

# TAXOLUTIONS



►► *ideas on taxes*

## NEW TAX INCENTIVES FOR BEING "GREEN"

**M**aking environment-friendly "green" choices may bring you tax savings, thanks to the Energy Tax Incentives Act of 2005 (Title XIII of the Energy Policy Act of 2005). Signed into law on August 8, this sweeping measure contains tax incentives for consumers purchasing energy-efficient cars and appliances, and for homeowners making certain energy-saving home improvements. This much debated and long delayed bill finally won approval from both the House and Senate in late July after years of protracted negotiations.

Opportunities for individuals include:

- A \$500 lifetime personal tax credit for qualifying improvements and property purchases for a principal residence, including energy-efficient windows and doors, insulation, heating and air-conditioning systems, hot water boilers, and furnaces. This credit applies to property placed in service in 2006 and 2007.
- A 30% tax credit up to \$2,000 for the purchase and installation of residential solar, photovoltaic (electricity-

generating solar), and fuel cell systems placed in service in 2006 and 2007.

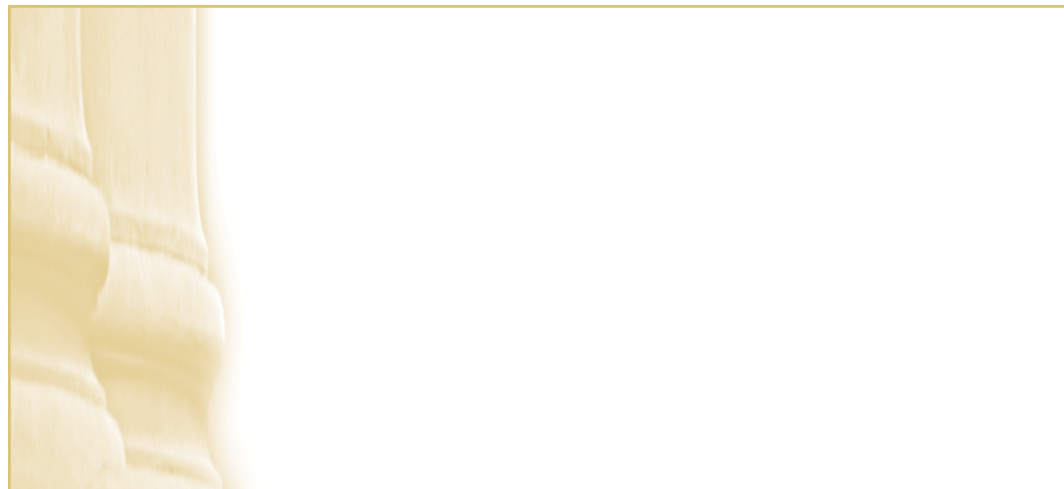
- Tax credits for the purchase or lease of hybrid and advanced lean-burn technology vehicles, which could be as much as \$4,000 for cars placed in service in 2006. This opportunity expires in 2011.
- Tax credits up to \$8,000 for fuel cell powered vehicles placed in service in 2006. This credit is reduced in 2010 and expires in 2015.

These tax incentives make adding energy-efficient improvements and property to principal residences more

attractive for homeowners, but the law limits the credit amount that can be claimed for specific types of improvements and property. For example, the maximum allowable credit for windows is \$200, while for hot water boilers it is \$150. To qualify, the energy-efficient improvement must have a life span of at least five years.

The 30% credit for the installation of solar, photovoltaic, and fuel cell equipment may be claimed up to a maximum of \$2,000 per year for solar water heating and photovoltaic systems, but only up to \$500 for each 0.5 kilowatt of capacity for fuel cell property. The credit may only be used for personal residences, and the

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equipment purchased may not be used to heat swimming pools or hot tubs.

### *Clean Fuel Deduction vs. New Vehicle Incentives*

The new tax credits for the purchase of energy-efficient vehicles (placed in service in 2006) are more generous than the \$2,000 clean fuel deduction they replace. Because a credit offers you a dollar-for-dollar reduction of your taxes, it is more valuable than a deduction, which reduces your taxable income. The amount of the new credit varies, however, depending on the vehicle's weight class, fuel efficiency, and lifetime fuel savings.

Unlike with the clean fuel deduction, these new opportunities apply to leased vehicles as well as new purchases. While this incentive program for hybrid cars, light trucks, and clean-burn vehicles will last through 2010, certain vehicle models may phase out of eligibility before then. This legislation imposes a 60,000-vehicle limit on each manufacturer for the full deduction.

