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Volume 6, Issue 1 A Quarterly Newsletter January 2005

Two New Federal Tax Laws

Two major tax laws were passed during this fall's pre-election period: the ***American Jobs Creation Act of 2004*** and the ***Working Families Tax Relief Act of 2004***. Both new acts have important ramifications on your personal tax return. Both also affect virtually every business and many individuals as small business owners and as investors in multinational corporations. Of the two, the *American Jobs Creation Act of 2004* is the more complicated and extensive. In fact, it is considered the most important tax bill for the business community since 1986.

Click here to review the changes that impact your personal tax situation and recommendations for some initial steps that you might take to maximize your tax benefits. The highlights are:

Child tax credit	Marriage penalty relief
AMT relief	SUV deduction
Vehicle donations	State sales tax deduction
Tax Shelters	

Click here for an introduction to some of the major changes that have taken place in connection with the tax law's application to business entities and business operations. Most of the changes present opportunities for your business to save more taxes. Some, however, set traps for the unwary while others are outright attempts to wring a few more tax dollars out of the business community. The highlights include:

Deduction for Manufacturers	Sec 179 limits
SUV deduction	Tax breaks for farmers

Depreciation for leasehold improvements & restaurant property
Extended business credits and deductions

Not discussed in these two articles, is a new exclusion for the use of the \$250,000/\$500,000 home-sale gain non-recognition rules if the property had been acquired in a Sec. 1031 exchange. Click here for Benny Kass' article regarding this.

Last Minute Tax Tips

If you're eligible to make a 2004 Roth IRA contribution, plan to do it by April 15, 2005, if not sooner. If you're not eligible for a Roth IRA due to income limitations, evaluate the choice to make a traditional non-deductible IRA contribution instead. The contribution amounts are \$3,000 for under 50 years old, and \$3,500 if 50 by 12/31/04.

Maximize your 401(k) or 403(b) contributions to your employer's plan. If you cannot maximize the contribution, be sure you put in at least the amount that gets you the maximum employer matching contribution.

Small business owners: review your retirement plan options and consider a Safe Harbor 401(k) Plan or a Cross-tested Plan for 2005.

Donating a vehicle? Do it in 2004 rather than 2005 to avoid the new rules.

Make any major purchases in 2004? Check out the new sales tax deduction rules.

Equipment Purchases

If you're already planning some equipment purchases for early next year, you might want to consider accelerating the purchase date to capture a valuable business tax break that expires at the end of December. That's the special bonus depreciation allowed on the purchase of **new** business equipment.

The Cost-of-Living Dollar Limits for 2005 Tax Year

IRA Contribution Limit \$4,000
50 & Over Catch-up Contribution \$500
401(k) deferral limit \$14,000
50 & Over Catch-up Contribution \$4,000
Annual compensation limit \$210,000
Defined contribution IRC Sec 415 limit \$42,000
Compensation limit for SEP eligibility \$450
Deferral limit for SIMPLE \$10,000
IRC Section 179 \$105,000
Unified Credit Exclusion \$1,500,000 in 2005
Self-employed health ins. AGI deduction 100%
Business mileage rate \$0.405/mile
Medical mileage rate \$0.15/mile
Charitable mileage rate \$0.14/mile

1st Year depreciation limits: (2004)
Passenger Autos
New \$10,710 Used \$3,060

Trucks & Vans under 6,000 unloaded GVW (2004)
New \$11,010 Used \$3,360

Social Security

Wage Base for 2005 \$90,000

Retirees under 65 may earn up to \$12,000 (\$1,000 a month). For each \$2 earned over the amount for the year, the retiree loses \$1 in benefits. Retirees turning 65 in 2005 can earn up to \$31,800 in the year without losing benefits, counting only earnings before the month they turn 65. For each \$3 earned over this limit, the retiree loses \$1 in benefits. No limit if 65 or over, effective January 1, 2000.

As you work and pay Social Security taxes, you earn "Credits", up to a maximum of 4 for each year. The amount of earnings it takes to earn a credit changes each year. In 2005, you earn one credit for each \$920 of your earnings. So if you have earned at least \$3,680 during the year, you get the maximum 4 credits. If you employ family members, you may want to be sure to pay them at least this amount so they earn their credits.

