TAX NEWS

Fall/Winter 2005 TAX CLIENT NEWSLETTER

The Fall/Winter 2005 Tax Client Newsletter brings you up-to-date on a number of important tax law changes for 2005. As a result of 2005 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.

Looking Back to October 2004

With the stroke of his pen, President George Bush signed into law two significant and separate tax bills last year: *The Working Families Tax Relief Act* (October 4, 2004) and *The American Jobs Creation Act of 2004* (October 22, 2004). In this Tax Client Newsletter, the new tax laws are referred to as 2004 Tax Act 1 and 2004 Tax Act 2. Significant provisions of both laws are effective for 2005 and beyond.

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

As you will read below, the *2005 Energy Bill*, the *Hurricane Katrina Emergency Tax Relief Act of 2005*, *The Working Families Tax Relief Act of 2004, The American Jobs Creation Act of 2004* and the *Jobs and Growth Tax Relief Reconciliation Act of 2003* offer a wide-range of tax benefits and challenges for many taxpayers.

2005 Energy Bill

In August 2005, President Bush signed into law the *Energy Policy Act of 2005*. While most of the Energy Act is forward looking (2006 and beyond), there are provisions in the 2005 Act that might affect decisions you are making before the end of the year. For example, the *2005 Energy Act* provides two new credits for energy efficient improvements made to personal residences. While the improvements must be made after 2005 - the availability of the future credits might cause you to postpone certain actions now. The eligible improvements in 2006 include:

To qualify, home improvements must be made to your principal residence and not to a second home. Examples of qualifying improvements include metal roofs that contain heat-reduction paint; exterior windows; exterior doors; skylights; insulation materials; systems designed to reduce heat loss; energy efficient electric heat pumps; electric heat pump hot water heaters; central air conditioning; circulating fans, etc. This list is by no means a complete list of the available "qualifying" options.

The new credit (available in 2006) will generally be equal to 30% of your cost, limited to $2,000 per type of item. There are some technical rules here (such as ones involving fuel cell property) which I will be pleased to review with you. You can expect the market place to take advantage of the available credits through their marketing plans. In general, the above credits will apply to property placed in service after 2005 but before 2008. You have time to take advantage of this opportunity.

The *2005 Energy Act* also includes a new tax credit for energy efficient dishwashers, clothes washers, and refrigerators manufactured in 2006 and 2007. Note that this is a manufacturer's credit and not a consumer-taxpayer credit!

One of the most significant features of the *2005 Energy Act* is a new incentive for the purchase of new hybrid (you must be the original owner) vehicles. Up until the end of 2005, the tax laws provide a maximum deduction of $2,000 for the purchase of "qualifying" energy efficient vehicles. After 2005, the deduction will be replaced with a new tax credit. In some cases, the new credit may be as high as $3,400.

The new credit for hybrid cars and trucks is made up of two parts. Part 1 is a "fuel economy credit" and Part 2 is a "conservation credit." The exact amounts of the credits available for qualifying vehicles are not available at this time. It has been reported (unofficially) that the Toyota Prius may qualify for a $3,150 credit and the Honda Accord only $650.

The decision regarding whether to purchase now or later is complicated and depends on a number of tax-related issues. Again, I will be pleased to review this issue and your tax situation with you. While the *2005 Energy Act* places a cap on the number of vehicles that can be sold (and available for the credit), the number is high enough that you do not have to run to the dealers!

Two interesting Websites to visit are:
www.FuelEconomy.gov and
www.HybridCars.com

2005 Katrina Emergency Tax Relief Act
To their credit, Congress and President Bush reacted in a timely manner by enacting the *Katrina Emergency Tax Relief Act of 2005*. While a majority of the Katrina Act provisions are applicable to persons in the affected areas, there are a number of provisions that offer tax benefits to many taxpayers regardless of where they live.

Under normal circumstances, the amount of cash donations to IRS-approved public charities that individual taxpayers can deduct (on Schedule A) is limited to 50% of a taxpayer's adjusted gross income. Please note that charitable deductions are also subject to a special phase-out rule associated with itemized deductions. In any case, the very good news is that the *2005 Katrina Act* provides that cash contributions between August 28, 2005 and December 31, 2005 are deductible up to 100% of your AGI. Unfortunately, there is no change to the rule that limits charitable contribution deductions to taxpayers who itemize and not to taxpayers who elect the Standard Deduction.

