold at auction, the American Jobs Creation Act of 2004 enacted some major changes to the rules effective January 1, 2005.

Under the 2004 Act, the general rule is that the amount of the deduction for the contribution of an automobile, boat or aircraft valued at more than \$500 is limited to the gross sales proceeds obtain by the charity when the vehicle is sold.

The 2004 Act provides for two circumstances in which the old (you get to deduct the fair market value) rules would apply: (1) the charity keeps the vehicle or (2) the charity makes significant improvements to the vehicle before selling it.

On June 3, 2005, the IRS issued some guidance (Notice 2005-44) on how the new law will be applied. The Notice says that the new gross proceeds limits on fair market value

hold that if the fair market value is less than the amount obtained by the charity, the donor is still to use the fair market value. The Notice also says that if a charity donates the vehicle or sells it at a nominal price in furtherance of its charitable purposes, the taxpayer can rely on the fair market value.

Here’s the bottom line. If you are thinking of donating a vehicle - do not believe everything that is being advertised. Call my office to make sure that you understand any limits you are facing and whether there are any alternatives available to you.

The IRS expects to bring in \$2.4 billion in extra tax revenue over the next ten years as a result of the new limits placed on vehicle donations.

Educator’s Deduction:

Educators can deduct (above-the-line) up to \$250 of qualified out-of-pocket expenses paid in 2005. If both spouses are eligible educators and a joint tax return is filed, each may deduct up to \$250. Eligible “educators” include teachers of K-12, counselors, principals, and aides in a school who work at least 900 hours during the school year.

“Qualified” expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (this includes computer equipment, software and services), and other materials used in the classroom.

Expenses for home schooling are not eligible for the deduction. This deduction is scheduled to expire after 2005.

Tuition and Fees Deduction:

An above-the-line deduction is available to taxpayers for “qualified” tuition and related expenses paid

for the taxpayer, the taxpayer's spouse, or the taxpayer's dependent. The amount that can be deducted is limited depending on adjusted gross income. While the maximum deduction for 2005 is \$4,000, there are some taxpayers (not eligible for the \$4,000 based on their income) who may qualify for a \$2,000 deduction. This very popular deduction is scheduled to expire after 2005.

Alert: If Congress doesn't extend this tax deduction beyond 2005, it might make sense for some taxpayers to consider paying for the first term of 2006 by December 31, 2005. In some cases this action would result in a tax deduction for 2005. As always, check with my office before you make any "advance" payments.

AMT:

Here's one topic that we would all love to forget about. The Alternative Minimum Tax (AMT) is designed to prevent high-income taxpayers from avoiding significant tax liability. A taxpayer's AMT for a tax year is the excess of the tentative minimum tax over the regular tax. All taxpayers subject to the regular income tax system are also subject to the AMT system. The number of taxpayers exposed to the AMT is rapidly increasing. The AMT is projected to affect about 3.8 million taxpayers in 2005 and more than 20 million by 2006. It appears that the government's definition of a "high-income taxpayer" is expanding like a balloon.

Taxpayers subject to the AMT will be happy to know that the 2004 Act extends the higher AMT exemptions through 2005. The exemptions are: \$58,000 for married taxpayers filing jointly and for surviving spouses

\$40,250 for single taxpayers \$29,000 for married taxpayers filing jointly. Unless Congress acts to extend the higher AMT exemptions, the amounts will revert to those that applied in the 2000 tax year (\$45,000, \$33,750 and \$2,250 respectively).

Health Savings Accounts

One of the most significant tax law changes for 2004 was 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.

HSAs allow taxpayers to save and pay part of their medical expenses with tax-advantaged money. The funds that taxpayers put into the accounts may grow and be used tax-free for qualified medical expenses. The accounts can be opened only in tandem with an HSA-qualified insurance policy that has a high deductible - in 2005, at least \$1,000 for single coverage or \$2,000 for family coverage.

The contributor to the HSA either the employee of 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 with

drawn penalty-free (but not taxfree) for any purpose.

If you have any question regarding whether a Health Savings Account is right for you and or your family - please contact my office to schedule an appointment.

Conclusion:

The American Jobs Creation Act of 2004 represents the biggest single piece of tax legislation since the Taxpayer Relief Act of 1997. When combined with the Working Families Tax Relief Act of 2004, taxpayers are left with a significant number of tax law changes. In the Summer 2005 Tax Client Newsletter we have reviewed many of the most significant tax law changes affecting you now.

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

Thank you for reviewing the Summer 2005 Tax Client Newsletter and for the opportunity to serve as your tax professional.