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DEADLINES

January 15
Monthly-filers Form 941 federal tax deposit due
DC sales tax return and payment due, quarterly and monthly filers
1040-ES voucher #4 due
Virginia, DC and Maryland individual estimated tax payment #4 due

January 20
Virginia and Maryland sales tax return and payment due, quarterly and monthly filers
DC income tax withheld return and payment due, quarterly and monthly filers

January 31
Form 941 due
Virginia income tax withheld return and payment due, quarterly and monthly filers
Maryland income tax withheld return and payment due, quarterly and monthly filers
State unemployment tax returns and payment due
Employees' Forms W-2 and recipient's 1099s must be provided
State annual summary card and transmittal of state copies of Forms W-2 due
Form 940 and related fed tax deposit/payment due
City of Fairfax business license renewal application and payment due
City of Alexandria business license renewal application and payment due
County of Arlington business license renewal application and payment due
County of Prince William business renewal application and payment due

February 1
County of Loudoun personal property tax return due

February 15
Monthly-filers Form 941 federal tax deposit due
DC sales tax return and payment due, monthly filers
Maryland income tax withheld return and payment due, monthly filers

February 20
Virginia income tax withheld return and payment due, monthly filers
DC income tax withheld payment return and payment due, monthly filers
Virginia and Maryland sales tax return and payment due, monthly filers

February 28
Forms W-3/W-2 must be filed with Social Security Administration
Forms 1096/1099 must be filed with Internal Revenue Service

March 1
County of Fairfax BPOL renewal applications and payment due
County of Loudoun business license renewal application and payment due
City of Falls Church business license renewal application and payment due
Town of Purcellville business license renewal application and payment due

March 15
Monthly-filers Form 941 federal tax deposit due
DC sales tax return and payment due, monthly filers
Maryland income tax withheld return and payment due, monthly filers
Calendar year Federal, DC and Maryland corporate tax returns due

March 20
Virginia income tax withheld return and payment due, monthly filers
DC income tax withheld payment return and payment due, monthly filers
Virginia and Maryland sales tax return and payment due, monthly filers

The special bonus depreciation applies to most new equipment you purchase, provided you place it in service before year-end. If your purchase qualifies, you can deduct 50% of the cost as a bonus depreciation expense in 2004. The bottom line is that you'll have an extra deduction against this year's taxable income. Most new business equipment and certain leasehold improvements qualify for the bonus.

Another expanded tax break for business purchases now continues through 2007. That's the provision that allows you to immediately expense the entire cost of some of your equipment purchases. Expensing allows you to write off the full cost against your taxes immediately, instead of deducting it as depreciation over several years. This year, you can potentially expense up to $102,000 of business equipment, subject to certain limitations. Most new or used tangible personal property you buy for your business qualifies.

Note that bonus depreciation applies only to new property, while expensing may be taken on new or used property. Also, the two benefits can be combined; the expensing option can be taken for a purchase, and the bonus depreciation can be used on the remaining basis if the property qualifies.

Maximize your tax benefits with careful planning and timing of equipment purchases.

Virginia Withholding Tax Formula Changes

Effective January 1, 2005, the withholding formula used to determine employee **Virginia** state income tax is changing to account for increases in the personal exemption and the standard deduction amounts. These changes will result in an increase in employee take-home pay.

Personal Exemptions: The personal exemption amount of $800 increases to $900, except for the additional personal exemptions allowed for taxpayers age 65 and over and for the blind, which remain at $800.

Standard Deduction: The standard deduction for married filing jointly increases from $5,000 to $6,000. Consequently, the married filing separately standard deduction increases from $2,500 to $3,000. The standard deduction for the single filing status remains at $3,000. Thus, the standard deduction amount of $2,500 previously used to compute withholding increases to $3,000.