Another valuable feature of the *2005 Katrina Act* is an addition $500 exemption (maximum of $2,000) for taxpayers who provide free housing for a period of 60 consecutive days to an individual/s displaced by Hurricane Katrina.

The *2005 Katrina Act* increases the mileage rate for Katrina related charity work. The new rate is 70% of the optional standard mileage rate. Since the optional standard mileage rate increased on September 1, 2005 from 40.5 cents per mile to 48.5 cents per mile, the Katrina charitable mileage rates are 29 cents from August 25-August 31 and 34 cents from September 1-December 31.

While Congress set out to address Hurricane Katrina concerns by way of legislation, the IRS has issued pro-taxpayer administrative rulings concerning Hurricanes Rita and Wilma.

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 educators - 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 non-reimbursed employee business expenses on 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 changed 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 such as where the charity uses the vehicle, gives or sells the vehicle to a needy family or substantially improves the vehicle. It is important that you receive written evidence regarding exactly what the eligible charity did with your car.

2005 Mileage Rates: A Split Year

	Jan 1-Aug 31	Sept 1-Dec 31
Optional Standard Mileage Rate	40.5 cents	48.5 cents
Medical Mileage Rate	15.0 cents	22.0 cents
Moving Mileage Rate	15.0 cents	22.0 cents
Charity Mileage Rate	14.0 cents	14.0 cents

2006 Mileage Rates
The Government has announced that it will delay the release of the 2006 mileage rates. Apparently the government wants to closely monitor gasoline prices. The 2006 mileage amounts will be available by the end of 2005.

Extending Tax Benefits
One of the most important features of *2004 Tax Act* was the decision to extend for several years certain tax benefits that were set to expire. 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.

Investors Win: Lower Capital Gains Rates
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 transaction after May 5, 2003. The lower rates are scheduled to expire after 2008.

There is no increase in the $3,000 annual limitation on deducting excess capital losses.

For 2005 and 2006, 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%
Historically, dividend income was taxed as ordinary income. Under the *2003 Tax 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.

For 2005 and 2006, the rates are 15% and 5% respectively.

The IRS reports that there has been significant confusion on the part of companies and brokers in reporting whether the dividends are "qualified" for the lower rates. The problem results from a special holding period that Congress created. 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.

Bottom line: Not all dividends 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.

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.

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.

Itemized Deduction for State Sales Taxes

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 most 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 releases in Publication 600. 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. Unless Congress acts, the popular deduction for state and local sales taxes will expire at the end of 2005.

Tax Deduction for Tuition and Fees

The above-the-line deduction for higher education expenses increased in 2004 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 $50,000 to $60,000 for single taxpayers and $70,000 to $80,000 for a married couple filing jointly.

The maximum IRA contribution for 2005 is $4,000 and an additional $500 for taxpayers who are 50 years of age or older in 2005. Note that the contribution limits in 2006 will be $4,000 and an increase in the additional catching-up to $1,000.

Roth IRAs continue to be an attractive investment option. The generous AGI test ($95,000 - $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.

The amount of money that eligible taxpayers may contribute to a Roth IRA in 2005 is $4,000 plus $500 catch-up (if 50 or older). For 2006, the contribution limits are $4,000 plus $1,000 in catch-up.

Traditional IRAs and Roth IRAs

Year	Amount	Catch-Up
2005	$4,000	$500
2006	$4,000	$1,000
2007	$4,000	$1,000
2008	$5,000	$1,000
2009	$5,000	$1,000

Note: Starting in 2009, the contribution amounts will be indexed for inflation.

NEW Roth 401(k) Plans

Effective January 1, 2006, eligible employees may participate in a 401(k) plan that operates like a Roth IRA with one big exception, there is no Adjusted Gross Income test associated with the Roth 401(k) plan. Since the account is designated as a Roth 401(k), the taxpayer-employee pays taxes on the amount of the contributions now and receives the tax-free reward later. The contribution limits on Roth 401(k) plans is the same as for other 401(k) plans. Contributions may be split between traditional 401(k) plans and the new Roth 401(k) plans.

Estate and Gift Tax Rules Update

Changes in the area of estate taxation have produced an increase in the lifetime exclusion to $1.5 million for 2004 and 2005. The exclusion goes up to $2,000,000 for 2006-2008.

