Lisa A. Scarazzo, CPA, PC

Annual Individual Tax Newsletter
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12904 Harbor Drive
Fairfield Office Park
Woodbridge, VA 22192

703/690-4257
703/491-2794
703/492-6829 Fax
www.lascpa.com

<u>Tax Update Newsletter for Individuals - 2005</u>

HAPPY HOLIDAYS TO ALL! The Holidays have arrived and the end of 2005 is rapidly approaching. We don't have many tax law changes to report to you this year, but this newsletter is a reminder of tax issues to be aware of when gathering your 2005 tax documents.

Vehicle Clean Fuel Deduction - Purchasing hybrid vehicles has become very popular in our area of the country due to difficult transportation issues. This type of purchase can provide you with tax relief. The following vehicles qualify for a $2,000 tax deduction in 2005:

Lexus RX 400h - Model Year 2006
Ford Escape Hybrid - Model Year 2005
Toyota Prius - Model Years 2001 through 2005
Toyota Highlander Hybrid - Model Year 2006
Honda Insight - Model Years 2000 through 2005
Honda Civic Hybrid - Model Year 2003 and 2005
Honda Accord Hybrid - Model Year 2005
Mercury Mariner - SUV
Chevrolet Silverado Pickup
GMC Sierra Pickup

New Mileage Rates - The standard business mileage rate for the 2005 year has been changed as of September 1, 2005. The rate is **40.5 cents** per mile from January 1, 2005 to August 31, 2005. The rate increased to **48.5 cents** per mile starting September 1, 2005. Charity work mileage for 2005 is 14 cents per mile with different rates if you were driving charitable mileage related to Hurricane Katrina. The Katrina mileage rate is 29 cents per mile between August 25th and August 31st. The Katrina mileage rate is 34 cents per mile between September 1st and December 31st. Moving and medical mileage rate for 2005 is 15 cents per mile until August 31st and changes to 22 cents per mile between September 1st and December 31st.

Charity - If you give more than $250 in cash or non-cash items to a charity, a receipt or letter is required before you file your income tax return. If you give more than $500, a detailed list is required to be included in the tax return. If you do not receive a detailed list from the organization, take pictures of the donated items and make your own list. Clean out your closets before 12/31/05 and give away the items to a nonprofit organization similar to Goodwill. Click on the "Information Center" on my Web site or <u>www.salvationarmy.org</u> for valuation guides to assess the fair market value of the items you are giving away. If the letter from the charity is dated after the filing date of the return, the deduction will be denied by the IRS.

Hurricane Katrina Donations - The IRS has limits on the amount of charitable contributions a taxpayer can deduct in one year: the taxpayer cannot deduct charitable contributions that exceed more than 50% of their adjusted gross income. This law has been lifted for Katrina contributions made between August 28th and December 31, 2005.

Donating Vehicles in 2005 - New Law: If you give away a vehicle and the fair market value is greater than

$500, you will need written documentation from the charity stating the amount they resold your vehicle for - you will only be allowed a deduction for the amount they received in the sale and not the blue book value!

Donate Appreciated Stock to Charity - If you purchased stock for $1.00 per share and the fair market value is now $10.00 per share, you can avoid paying capital gains on the $9.00 increase in price by gifting it to a qualified charity. Not only that, you receive a charitable contribution deduction for the fair market value of $10.00 per share when you only had an out-of-pocket expense of $1.00 per share. This transaction must be well documented with a letter from the charitable organization and proof of the fair market value on the date that it was gifted.

Charges to your Credit Card - Deductible expenses such as medical bills, charitable contributions, and business supply purchases can be deductible if you charge them to your general use credit cards (Visa, Master Card, etc) before 12/31/05. This does not apply to specific store credit cards.

Retirement Contributions - Contributing to a retirement account through your employer is always a great tax break. The income and earnings are non-taxable in the current year, but become taxable upon withdrawal. Generally, there is a 10% penalty if the money is withdrawn before age 59 1/2. The maximum deferral for 401(k)s and 403(b)s has increased to $14,000 for 2005. If you are age 50 or older by 12/31/05, this increases to $18,000. **Alert for 2006**, the maximum deferral for 401(k)s and 403(b)s is **$15,000** - and if you are age 50 or older by 12/31/06, it is **$20,000**. Check with your HR Department to increase your contribution amounts in January, 2006. Please let me know if you decide to do an early withdrawal from a qualified retirement account. You will lose at least 30% and sometimes as much as 50% to taxes on an early withdrawal.