For tax year 2005, the \$2,000 clean fuel deduction will still be in effect, and if you purchase a qualified hybrid car or SUV before December 31<sup>st</sup>, you may be eligible. If you are planning a green vehicle purchase, consider the tax benefits of waiting until 2006. The IRS, as of June 2005, approves the following hybrids:

- 2005 Honda Accord Hybrid
- 2005 Honda Civic Hybrid
- 2005 Honda Insight
- 2005 Toyota Prius
- 2005 Ford Escape Hybrid

- 2006 Lexus RX 400h
- 2006 Toyota Highlander

In order to qualify for the clean fuel deduction, you must purchase the vehicle new, for your own use, and drive it mostly in the U.S. Furthermore, it must meet all federal and state emissions standards.

### *Business Incentives*

This far-reaching energy bill also provides tax incentives for businesses. While this legislation's greatest impact will be felt in the oil and energy sectors, companies in all industries making energy-efficient purchases and property improvements may be eligible for the following tax breaks:

- A \$2,000 tax credit to eligible contractors for the construction of each new energy-efficient home (meeting certain standards). Applies to homes purchased in 2006 and 2007.



- A tax credit for manufacturers of energy-efficient appliances, including refrigerators, dishwashers, and washing machines. Applies to appliances produced in 2006 and 2007.
- A tax credit of up to 30% for the business installation of qualified fuel

cell power plants and a 10% credit for purchasing stationary microturbine power plants placed in service in 2006 and 2007.

- Expansion of the Code Sec. 45 renewable energy production credit—currently applicable to the production of electricity from wind, closed- and open-loop biomass, geothermal, small irrigation, landfill gas, and trash combustion—to include hydropower and Indian coal. Expiration dates have been extended, and vary according to facility type.
- A tax credit of up to 30% for businesses investing in solar energy property may be claimed in 2006 and 2007.
- A maximum deduction of \$1.80 per square foot for the cost of major energy-saving improvements to, and property purchased for, commercial buildings. Applies to property placed in service in 2006 and 2007.
  - A 30% tax credit for the installation of alternative fueling stations to be used in trade or business.

Businesses can benefit from the new law when making energy efficiency improvements, buying alternative energy equipment, purchasing "green" vehicles, and using alternative fuels.

Contractors may claim the full \$2,000 tax credit per new home provided the heating and cooling systems of the house use at

least 50% less energy than those of conventional houses. A credit of \$1,000 may be claimed for dwellings with energy efficiency levels of at least 30% above those of standard houses.

Given the size, scope, and complexity of this legislation, proper planning for new opportunities is essential. For specific guidance, please call us. ■

## FROM A "STEP-UP" TO A STEP BACK: THE RETURN OF CARRYOVER BASIS IN 2010

For a single year, 2010, the estate tax is scheduled to disappear, but will revert to higher levels in 2011 unless Congress takes further action. This temporary repeal, mandated by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), goes into effect following a gradual increase in the estate tax exemption amount, and a decrease in the highest estate and gift tax rates. But even as certain types of tax burdens are phased out, other types of taxes will be levied on the heirs of estates. Until December 31, 2009, inherited property receives a "step-up in basis," but in 2010, property becomes subject to "carryover basis" rules.

### *Step-Up vs. Carryover Basis*

Generally defined as the purchase price of the property minus certain adjustments, basis is used to calculate the amount of capital gains tax owed when an heir to an estate sells the property. Under the step-up provision, the basis of inherited property is increased to the fair market value (FMV) of the property on the date of death. In practice this means that, when inherited property is sold, the stepped-up basis—sometimes referred to as the "fresh start basis"—is subtracted from the proceeds of the sale. Heirs then owe capital gains taxes only on the remaining amount.

Under carryover rules, inherited property receives a basis equal to the amount the

deceased originally paid for the item. Depending on how much the property value increased between purchase by the deceased and sale by the heir, the recipient of the property could owe much more in capital gains taxes under the carryover basis provision than under step-up basis rules.

In 2010, carryover basis applies to assets above \$3 million inherited by the spouse of the deceased, and assets of more than \$1.3 million inherited by anyone other than the spouse. Inheritances below these limits are subject to the step-up basis rules. Following the expiration of EGTRRA provisions on December 31, 2010, the step-up basis is scheduled to go back into effect, and estate tax will be assessed on property in excess of \$1 million, with a maximum tax rate of 55%.

Critics of carryover basis charge that it will potentially complicate tax matters for heirs, as it may be difficult to establish how much the deceased originally paid for a particular piece of property.

### *Future of the Estate Tax*

Meanwhile, Washington lawmakers are debating whether the estate tax should be permanently abolished after EGTRRA sunsets in 2010. The House of Representatives voted in April to make the estate tax repeal permanent,

but the Senate is still considering the issue. The complete elimination of the tax would cost the federal government an estimated \$75 billion a year between 2014 and 2024.

An alternative proposal by Sen. Jon Kyl (R-AZ) would fall short of a permanent repeal of the estate tax, instead making the estate tax rate equal to the 15% tax rate on capital gains, and allowing exemptions of \$3.5 million for individual estates and \$7 million for married couples. Yet even this proposal, opponents argue, would be the equivalent of three-quarters of the cost of a full repeal.