Filing Thresholds: The filing threshold increases are as follows:
The filing threshold for single taxpayers increases from $5,000 to $7,000;
The filing threshold for married taxpayers filing jointly increases from $8,000 to $14,000; and
The filing threshold for married taxpayers filing separately increases from $4,000 to $7,000.
The increases in the filing thresholds will affect whether employers are required to withhold taxes from certain taxpayers.

The Employer Withholding Booklet is now being updated and should be available for downloading by the end of the first week of December.

Tax Organizers

As usual, the Tax Organizers are scheduled to go out shortly after Christmas. Using our Tax Return Organizer saves us time and, therefore, saves you money on the preparation of your tax return. We also have the Organizer available in electronic format for those that are more "techie" oriented. An e-Organizer will be sent to those clients that we have a valid email address on file. If you don't get either type of Organizer, and you would like one, please give us a call or go to our website.

HAPPY HOLIDAYS

Websites of Interest

Small Business Sites

National Federation of Independent Business's tools and tips for small business owners at www.nfibonline.com

Current and archived versions of *Entrepreneur*, *BizStartups* and *HomeOfficemag* magazines www.entrepreneurmag.com

Free articles on buying, selling, or determining the value of your business at www.businessbookpress.com

Help for small businesses with sample business plans, employment and other legal forms, articles and guidance on various topics www.businessknowhow.com

To keep informed on tax related issues quickly and easily, visit Small Business and Self-Employed Community at http://www.irs.gov/businesses/small/index.html

The Center for Business Planning offers sample business plans, analyses of business strategies, info on evaluating business and marketing plans www.businessplans.org

Want to know what IRS examiners will look for, and how, when auditing certain industries?
http://www.irs.gov/businesses/small/article/0,,id=108149,00.html (cut & paste this URL in your browser's address box)

Tools for evaluating the lease vs. purchase of a new vehicle: www.leaseguide.com/index2.htm

How do your employee benefits compare with the federal government's? http://www.opm.gov/oca/leave/HTML/factindx.asp

College Savings

College Savings and 529 Plans: www.collegesavings.org www.savingforcollege.com
www.dccollegesavings.com www.collegesavingsmd.org www.vpep.state.va.us
College savings and 529 Plan rebates www.upromise.com

Retirement Savings and Retirement Plan Information

To determine your required minimum distribution: http://www.newrmd.com/
Roth IRA information: www.rothira.com
Retirement Plan comparison: www.selectaretirementplan.org
Retirement Plan options http://www.dol.gov/ebsa/pdf/choosing.pdf
Retirement Plan Dollar Limitations (COLA): www.irs.gov/ep go to Published Guidance & Cost of Living Increases
or http://www.irs.gov/pub/irs-tege/cola_table.pdf
Small Business 401(k) Plans: http://www.dol.gov/ebsa/publications/401kplans.html

General Interest

Product reviews www.consumerreview.com

Missing Records and Unclaimed Property

To track down missing records, locate lost assets, or discover property you didn't know you had:
- Birth, marriage, and death certificates www.cdc.gov/nchs/howto/w2w/w2welcom.htm
- Military records www.nara.gov/regional/mprsf180.html
- Passport records www.travel.state.gov/passport_records.html
- Missing a pension from a previous employer www.pbgc.gov

Holders of abandoned or unclaimed property reporting requirements (new rules effective 7/1/04):
- Maryland: http://compnet.comp.state.md.us/compliance/ Virginia: http://www.trs.virginia.gov/ucp/ucp.asp
- DC: http://cfo.dc.gov/cfo/cwp/view,a,1326,q,590614,cfoNav,|33208|.asp

Estate Planning

To assist in various aspects of estate planning: http://www.learnestateplanning.com/index.html

2004 Tax Legislation: Tax Breaks for Individuals

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Working Families Tax Relief Act of 2004

Child credit. Parents of children under 17 can continue to claim a $1,000 child tax credit for every child through 2010. Without the new law, the child credit would have dropped to $700 per child in 2005.

Marriage penalty relief. Married taxpayers filing jointly will continue to benefit from full marriage penalty relief. Through 2010, joint filers will pay tax at double that of single filers for the 15 percent rate. For 2005, this means having the high end of the 15 percent tax bracket pegged at $59,400, rather than at $53,450. The change in the standard deduction for married couples filing jointly is equally as dramatic, $10,000 in 2005 instead of $8,700.