IRAs - Putting money into a traditional individual retirement account is a good idea, but can be very tricky. If you are eligible to participate in a retirement plan with your employer or your income exceeds $70,000 (Married Filing Jointly) or $50,000 (Single), you may be limited or not eligible to take a deduction for a contribution to a traditional IRA. You may want to make the contribution anyway, but it will be necessary to track the non-deductible amounts on Form 8606. If the non-deductible amounts are not tracked, you could end up paying tax on the money twice.

The Roth IRA has become very appealing because the distributions will not be taxed when withdrawn as long as the money is in the account for at least 5 years and the taxpayer is age 59 ½ at the withdrawal date. You are not eligible to make a Roth contribution once your adjusted gross income exceeds $160,000 (Married Filing Jointly) or $110,000 (Single). If you have concerns about the taxation of a distribution or limits for contributions, please contact our office.

The maximum contribution amount for both traditional IRAs and Roth IRAs is $4,000 if you are under 50 years of age, and $4,500 if you are age 50 as of 12/31/05. The maximum contribution for the 2006 year remains at $4,000 if you are under 50 years of age and increases to $5,000 if you are age 50 as of 12/31/06.

Child Credit - The maximum child credit for 2005 is $1,000 per child under the age of 17. This credit will not be available to some taxpayers due to their income level.

Dependent Day Care Credit - The maximum child care expenses for one child is $3,000 and for two or more children is $6,000. Depending upon a taxpayer's income, the maximum credit for one child could be $1,050 or $2,100 for two or more children.

College tuition - We now have both a higher education <u>deduction</u> and a higher education <u>credit</u>. The deduction is maximized at $4,000 and the credit can go up to $2,000. The tax return must be prepared both ways in order to determine what is the greater tax break to the taxpayer. Taxpayers are not allowed to claim both the deduction and the credit in the same year for the same student. The education expenses must be paid during the year and cover tuition and fees (not books, room, board, or activity fees). There are two available credits -The first is the Hope Credit for first and second year students who attend school at least half time. The second is the Lifetime Learning Credit which is available for any student. There is no limit to the number of years that the Lifetime Learning Credit can be claimed and it is available to all individuals.

Teachers - You may claim a deduction of $250 for expenses paid for your classroom including books, supplies, computer equipment, and supplementary materials.

Did you refinance this year? Almost everyone has refinanced in the last couple of years with the lower interest rates. This has been great for increasing cash flow, but be aware that it may increase your taxes. Many taxpayers are paying lower interest rates and therefore will have a lower mortgage interest write off, which increases the taxable income. Be sure to bring in your refinance settlement sheet for the preparation of your tax return. Any points paid at refinance are considered to be mortgage interest and will be written off over the length of the loan using an amortization schedule. If you had a prior refinance with points, the remaining unamortized points can be taken as a deduction.

Home Equity Interest - There are limits on the deductibility of home equity interest. A taxpayer may not deduct all of the interest if the principal amount of the home equity loan is greater than $100,000. Please let us know if you have a home equity loan as there are other limitations to this deduction.

Capital Gains Tax - The long term capital gains rate was reduced to 15% on May 6, 2003. For taxpayers in the 15% tax bracket, their capital gains rate will be 10%. Be sure to review your capital gains and losses realized so far this year. If you have net gains, take offsetting losses of equal value to make them tax free. If you have net losses, use them before year-end by realizing a gain. The maximum allowable capital loss in one year is $3,000. If your loss is greater than $3,000, the excess is carried forward to future tax years.

Rental Properties - Owning a rental property will not give you a current-year tax break if your income is greater than $150,000. Once your adjusted gross income reaches $100,000, your losses will begin to phase out as a current year deduction. No losses are allowed in the current-year if your adjusted gross income exceeds $150,000 unless you are in the business of real estate management. The disallowed losses will carry forward until the year that your income drops below $150,000 or you sell the property. Please contact our offices if you are intending on selling your rental so we can review the tax consequences.

