TAX NEWS LETTER 2005

November 18, 2005

Believe it or not, “tax season” will soon be upon us! The best time to think about tax and financial planning is during the fall each year. Therefore, I decided to write this letter to keep you informed of recent tax law changes.

The year 2005 certainly has seen many changes affecting our lives. The Bush administration and congress continue to deal with serious issues involving the hurricane destruction in Louisiana and Mississippi, high gasoline prices and the war in Iraq. As a result, only marginal income tax legislation took place during 2005. Legislation that was enacted evolved around creating energy incentives and responding to the high cost of gasoline.

I have broken down this review into three areas: tax legislation for new and expiring laws, on-going tax planning ideas and practical education section called “Steve’s tax corner” of common concerns.

New tax law additions:

- Mileage deduction rate for business use of personal owed vehicles increased from 40.5 cents per mile to 48.5 cents per mile effective September 1, 2005. This change will require taxpayers to report their business miles for two separate time periods. Charitable mileage donation rate will remain the same at 14 cents per mile while the medical mileage deduction will increase to 22 cents per mile.

- Energy incentives for individuals and businesses:

    - $500 maximum “lifetime” energy tax credit available for expenditures in 2006 and 2007. Qualified expenditures include the cost of exterior doors, windows, insulation, furnaces, central air and certain metal roofs. Credit is limited to $200 for each “type” of expenditure.

    - $2,000 maximum tax credit for the purchase of solar equipment in 2006 and 2007. Credit is limited to 30% of the initial cost as installed.

    - Purchase or lease of a “green” (electric hybrids, lean burn, fuel cells and alternate fuels) vehicle in 2006 and or in 2007 providing a maximum income tax credit of $3,400. This credit replaces the prior deduction allowed in 2005 and earlier years. The credit is based on two components: fuel economy and conservation. IRS must certify the type of auto purchased. Examples include” Ford Escape Hybrid, Toyota Prius and the Honda Insight. Tax savings depends on the fuel savings compared to 2002 vehicles with an average savings expected to be between $1,500 and $2,250.

- Energy incentives for individuals and businesses - continued:

    - $2,000 tax credit to home builders that complete construction of a residence after 2005 or for any home purchased in 2006 and 2007 that provide for a 50% increase in energy efficiency over comparable structures.

- IRS has defined the term "qualifying child" for dependent exemption purposes. Beginning in 2005, a dependent must meet tests for relationship, age, abode (residence) and support. In general, these laws are the same as before 2005 except under the abode test the dependent must live in the same place as the taxpayer for at least one-half the year.

- Beginning in 2006, employer 401k plans can now allowed to accept "ROTH" IRA type pension contributions. New 401k ROTH allows for higher contribution amounts than those in a regular IRA type ROTH. Rules governing the ROTH are the same as under the IRA rules.

<u>Expiring tax provisions:</u>

- State & local sales tax itemized deductions are eliminated effective for tax years beginning January 1, 2006. Background: for tax years 2004 and 2005, a sales tax deduction was allowable in place of state income tax deductions when the latter was less. In general, this deduction benefited residents of states with no state income taxes.

- Out-of-pocket expenses paid by school teachers are eliminated starting in 2006. For years through 2005, the deduction was limited to $250.

- Qualified tuition expense deduction for amounts paid to post-secondary (college) will be disallowed starting in 2006. Deduction was limited to $4,000.

<u>On-going provisions:</u>

- Annual gift tax exemption remains at $11,000 per donee per year. Expected to increase to $12,000 in 2006.

- IRA contribution deduction increased to $4,000 per person ($4,500 if age 50)

- Person deductions such as the standard deduction ($10,000 for married filing jointly and $5,000 single) and personal exemptions have increased to reflect cost of inflation.

- Maximum capital gain tax rate remains at 15% (10% if in the lowest tax bracket) of net long-term capital gains.

Steve's Tax Corner:

Topic: "Not all tax deductions are created equal"

Did you know that different deductions for the same amount can result in different tax savings? In other words, some deductions are more valuable and therefore more efficient than others. Which type of deduction you have may influence your decision regarding investment and financial alternatives.

In general, deductions are classified as either business or personal. Business deductions are by far the best and most efficient form of tax savings. These deductions are generally associated with a self-employed business, real estate rental properties, farm operation or pension and retirement contributions. Personal deductions include the standard deduction based on filing status (married, single, head of household, etc), personal exemption and "itemized deductions (medical, state and local taxes, mortgage interest and charitable donations)". By far, itemized deductions are the least tax efficient in terms of tax savings.

As an example, real estate property taxes deducted on Schedule E (1040) will yield a greater deduction than that paid for a vacation home and reported on Schedule A (1040) as an itemized expense. The same can be said for mortgage interest paid, investment expenses, employee expenses, legal costs and yes accounting fees!

Currently, congress is considering new laws that will further limit the use of itemized deductions in an attempt to simplify the law and to treat taxpayers in different states more equally. For example, in future years, state income tax deductions may be abolished (to make fairer to residents in states without and income tax) all together and there will be a "cap" on mortgage interest expenses.

For most people, pension contributions are the single best most tax efficient deduction. Contributions can be in the form of an IRA plan or through employer plans such as a 401(k), 403(b) or SEP (simplified employer pension (IRA plans)).

I hope this information has been helpful. Please contact me if you want to discuss any of the above items.

Sincerely,

Stephen B. Smith, CPA