

# Federal Update

## **Educators Deduction**

The Educators Deduction, which allowed educators to claim a tax deduction for money they spent on books and classroom supplies, expired in 2003, but The Working Families Tax Relief Act of 2004 reinstated it.

## **State and Local Sales Tax Deduction**

Taxpayers who itemize deductions will have a choice of claiming a state and local tax deduction for either sales or income taxes on their 2004 and 2005 returns. The IRS will provide optional tables for use in determining the deduction amount, relieving taxpayers of the need to save receipts throughout the year. Sales taxes paid on motor vehicles and boats may be added to the table amount, but only up to the amount paid at the general sales tax rate. Taxpayers will check a box on Schedule A, Itemized Deductions, to indicate whether their deduction is for sales or income taxes. Save receipts to show actual sales tax paid, or use IRS tables that are based on income. Add the sales tax you paid on boats or cars, which is not included in the tables.

## **Sports Utility Vehicle Deduction**

A loophole in the income tax law allowed business owners of luxury SUVs to claim a \$100,000 write-off. This SUV bonanza has come to an end. Now you can only take the deduction on vehicles weighing more than 14,000 pounds. The deduction for Hummers and other large sports utility vehicles is capped at \$25,000. Businesses cannot take a first-year deduction of more than \$25,000 for an SUV. The business would depreciate the remaining cost.

## **Health Savings Accounts (HSAs)**

The new tax law creates Health Savings Accounts (HSA) for taxpayers who have a high deductible health plan. You or your employer set up a tax-exempt account at a financial institution such as a bank or insurance company and make tax-free contributions to the account up to the amount of your annual deductible (but not more than \$2,600 for yourself or \$5,150 for family coverage). If you're over 55 years old, you may contribute up to \$3,010 for yourself or \$5,650 for family coverage. These funds are then used to pay you back for qualified medical expenses you incur.

## **Incentive Stock Options and Employee Stock Purchase Plans**

If you exercised incentive stock options (ISOs) or employee stock purchase plan options (ESPPs) in 2004 you won't have to pay Social Security and Medicare (FICA) taxes or Railroad Retirement taxes on the resulting compensation.

If you have a disqualifying disposition of stock that you acquired by exercising a statutory stock option, your employer is no longer required to withhold federal income tax from your compensation if you exercised the option after the date the new tax law was enacted.

# Federal Update

## Car Donations

The IRS is tired of people donating their old clunkers to charity and taking a too-generous tax deduction, so they've increased the reporting requirements. **Beginning in 2005**, if you donate a car, boat, or airplane to charity and claim more than a \$500 deduction on your income taxes, you must comply with new requirements. Under the new rules, the charitable organization must provide an acknowledgement to the donor within 30 days of the sale stating the amount of gross proceeds. Alternatively, if the charity significantly uses or materially improves the vehicles, the charity must certify this intended use and duration and provide an acknowledgement to the donor within 30 days of the contribution. If the charity significantly uses or materially improves the vehicle, generally, the donor may deduct the vehicle's market value.

For 2004, however, the new rules do not apply. Under the rules in effect for 2004, taxpayers will be able to deduct the fair market value of the contributed property.

## Sale of Personal Residence Acquired in a Like-kind Exchange

Taxpayers who convert rental property to a principal residence should know that a tax law change may limit their ability to exclude gain on the sale of that residence if they obtained the property through a like-kind exchange. Generally, a taxpayer can exclude up to \$250,000 of gain on the sale of a home, provided the individual has owned and used it as a principal residence for two out of the five years before the sale. The exclusion is \$500,000 for a married couple if both meet the use test. The American Jobs Creation Act of 2004 does not allow any exclusion if the taxpayer sells the home within five years of acquiring the property through a like-kind exchange. The new law applies to sales after October 22, 2004.

## Deduction for Discrimination Suit Costs

A new deduction is available for those who pay attorney's fees and court costs in connection with discrimination suits. Taxpayers can take the new deduction whether they itemize or not. The deduction cannot exceed the amount includible in income for the year on account of a judgment or settlement resulting from the discrimination claim. Generally, personal legal expenses are not deductible, but an employee who incurs legal expenses related to doing or keeping his job could deduct these expenses on Schedule A as a miscellaneous itemized deduction. However, under The American Jobs Creation Act of 2004, an individual with legal fees and court costs arising from a discrimination suit may deduct the costs directly from income on the front of the tax return; this is known as an above-the-line deduction.

Under this new deduction, amounts paid for attorney's fees and court costs are deductible in computing alternative minimum tax, and are not subject to the 2 percent floor on miscellaneous itemized deductions or the overall limitation on itemized deductions. The Act, signed into law on Oct. 22, 2004, describes the discrimination claims qualifying for this new deduction. Only costs paid after Oct. 22, 2004, for judgments or settlements occurring after that date qualify for this deduction.

# California Update

## **Amnesty**

Recent legislation authorizes the FTB and the Board of Equalization to administer a Tax Amnesty Program. Tax amnesty is a limited time chance for individuals and businesses to pay past due income, franchise, sales, or use taxes and the related interest penalty-free without the fear of criminal prosecution. Amnesty runs from February 1, 2005, through March 31, 2005. Taxpayers eligible to participate in amnesty but choose not to do so will be subject to additional penalties. Amnesty is opened to both individuals and businesses for taxable years 2002 and prior.

Taxpayers currently under criminal investigation are not eligible for amnesty.