Tax Tip: Like Kind Exchanges - To avoid paying capital gains on the sale of your rental, you can engage in a 'Like Kind Exchange' in which you purchase another rental and swap properties. The capital gains are deferred until you sell the replacement property. It is also possible to rent the replacement property for 3 years and then move into it for the next 2 years as your primary residence so that the exclusion available on personal residences can be used when it is sold as mentioned below under 'Sale of Personal Residence'. A personal residence or second residence does not qualify for use in the initial Like Kind Exchange.

Sale of Personal Residence - In general, if you have both lived in and owned your personal residence for 2 of the last 5 years and the gain is not larger than $500,000 (Married Filing Jointly) and $250,000 (Single), then there is no capital gains tax due on the sale. If you have been in the home less than 2 years, you may qualify for a reduced exclusion and still not be subjected to the gains tax. The reduced exclusion is available for medical purposes, changing jobs, and unforeseen circumstances (such as death, divorce, multiple births, and disasters). Please let me know if you are selling your personal residence so we can review the tax consequences.

Moving - The moving deduction is available only if you have changed jobs and moved at least 50 miles. The new job and home must be more than 50 miles from the former job and home. Remember to always inform the IRS of a change of address. This can be done by completing Form 8822. The form can be found at the IRS Web site www.irs.gov, or we can provide the form if you give us a call.

Inheritance - In general, money and assets received through an inheritance are not taxable income. There is an exception for annuities and IRA accounts. If you have received a distribution from an IRA or annuity due to a death, you will most likely be taxed on the income on your individual income tax return.

Gifts - Giving a gift to an individual or family member is not a tax deduction, but instead can cause the individual giving the gift to owe tax. The IRS has limits as to the amounts an individual can give before they are required to file a gift tax return and possibly owe gift tax on the money. This amount has increased to $12,000 for 2006. As a taxpayer, you can give up to $12,000 to any other individual before you are required to file a gift tax return.

AMT - Alternative Minimum Tax is a parallel tax system that is used to make sure that high income earners are not escaping taxation. The new lower tax rates mean that more taxpayers will be facing this parallel tax system. AMT requires adjustments to the regular taxable income for tax preference items, and this eliminates favorable deductions. The maximum alternative tax rate is 28%, but tax is recalculated at a higher taxable income amount, causing a higher tax bill than expected. If you are subjected to AMT, it will not benefit you to make your 4th quarter estimated state income tax payment by December 31st. Making this payment in 2005 is usually a good tax tip, but if you are subjected to AMT, state taxes are a disallowed deduction and will not reduce your IRS tax liability.

Social Security Earnings - If you are drawing social security benefits and between the age of 62 and full retirement age, the maximum amount of earnings you can make in 2006 is $12,480.

The maximum amount that a taxpayer's wages can be taxed for social security purposes in 2006 is $94,200.

Head of Household Changes - Taxpayers will no longer be able to use the Head of Household filing status if they do not have a qualifying child or a child who they could claim as a dependent. If you have a grown child living in your household that is not claimed as a dependent on your tax return, you will not be eligible to use the lower tax 'Head of Household' filing status.

Electronic Filing - All tax returns prepared in this office will be filed electronically for 2005. There will be no charge for this service. It will be necessary for the taxpayer to review and approve his or her tax return before we transmit the data electronically to the IRS and the state. We must receive a signed Form 8453 (The IRS e-filing form) from the taxpayer before we submit the electronic tax data.

Informational Data - An 'Informational Data Sheet' will be sent to all clients at the beginning of January to assist them in gathering their tax data. This will provide my office current contact information for our data base and assist in preparing accurate tax returns.

Privacy Statement

Federal law requires that once a year I inform you of our Privacy Policy. As you know, we collect certain personal information about you in order to prepare your tax returns. The information is either provided by you or obtained by our office with your permission. No personal information will ever be disclosed about you to anyone except that which is already public by law.

Should you become an inactive customer, we will continue to adhere to the policy regulations as written here. The information you give us about your personal or business records is reserved only for our employees who need to know in order to service your account.

Procedural, physical, and electronic safeguards will be maintained in compliance with federal standards regarding your personal information. We are committed to retaining your confidence and want to assure you that any information you give us remains safe and confidential.