

# TAXOLUTIONS



►► *ideas on taxes*

## THE EXPANDING REACH OF THE ALTERNATIVE MINIMUM TAX

Millions of taxpayers every year maximize their deductions to cash in on tax savings and find themselves paying more than they ever expected. Welcome to the parallel universe of the alternative minimum tax (AMT). An estimated two million Americans were forced to pay the AMT last year, and some three million are expected to pay it this year. With the Tax Act of 2003, Congress provided some AMT relief through 2004 by increasing exemptions, and the recently passed Working Families Tax Relief Act of 2004 extends the increases through 2005.

The AMT was enacted in 1969 to make it harder for wealthy people to avoid paying any income tax at all by taking advantage of write-offs and tax shelters. Today, however, the AMT is more likely to hit middle to upper-middle income people than the very rich. This is because the AMT exemption amounts, unlike the regular tax brackets, have not been raised in line with inflation. And, ironically, deductions that were introduced to cut the tax bills of people of more modest means have caused some families who claim these deductions to be lumped together under AMT rules with the tax-avoiding rich.

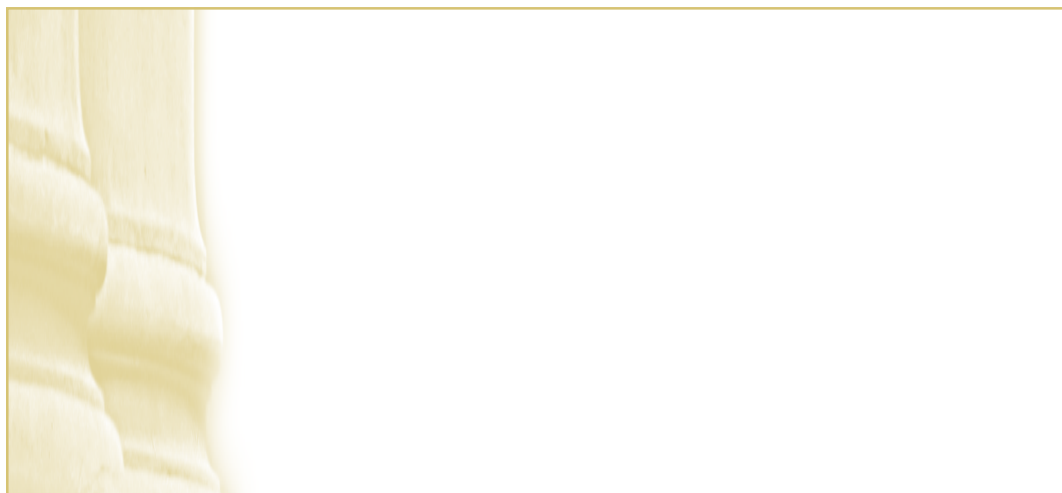
A report<sup>1</sup> published by the Tax Policy Center, a joint venture of the Urban Institute and Brookings Institution, examines the expanding reach of the AMT on the heels of two historic tax reduction measures: the Tax Acts of 2001 and 2003. While both of these measures provided AMT relief by increasing exemption amounts, the concurrent reduced income tax and capital gains rates have and will expose a greater number of taxpayers to the AMT. The authors estimate that without reform over 29 million taxpayers could be subject to the AMT in 2010.

Generally, the AMT hits individuals and small businesses that make substantial

use of exemptions and deductions. Claiming exemptions for dependents or deductions for state and property taxes can trigger the AMT. This means that large families, or those living in high-tax states like California or New York, are more likely than other Americans to pay the AMT. Events such as the exercise of incentive stock options (ISOs), or the sale of property, can also result in very large AMT bills.

Under the AMT, individuals are taxed at rates of 26% and 28% on the amount of taxable income above the exemption amounts. For 2004 and 2005, these are \$40,250 for singles or heads of household,

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## GROWTH INCENTIVES FOR BUSINESS OWNERS

With the economy showing signs of recovery, many small business owners who tightened their belts during the slowdown are now thinking about investing in new computers, phone systems, machinery and other equipment. While it is generally true that capital investments should only be made as needed to grow the business, tax breaks that are due to expire at the end of 2004 or 2007 provide a strong incentive for owners to buy now the tangible business property they plan to acquire or replace in the short to medium term.

### *Enhanced First-Year Expensing Deductions*

As part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Congress enhanced previous tax legislation intended to encourage entrepreneurs to grow their businesses through the purchase of technology, machinery and other equipment. Under JGTRRA, the amount a business owner could deduct for the acquisition of qualifying property quadrupled from \$25,000 to \$100,000 in 2003, and is \$102,000 in 2004. This amount will be indexed for inflation through 2007 thanks to the American Jobs Creation Act of 2004. This type of deduction is referred to as a Section 179 deduction, or first-year expensing.