## **Federal Conformity Item.**

- \* California has conformed to the Military Family Tax Relief Act. (Page 5, 2004 Tax Hints)
- \* For tax years beginning in 2004 and 2005 taxpayers can elect to take state sales tax as an itemized deduction, instead of taking an itemized deduction for state and local income taxes. **California has not conformed to this Act.**

## **Teacher Retention Credit**

The Teacher Retention Credit is suspended for tax years 2004 and 2005.

## **Net Operating Loss**

For taxable years beginning on or after January 1, 2004, California has reinstated the Net Operating Loss (NOL) carryover deduction. The carryover periods for NOL deductions that were incurred:

- \* Beginning before January 1, 2002, has been extended for two years.
- \* Beginning on or after January 1, 2002, and before January 1, 2003, has been extended for 1 year.

## **Telefile Discontinued**

TeleFile is no longer available to file California tax returns.

## **Changes in the Child and Dependent Care Expenses Credit:**

- \* Earned income must have a source in California
- \* Dependent Care must be provided in California

**The Tax Institute  
Quick Tax Facts**

**Key Figures for the 2004 tax year**

**STANDARD DEDUCTIONS**

Married, filing joint return	\$9,700
Surviving spouse	\$9,700
Head of Household	\$7,150
Single	\$4,850
Married, filing separate return	\$4,850
Dependent standard deduction minimum	\$800
Additional amount for blindness and / or age	\$950
Additional amount as above if single or HH	\$1,200

**EXEMPTIONS**

Personal and Dependent Amount	\$3,100
Estate Amount	\$600
Simple Trust Amount	\$300
Complex Trust Amount	\$100
Joint returns or surviving spouse (Phaseout)	\$214,050
Head of Household (Phaseout)	\$178,350
Single (Phaseout)	\$142,700
Married, filing separate return (Phaseout)	\$107,025

**ITEMIZED DEDUCTIONS**

Married, filing separate (Phaseout)	\$71,350
Others (Phaseout)	\$142,700

**TRANSPORTATION**

Fringe Benefit: Employer-provided passes and vehicles	\$100/mo.
Fringe Benefit: Qualified parking limit	195/mo.
Business Mileage Rate	\$0.375
Charitable Mileage Rate	\$0.14
Medical and Moving Mileage Rate	\$0.14
Depreciation Component of Standard Mileage Rate	\$0.16
High Cost Per Diem Travel Rate (after 10/31/03)	\$207
Low Cost Per Diem Travel Rate (after 10/31/03)	\$126

**RETIREMENT PLANS**

Maximum Annual Benefit for Defined Benefit Plan	\$165,000
Maximum Annual Contribution Defined Contribution Plan	\$41,000
Highly Compensated Employee Definition (In general)	\$90,000
SIMPLE Contribution Limit	\$9,000
SEP De minimis Compensation Amount	\$450
SEP Nondiscrimination Compensation Amount	\$205,000
401 (k) Maximum Compensation Amount	\$205,000
401(k) Maximum Exclusion (In general)	\$13,000
IRA Deduction Limit (In general)	\$3,000
Catch-up Contributions (Extra amount for taxpayers over age 49)	
Traditional and Roth IRAs	\$500
SIMPLEs	\$1,500
401(k), 403(b) and 457 Plans	\$3,000

## Key Figures for the 2004 tax year

### CAPITAL GAIN RATES (ASSETS HELD MORE THAN 12 MONTHS)

General Rate:	15%
Low Rate: (Taxpayers in 10% or 15% bracket)	5%
High Rate: Collectibles (coins, art, antiques)	28%
Recaptured gain on real estate (Sec. 1250 gain)	25%
Dividends, qualified (General rate)	15%
Dividends, qualified (Taxpayers in 10% or 15% bracket)	5%

### PAYROLL TAXES

Soc. Sec. (Self-employed) Combined rate (OASDI+Medicare)	15.3%
Soc. Sec. (Employer or Employee) Rate (OASDI+Medicare)	7.65%
OASDI Maximum Base	\$87,900
FUTA Rate	6.2%
FUTA Wage Base	\$7,000
Nanny Tax Threshold	\$1,400

### ADJUSTED GROSS INCOME LIMITS

Casualty Loss Threshold	10%
Medical Deduction Threshold	7.5%
Miscellaneous Itemized Deduction Floor	2%

### EDUCATIONAL TAX INCENTIVES

Hope Scholarship Credit	\$1,500
Lifetime Learning Credit	\$2,000
Student Loan Interest Deduction	\$2,500
U.S. Savings Bond Interest Exclusion (Phaseout)	
Married, filing joint return	\$89,750
Single, QW or head of household	\$59,850
Married, filing separate return	\$0

### VARIOUS OTHERS

Exclusion of gain from sale of residence:	
joint filers	\$500,000
single filers	\$250,000
Maximum child tax credit (per qualifying child)	\$1,000
Maximum Section 179 deduction limitation	\$100,000
Teacher's Classroom Expense Deduction	\$250
Foreign earned income exclusion	\$80,000

### CALIFORNIA KEY FIGURES FOR 2004

Dependent exemption credit	\$265
Personal exemption credit, single, MFS or HH	\$85
Personal exemption credit, MFJ or QW	\$170
Standard Deduction Single or Married filing Separate	\$3,165
Standard Deduction Married filing Joint, Head of household, or Qualifying widow	\$6,330
State Disability Insurance rate (2005)	1.08%
State Disability taxable wage limit (2005)	\$79,418
Maximum State Section 179 Deduction Limitation	\$25,000
Renter's Credit (nonrefundable):	
Single or MFS and AGI does not exceed \$29,955	\$60
HH and married couples and AGI does not exceed \$59,910	\$120