### *Planning Ahead*

Unresolved questions about the future of estate tax rates, gifting, exemptions, and the tax basis of assets make estate planning very challenging. Because it is impossible to predict what laws will be in force at the time of death, it is important to prepare for a number of different scenarios. If you are currently involved in the estate planning process, prepare for the possibility that your inherited assets will be subject to carryover basis rules by collecting the documents your family would need to establish the original price paid for your assets. For more information, call us. We can help ensure your estate plan keeps pace with legislative changes. ■

## GIVING STOCK TO CHILDREN, SAVING ON TAXES

Giving stocks that have appreciated in value to children and grandchildren in lower tax brackets is more attractive thanks to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). For a few more years, long-term capital gains will be taxed at 15% versus 20% for investors in upper income brackets. Meanwhile, those in lower income tax brackets pay a lower

long-term capital gains rate of 5%. For families, the savings can be significant and very helpful in meeting major goals, such as funding a college education.

### *A Closer Look*

For illustrative purposes, let's take a look at a hypothetical example. Suppose Janet and Tom Shea have owned 200

shares of stock in company XYZ for 15 years. Its current fair market value (FMV) is \$20,000, and their basis is \$2,000. Their daughter Abby is 18 years old and about to begin her freshman year of college. The Sheas, who are in the 28% federal income tax bracket, would like to use this stock to help pay her tuition. If they sell the stock at its current FMV,

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they will owe \$2,700 in capital gains taxes ( $\$18,000 \times 15\%$ ).

However, if they give the stock to their daughter Abby, who is in a 10% federal income tax bracket, and she sells the stock, the gain will be subject to the lower 5% rate, which applies to taxpayers in the 10% and 15% brackets. If Abby sells the stock and the FMV is \$20,000, she will owe \$900 in long-term capital gains tax ( $\$18,000 \times 5\%$ )—\$1,800 *less* than her parents.

When gifts of stock are made to individuals, the recipient's basis is the same as the donor's. Furthermore, the recipient also keeps the donor's holding period. So in this case, even if Abby sells the stock one month after receiving the gift, she would still qualify for the long-term capital gains rate, since her holding

period would include the length of time that her parents held the stock. This is beneficial because short-term capital gains (investments held less than one year) are taxed at the investor's generally higher marginal rate.

### *Key Planning Points*

A couple can give away as much as \$22,000 (\$11,000 for individuals) in appreciated stock to each of their children or grandchildren, every year, without incurring gift taxes. Donors, however, should weigh any disadvantages that could be caused by the kiddie tax that applies to children 14 years of age and younger. Under the kiddie tax, a child's unearned income over \$1,600 is taxable at the parent's tax rate.

The 5% rate will remain in effect through 2007. In 2008, the long-term capital gains tax for taxpayers in the lowest two brackets will be eliminated for one year. Simply put, taxpayers in the 10% and 15% brackets will owe zero taxes on their long-term capital gains. Unless Congress takes additional legislative action, the former long-term rates of 20% and 10% will again take effect in 2009. Families with children who will be age 14 or older may want to consider the potential benefits that could be realized with advanced planning.

As you develop your strategies, it is important to remember that gifts are irrevocable and that you relinquish control of assets. However, with proper planning, you may be able to significantly reduce your family's tax bill. ■

## *S Corporations Receive Greater IRS Scrutiny*

S corporations will receive greater scrutiny under a study conducted by the National Research Program (NRP) to evaluate the reporting compliance of the nation's most common business entity. Audits will be conducted on 5,000 randomly selected S corporation returns from 2003 and 2004.

According to the most recent studies, the number of S corporations has skyrocketed from 724,749 in 1985 to over 3 million in 2002. "The use of S corporations has exploded," said IRS Commissioner Mark W. Everson. "The IRS needs a better understanding of what this means for tax compliance. This research is critical for achieving our strategic goal of ensuring that corporations and high-income individuals are paying their fair share."

The IRS launched the NRP in 2000 to measure payment, filing, and reporting compliance for different types of taxes and

various types of taxpayers. The NRP's latest findings are expected to help the IRS assess the current reporting of income, deductions, and credits from S corporations, as well as assist the IRS in flagging future returns that pose the greatest risk.

"This research effort provides us the knowledge we need to both improve compliance and reduce unnecessary taxpayer burden," said Everson.

This increased focus comes on the heels of recent legislation that enhanced the rules governing S corporations. In 2004, the American Jobs Creation Act expanded the permissible number of shareholders from 75 to 100 and now allows eligible members of the same family to be treated as a single shareholder.

Because S corporations receive pass-through tax treatment and provide a measure of personal liability protection, they can be a good choice for business

owners. Please call us for more information regarding this popular entity and for answers to your compliance questions.