Section 179 can mean substantial tax relief for small business owners, many of whom are now able to fully deduct purchases of equipment they need to run their company. Owners can further benefit from the new rules by buying on credit, while claiming a deduction on the full cost of the property. Section 179 also lightens the tax compliance and record-keeping burdens of small business owners who are no longer saddled with the task of depreciating the cost of property over a number years.

First-year expensing starts to phase out, however, with investments over \$410,000, and disappears completely if a firm buys equipment worth \$512,000 or more. There are other restrictions as well. The total first-year expense deduction cannot be more than the taxable income from the active conduct of business. While qualified property under Section 179 includes many of the



tools needed to run a business — such as chairs, photocopiers, and machinery — it does not cover land, buildings, or inventory.

JGTRRA did, however, add off-the-shelf computer software to the list of items that qualify for Section 179 treatment. Because software was previously classified as intangible property, businesses were only permitted to amortize such purchases over a period of up to three years, rather than take an upfront deduction.

It is also possible to apply a portion of the Section 179 expense deduction to the purchase of a truck or SUV with a gross vehicle weight rating over 6,000

pounds. While Congress narrowed this loophole with the American Jobs Creation Act, business owners will still be able to write off \$25,000 on the purchase of a truck or SUV that weighs enough to qualify.

### *Bonus Depreciation Deductions*

First-year expensing was not the only juicy tax break for small businesses that took effect in 2003. Owners can now lower their tax bills by accelerating deductions on equipment purchases that they would otherwise have had to depreciate over several years. JGTRRA raised the amount businesses could depreciate from 30% to 50% of equipment placed into service after May 5, 2003. Known as bonus depreciation, this deduction allows owners of qualifying equipment to take a higher percentage of the adjusted cost in the first year, and the remaining amount over the scheduled depreciation term.

Companies can take maximum advantage of both first-year expensing and bonus depreciation by deducting the first \$102,000 of equipment costs under Section 179, then using the 50% bonus depreciation and regular depreciation rates for other property purchases.

### *Warning: Time Is Running Out on Small Business Tax Breaks*

Business owners who want to make use of these generous deductions should keep in mind that they will not last forever. The Section 179 expensing limit of \$102,000, which had been due to fall back to \$25,000 at the end of 2005 was extended by Congress in early October to cover equipment purchased in 2006 and 2007. However, the bonus depreciation deduction only applies to property and business vehicles placed in service by December 31, 2004. ■

## "WHAT PRICE LOVE?" PAYING THE MARRIAGE PENALTY

When does one plus one not equal two? When it comes to paying federal income taxes. If your spouse earns significantly more than you do, or vice versa, you and your sweetheart enjoy what is known as the "marriage bonus." This means that, as a couple, you are paying less in taxes than you did when you filed two single tax returns. But if the two of you have similar incomes, your combined tax bill may be bigger than it was when you were single filers.

The government is aware that this discrepancy in tax rates can be burdensome for dual-earner couples, and have taken some steps to alleviate—but not eliminate—the so-called "marriage penalty." The Tax Acts of 2001 and 2003 provided marriage-penalty relief measures, and under the recently passed Working Families Tax Relief of 2004, these provisions will remain in effect through 2010. For married couples filing jointly, the 15% bracket and the standard deduction will remain twice the size of those for single taxpayers.

For 2004, the married filing jointly standard deduction of \$9,700 is double the single standard deduction of \$4,850. In addition, the upper limit of the 15% tax bracket for married filers, \$58,100, is double the \$29,050 limit for single filers.

For higher earning couples, the tax relief provided by these changes is likely to be negligible at best. If you itemize your deductions, you will not benefit from the standard deduction breaks.

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and \$58,000 for joint filers. The AMT exemptions phase out gradually at higher income levels. Without further legislation, the exemptions will revert back to \$45,000 for joint filers and \$33,750 for single filers.

Be aware that taxable income is calculated very differently under AMT rules than under the regular tax code. The AMT system does not allow personal exemptions for an individual or dependents, deductions for state and property taxes, deductions for interest on a second mortgage, or a number of other common write-offs, such as out-of-pocket business expenses. Depending on the individual's situation, the loss of these deductions can result in a substantially higher tax bill. Let's review some tips for minimizing your AMT liability.

1. Accelerate income and defer deductions. If you can arrange it, have your salary and bonus paid in advance, and take the bulk of your deductions in a year when you are less likely to be subject to AMT. The more income you have relative to your deductions, the less you will pay in AMT.

2. Be careful when cashing in investments, as a large capital gain may do more than push you into the AMT zone: if it is big enough, it can also wipe out all or part of your AMT exemption. If you are considering selling assets such as stock or mutual fund shares, you may want to time the sale of these assets for a year when your other income is lower, or spread the sale over several years.