The 10 percent tax bracket's upper limit for married taxpayers filing jointly stays at $14,000 ($14,600 inflation indexed) for 2005 rather than dropping to $12,000. For single taxpayers, it stays at $7,000 rather than dropping to $6,000.

AMT relief. The alternative minimum tax (AMT) exemption amount remains at $42,250 for single individuals and $58,000 for married couples for one more year. Taxpayers can also use the personal nonrefundable credits against AMT liability for one more year.

American Jobs Creation Act of 2004

If you run a small business, many benefits in this new law will show up on your personal tax return. A broad-reaching manufacturer's deduction (which even reaches some service-intensive businesses), S corporation reform that helps family businesses, and an extended accelerated "section 179 expensing" deduction are among the more important small business provisions. Farmers also share in additional tax breaks.

Several notable provisions in the American Families Tax Relief Act of 2004, however, will have a direct impact on your individual tax return:

SUV deduction. Large sports utility vehicles will no longer be able to be driven through a tax loophole by business owners. Because the vehicle caps on depreciation do not apply to cars or trucks weighing more than 6,000 pounds, those who have any sort of business operation (even a profitable sideline business) could deduct up to the full cost of the SUV immediately as a section 179 deduction. The section 179 deduction was limited only by a $100,000 per year cap. Effective for vehicles placed in service after October 22, 2004, the expensing deduction is limited by a $25,000 cap, rather than $100,000. But the loophole is not fully closed yet. Regular vehicles generally are limited to a $2,960 write off in the year of purchase, so buying a heavy SUV still may save you considerable up front costs.

Vehicle donations. Congress voted to limit dramatically the deduction for vehicles contributed to charity. If the charity sells your vehicle without using and improving it (which is usually the case under most vehicle-donation programs), your charitable deduction cannot exceed the gross proceeds that it receives from the sale, usually a deeply discounted below-wholesale price. Stiff penalties will be imposed on charities that don't approach this obligation honestly. The charity also is required to pass along to the IRS the information in a written acknowledgment that it is required to give to the donor.

The new acknowledgment rule for arm's-length sales applies for contributions made after December 31, 2004. If you are thinking about donating a vehicle, doing so before 2005 may make sense as far as the size of your charitable deduction is concerned.

State sales tax deduction. The new law allows individuals to deduct state sales taxes instead of deducting state and local income taxes as an itemized deduction. This election is available in 2004 and 2005. If you elect to deduct state and local sales taxes paid, you will have two options: determine the deductible amount by accumulating receipts, or by using tables to be prepared by the Secretary of the Treasury based on average consumption and other factors.

This deduction is available for all states, including states without an income tax. If you make several major purchases for the year, such as a luxury car or boat, you may find that electing to deduct sales tax will pay off if you combine those purchases with daily sales tax expenses. Because this election is available for the entire 2004 tax year, getting organized and finding your sales receipts since January 1, 2004, should be a priority.

Tax shelters. If you invested in tax shelters, your past may haunt you. Certainly, you need to be more cautious going forward in investigating any private investment offering in light of the Congress's continuing campaign against tax shelters and abusive tax schemes. Congress approved increasing penalties for promoters and investors failing to disclose their participation in abusive transactions. The new law also relaxes the confidentiality rules, making conversations about tax-deals more subject to disclosure to the IRS than ever before.

2004 Tax Legislation: Tax Breaks for Business

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New deduction for manufacturers. Even if you don't think you are a manufacturer, this new deduction may be for you. Four years ago, the World Trade Organization declared the FSC/ETI (foreign sales corporation/extraterritorial income) tax regime for exporters an illegal trade subsidy and began to slap high fines on those businesses. In response, Congress has repealed that system (over a four-year period). In its place, it approved a new deduction for manufacturers.