The maximum tax rate for estate and gift tax for 2005 is 47% and 46% in 2006.

The gift tax lifetime exclusion remains at $1 million as does the annual $11,000 per recipient (donee) tax-free gifts rule. For 2005, the $11,000 is doubled to $22,000 in the case of joint gifts from a married couple. For 2006 the annual gift exclusion is $12,000/$24,000 respectively.

The 529 College Savings Plans rules permit five years worth of gift giving at one time. In 2005 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. While there is a reporting requirement - no taxes will be owed on the gifts.

President Bush's Tax Advisory Panel

On November 1, 2005, President Bush's Tax Advisory Panel delivered its final report to Treasury Secretary John Snow. The report created some controversy ever before it was released. The panel, which began its work on February 16, offers two choices for changing the tax system.

Plan A calls for Streamlining the Income Tax by:

- Create only 4 tax brackets
- Limit the home-mortgage interest deduction
- Eliminate the deduction for state and local income taxes
- Eliminate the AMT (and this alone will cost lots of money)
- Eliminate the tax on dividends
- Lower the tax on long-term capital gains

Plan B is called the Progressive Consumption Tax. This proposal calls for:

- Create 5 tax brackets
- Create a new "family credit"
- Create a new "savers credit"
- Eliminate the AMT
- Offer an incentive for dividends from a corporation's domestic activities
- Allow all taxpayers to deduct gifts to charities

The above discussion is only part of what the Advisory Panel has proposed. The next step is for the Treasury Department to review the report and make recommendations to President Bush and Congress.

Did you know?

1. 2006 COLA increase for Social Security recipients is 4.1%. The 2005 increase was 2.7%.
2. 2006 Medicare Part B premiums are up 13% to $88.50 a month. The 2005 increase was 18%.
3. The 2006 FICA wage base is $94,200. The 2005 FICA wage base was $90,000.
4. In 2006, 161 million taxpayers will pay FICA taxes.
5. In 2006, 11.3 million taxpayers will pay higher taxes as a result of the increase in the FICA wage base.
6. 2006 Standard Deduction will likely be $10,300 for a married couple filing jointly, $7,550 for Head of Household and $5,150 for single taxpayers and married filing separately.
7. Exemptions will likely be worth $3,200 in 2006.
8. One year relief from AMT is estimated to cost as much as $22.6 billion.
9. The new (2005) uniform definition of a child will make it harder for some taxpayers to qualify for Head of Household filing status.
10. In 2006 the exempted amount of annual gift giving will increase to $12,000 (up from $11,000 in 2005). The exclusion is $24,000 in the case of a married couple making a joint gift.

Conclusions

The *2004 Tax Acts* provide tax benefits for millions of taxpayers. The bulk of the *2004 Tax Acts* are effective for year 2005 and beyond.

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 gains and dividends for a short period of time.

The *2005 Energy Act* offers some interesting new tax credits for energy efficient improvements to a personal residence. The improvements must be made in 2006 or 2007. The *2005 Energy Act* creates a new tax credit (not a deduction anymore) for certain new hybrid vehicles.

The *2005 Katrina Act* offers tax benefits to taxpayers in and out of the Hurricane affected areas.

Looking into the crystal ball - 2006 will bring a national debate over the subject of tax reform and proposals including abolishing the tax code and replacing it with a national sales tax, consumption tax or flat tax. While the President's Tax Advisory Panel has not advocated a national sales tax or consumption tax the ideas will be discussed. Each of the proposals will require careful study and debate. Say what you want about the Advisory Panel - some interesting ideas are up for discussion.

Congress, for its part, must address expiring tax benefits. Scheduled to expire at the end of 2005 are the 1) sales tax deduction, (2) tuition and fees deduction and (3) educator's expense deduction. The idea of making the 2001 tax cuts permanent will be under consideration as will the repeal of the federal estate tax.

It is not likely that the favorable tax rates on capital gains or dividends will be changed in any negative way during 2006.

Social Security reform was high on President Bush's 2005 economic agenda. President Bush endorsed the idea of establishing "limited" private accounts out of Social Security savings. The word "inside Washington" is that Social Security reform is off the table for now and with 2006 being a congressional election year - likely off the table until 2007.

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

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

Best wishes,