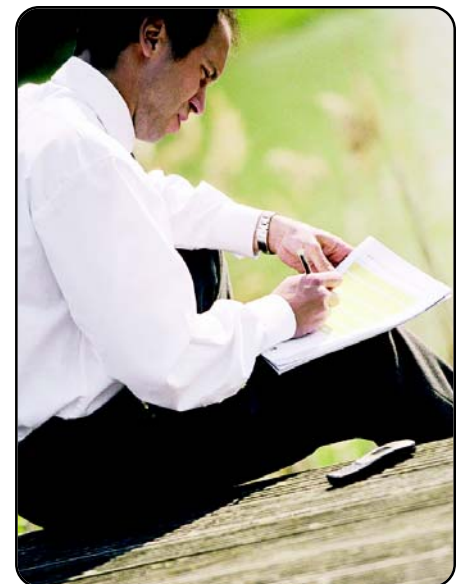
3. Consider carefully the tax implications before exercising incentive stock options (ISOs). You may face a large AMT bill on the spread between the stock option exercise price and the fair market value (FMV) of the shares if you fail to dispose of them in the same year.

4. Avoid state and local municipal bonds that are used to finance "private activities," such as the construction of sports stadiums or hospitals, as the interest from these bonds is not tax free under AMT rules.

Until Congress sees fit to reform or eliminate the AMT altogether, the best defense against this "stealth tax" is to be aware of the threat, and prepare accordingly. Contact us for help navigating the

AMT maze, and for more information on minimizing your liability. ■

*<sup>1</sup>Leonard E. Burman, William G. Gale, Mathew Hall, Jeffrey Rohaly, and Mohammed Adeel Salleem, "The Individual Alternative Minimum Tax: A Data Update," August 30, 2004.*



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## WHAT PRICE LOVE?" PAYING THE MARRIAGE PENALTY

Regardless of the adjustments in the law, the upper limits of the married filing jointly tax brackets above 15% are due to remain significantly below the doubled amount for single filers. Be aware, too, that the married filing

jointly phaseouts for credits and deductions are not double those of single filers, and the child and dependent care credit phase out at the same point for all filing statuses.

You and your spouse do, of course, have the option of filing separate tax returns. This may make sense if you and your spouse both have taxable income and stand to benefit from taking deductions separately. Bear in mind, however, that filing separately will not change the rate at which you are taxed: the limits on married filing separately brackets are exactly half those

of married filing jointly. There are also some potential drawbacks to filing separately as a married couple.

### *Making the Marriage Penalty Work For You*

But before giving up on wedded bliss altogether, you may want to consider the tax advantages married couples do enjoy. If you are covered under medical and dental plans provided by your spouse's employer, these benefits are tax free for both of you. Spouses also have substantial legal and tax advantages over single people when it comes to inheritance and the transfer of retirement benefits. Call us for guidance in choosing the right tax strategies for your specific situation. ■



## *The Working Families Tax Relief Act of 2004*

The Working Families Tax Relief Act of 2004 (WFTRA) was passed by wide margins in both the House and Senate in September, and was signed by President Bush on October 4. The new legislation will cost some \$146 billion over the next decade, and affect an estimated 94 million American taxpayers.

WFTRA provides for extensions of 2001 and 2003 tax cuts that have proven popular with American families. Together, these "family tax" provisions carry a 10-year price tag of \$131.4 billion. They include:

- *Extension of the \$1,000 Child Tax Credit through 2010*—Parents with dependent children under age 17 are entitled to claim a tax credit of up to \$1,000 per child in 2004. WFTRA extends the \$1,000 child tax credit through 2010. The credit had been

scheduled to fall back to a maximum of \$700 in 2005.

- *Extension of marriage penalty relief through 2010*—The 2003 Tax Act accelerated measures scheduled for later years by the Tax Act of 2001, which provide married couples with a standard deduction and 15% tax bracket that are twice the size of those for single taxpayers. Under WFTRA, these provisions will remain in effect through 2010.

- *Extension of the expanded 10% tax bracket through 2010*—The income cap for the 10% bracket in 2004 is \$7,150 for single filers, and \$14,300 for joint filers. The caps for this bracket were due to fall back to \$6,000 and \$12,000 in 2005, but under WFTRA, they will remain at the higher levels, with inflation indexing.

- *AMT relief through 2005*—The alternative minimum tax (AMT) is

sometimes triggered when taxpayers claim substantial deductions. The 2003 tax act set the AMT exemptions at \$58,000 for married couples and \$40,250 for single people. These exemptions were due to be reduced to \$45,000 and \$33,750, respectively, but under WFTRA will remain at the higher levels through 2005.

The remainder of the tax cut package affects businesses, extending: the research and development (R&D) tax credit, as well as the work opportunity and welfare-to-work tax credits; tax credits for electric and clean-fuel vehicles and electricity produced from renewable sources; Archer Medical Savings Accounts (MSAs); expensing of environmental remediation costs; enhanced deductions for corporate donations of scientific property and computers; and incentives for investment in D.C. and the New York City "Liberty Zone."