The new deduction for manufacturers, which itself is phased in gradually over six years, surprised many experts. It covers all income from manufacturing in the United States, not only from export businesses. It represents up to a 3 percentage point drop in a business's effective tax rate. What's more, "manufacturing" is defined very broadly to include not only traditional manufacturing, but also construction, engineering, energy production, computer software, filmmaking, and the processing of agricultural products. Corporations, individuals, S corporations, partnerships, estates, trusts, and cooperatives can take advantage of the new deduction.

Small business expensing and depreciation. Two years ago, Congress raised the threshold for small business expensing from $25,000 to $100,000. The enhanced treatment was designed as a temporary measure to stimulate the economy, falling back to $25,000 in 2006. The new law extends the higher small business expensing amounts through 2007.

The SUV deduction. Large sports utility vehicles and luxury passenger trucks will no longer be able to be driven through a large tax loophole by business owners. Because the vehicle caps on depreciation do not apply to cars or trucks weighing more than 6,000 pounds, taxpayers could deduct up to the full cost of the SUV immediately as a section 179 deduction. Now the deduction for vehicles weighing not more than 14,000 pounds is capped at $25,000, effective for property placed in service after October 22, 2004. However, that is still a lot more than the cap placed on "regular vehicles," which hovers around the $3,000 level.

Depreciation. Congress approved a 15-year recovery period, using straight-line depreciation, for qualified leasehold improvements to nonresidential real property. The new law also provides a 15-year recovery period and straight-line depreciation for qualified restaurant property.

S corporation reform. The new law dramatically changes the S corporation rules. Under the recent legislation, the permissible number of S corporation shareholders increases from 75 to 100. In addition, Congress also approved treating all members of a family as one S corporation shareholder. If you own a family business, this can represent a significant tax break.

The new law also permits traditional and Roth IRAs to hold shares in a bank that is an S corporation; allows suspended losses or deductions to be transferred in the case of transfers of stock to a spouse incident to divorce; eases the rules for determining potential current beneficiaries of an electing small business trust; relaxes some passive activity loss rules as they relate to qualified subchapter S trusts; gives relief from inadvertent invalid subchapter S subsidiary elections and terminations; and provides for qualified subchapter S subsidiaries to file information returns.

International tax reform. If you do business abroad, you will need to react to the American Jobs Creation Act in many different ways. Congress approved reducing the number of foreign tax credit baskets from nine to two: passive category income and general category income. The new law also delineates some financial services income as general category income and allows taxpayers to make a temporary election about certain creditable foreign taxes. Congress also approved changes to the interest expense allocation rules for the foreign tax credit limitation. An actual list of all the changes in this area literally goes on for pages.

Tax breaks for farmers. Agribusiness as well as traditional farmers make out well under the new tax laws. In addition to qualifying the processing of agricultural products as "manufacturing" eligible for the three-percent corporate tax reduction, the new law adds over 20 agricultural tax breaks and incentives to the Code, including significant provisions affecting weather-forced livestock gain and the alternative minimum tax as applied specifically to the usual ups and downs of farm income from year to year.

Extended business credits and deductions. The Working Families Tax Relief Act of 2004 is not just for families. An entire section of this new law extends over 20 temporary business incentives, which either had expired at the end of 2003 or at the 2004 midpoint. These include the research credit, the welfare-to-work and work opportunity tax credits, environmental remediation expensing, which is extended for expenses paid or incurred after 2003 and before 2006, and the renewable source energy credit.

Revenue Raisers. Not all of the provisions in the new tax laws are favorable. Over $100 billion in "revenue raising" provisions temper the celebration. These provisions also form a long list and need to be monitored. Under the new legislation, tax shelter investors have been asked to pay up with increased penalties; the personal use of company aircraft by the company's executive/owners can no longer be deducted by the business in an amount that is greater than what is considered compensation to the employee; and the size of vehicle donations, whether by a business or an individual, also has been severely restricted, effective starting in 2005.

New Tax Law Restricts Property Exchanges

By Benny L. Kass
The Washington Post
Saturday, October 23, 2004; Page F08

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The far-reaching corporate tax law passed by Congress this month puts a new restriction on tax breaks for investors who obtain property through what is known as a like-kind, or Starker, exchange and then convert the property into a principal personal residence.

This topic is complex; understanding it requires some background.

When a real estate investor sells property, and the property has been held for at least one year, the investor owes capital gains tax on the profit. Currently, the federal capital gains tax rate is 15 percent.

However, if the investor wants to purchase other property, there is a way to defer paying the tax. It is called a Section 1031 exchange, like-kind exchange or Starker exchange (named after the investor whose Supreme Court case legitimized such deals).

Under Section 1031 of the Internal Revenue Code, no gain is recognized - and thus no tax is paid - if the investor exchanges one piece of real estate for another, and complies with the rules spelled out by the IRS.

Let's say an investor owns a property and wants to get rid of it. This is called the "relinquished property." The property was bought for $100,000, and is now worth $600,000. (For this discussion, we will ignore any depreciation the taxpayer has taken over the years, but depreciation is an important factor in determining gain.) When the property is sold, the investor has a profit of $500,000. At the current capital gains tax rate, the investor would have to pay $75,000 in federal taxes.

However, if the investor decides to do a Starker exchange, the tax will be deferred. The investor must identify a replacement property within 45 days from the date the relinquished property is sold, and must go to settlement on the replacement property within 180 days from the previous sale.

The investor cannot have any access -- or control -- over the relinquished property sales proceeds. They must be held in escrow by a neutral third party, and turned over directly to the title attorney handing the settlement on the replacement property.

If a successful 1031 exchange takes place, the tax basis of the relinquished property becomes the tax basis of the replacement property. Thus, in our example, even if the investor pays $800,000 for the new property, its basis will still be $100,000.

This is called a like-kind exchange, because real property must be exchanged for other real property. You cannot exchange a single-family house for a piece of expensive farm machinery.

However, the definition of real estate is very broad. As long as the replacement property is real estate, the 1031 exchange will work. Thus, a single family house can be exchanged for a farm; an office building for a vacant lot.

Let's look at what Congress has just done.

Say the investor owns a single-family rental house in the city. It has appreciated considerably. The investor plans to retire in two years to Florida. He sells the relinquished house and exchanges it for a replacement property in Tampa. He rents out the Florida house for two years. Upon retirement, he moves into that property and treats it as his principal residence.

Under other provisions of the tax law, specifically section 121(d), if you sell your principal residence, and have lived in it for two out of the five years before it is sold, you can exclude up to $500,000 of gain (if you are married and file a joint tax return) or $250,000 if you file an individual tax return.

Thus, before the recent tax law, the investor could live in the house for two years, sell it and treat it as his principal residence, thereby taking advantage of the above-mentioned exclusions. In other words, there would be situations (depending on the numbers) in which the investor would either avoid paying any capital gains tax, or would have a much smaller tax bill.

The new law imposes a five-year restriction on that loophole. It states: "If a taxpayer acquired property in an exchange in which Section 1031 applied, [Section 121(d)] shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property."

What does this mean? In our example, if the investor did not like his Tampa house and wanted to sell it less than five years from the date of its acquisition, he would not be able to claim the $250,000/$500,000 exclusion of gain. He would have to pay the entire capital gains tax.

That would not be a major catastrophe for investors who want to convert their replacement investment property into a principal residence. It merely puts a five-year waiting period into the equation. It should be noted that the investor can still defer (or even avoid) paying capital gains tax by going the 1031 exchange route.

Say the investor sells the relinquished property. Within the required 180 days, he obtains the replacement property. He must rent it out for at least one year to assure that the process will be considered a valid 1031 exchange. At the end of that year, he has the right to move into the property, and convert it to his principal residence.

What is not clear from the new law is how long after the five-year period the investor has to hold on to the replacement property before he can take advantage of the Section 121(d) exclusions. Can he sell it in the sixth year, or does he have to use and own the property for two years after the new statutory five-year period? I suspect that the Internal Revenue Service will address that issue.

A Starker exchange still makes sense for the many investors who have seen fantastic appreciation in their real estate holdings. And if you ultimately want to convert the replacement property into your principal residence, that option still is available.

It's just that now, under the new law, to take advantage of the exclusions, you will have to wait at least five years before you can sell that property.