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American Jobs Creation Act Cuts Taxes, Closes Loopholes

The American Jobs Creation Act of 2004, passed by both houses of Congress in October, is a $136 billion tax package that closes certain loopholes, while creating new tax breaks for businesses and individuals. Most significantly for small business owners, the legislation extends through 2007 increased expensing limits under Section 179, adjusts the rules applying to S corporations, provides tax breaks for manufacturers, and reduces substantially the amount small businesses can write off for the purchase of a large SUV.

The new law, which was originally intended to put an end to subsidies benefiting U.S. exporters that have been deemed illegal by the World Trade Organization(WTO), contains numerous "domestic production incentives" and other tax benefits for manufacturers, farmers, corporations and other diverse business groups. It is the most far-reaching piece of corporate legislation passed by Congress in nearly two decades.

Extends Enhanced Expensing

AJCA extends for two additional years the Section 179 expensing limit that was set by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). For tax year 2004, this provision allows small businesses to write off up to $102,000 on investments in qualifying equipment ($105,000 in 2005). This includes purchases of computer software, which was first defined as qualifying property by JGTRRA in 2004. The deduction starts to phase out if more than $410,000 of equipment is put into service ($420,000 in 2005). With the recent reform, these enhanced limits will be in effect through 2007, adjusted annually for inflation.

Puts the Brakes on SUV Loophole

But under the new law, small business owners will no longer be permitted to apply the full section 179 expensing limit to the purchase of certain types of SUVs. Previously, first-year expensing could be used in lieu of the much less generous depreciation provisions that apply to most cars used for business purposes. The revised rules call for a deduction of no more than $25,000 for an SUV that weighs between 6,000 lbs. and 14,000 lbs. This provision applies to vehicles placed in service after the date of enactment, October 22, 2004.

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S Corp Rules Modified

A simplification of the rules affecting S corporations is another aspect of the new law likely to be of interest to small business owners. The number of permissible number of S corporation shareholders has been increased from 75 to 100. Furthermore, members of the same family may be treated as a single shareholder in an S corporation, and the new law clarifies what constitutes a "family." These and other changes to the rules should add to the popularity of the S corporation as a business entity option, especially among small, family-run businesses.

Manufacturing Incentives

Manufacturers also benefit from the legislation, which expands the definition of "manufacturer" to include more businesses and puts into effect a new deduction. Qualified manufacturing activities now include computer software, energy, and film and video production, as well as certain agricultural processing, construction, engineering, and architectural activities. The deduction phases in beginning in 2005 and 2006, when businesses will be allowed to deduct 3% of the lesser of their income from qualified production activities or their taxable income. From 2007 through 2009, the deduction will be 6%, and in 2010, the deduction rises to 10%.

New Sales Tax Deduction

For individuals, the act also includes a provision which allows certain taxpayers to claim state and local sales taxes as an itemized deduction in lieu of state and local income taxes for 2004 and 2005. This will have the greatest impact on people living in states with no income tax or very high sales taxes. The new deduction must be itemized, and cannot be claimed by taxpayers subject to the alternative minimum tax (AMT).

The Working Families Tax Relief Act

Two weeks prior to the enactment of AJCA, the Working Families Tax Relief Act of 2004 (WFTRA) was signed into law. Commonly referred to as the "Extenders Package," this measure continues popular tax breaks set to expire or, in some cases, renews retroactively provisions that had already expired. Affecting both businesses and individuals, WFTRA will affect approximately 94 million taxpayers over the next ten years at an estimated cost of $146 billion.

In a nod to businesses and professionals, WFTRA continues the following opportunities through 2005:

- The Research and Development (R&D) Tax Credit
- The Welfare-to-Work (WtW) Tax Credit
- The Work Opportunity Tax Credit (WOTC)
- Tax credits for electric and clean fuel vehicles
- Tax credits for electricity produced from renewable resources
- Allowance for contributions to Archer Medical Savings Accounts
- Expensing of environmental remediation costs
- Enhanced deductions for corporate donations of scientific property and computers
- The teacher's classroom expense deduction
- Tax incentives for investments in the District of Columbia and New York City "Liberty Zone"

For individual taxpayers and families, WFTRA extends:

- The $1,000 Child Tax Credit through 2010
- Marriage penalty relief through 2010
- The expanded 10% income tax bracket through 2010
- Alternative minimum tax (AMT) relief through 2005

As with much of the tax legislation passed over the last four years, many provisions are temporary. For specific guidance on the ways you can take advantage of the latest reform, call us. We will be happy to advise you. ■

Your Legacy and Generation-Skipping Transfer Taxes

When you ask wealthy individuals to detail the key to their financial success, many will respond that it's all a matter of hard work and perseverance throughout the years. They will also add that maintaining financial security for their families, and possibly for future generations, is oftentimes an even greater challenge. As a result, many high net worth individuals concentrate their personal planning efforts on minimizing estate and gift taxation while maximizing the passing of assets to heirs. But, the generation-skipping transfer (GST) tax is an equally important, yet often overlooked, estate planning issue.

Taking a Closer Look

The GST tax is an additional tax imposed on certain transfers (during your lifetime or at death), which can

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either be outright, or in trust, to a person at least two generations removed from you (the transferor). For example, suppose a grandparent wishes to transfer assets to a grandchild. In this case, the grandparent would be considered the transferor, and the grandchild, a skip person, because the transfer "skips" a generation (the grandparent's own children).

As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the GST tax is scheduled for repeal in 2010, but reapplies in its entirety as of 2011. Prior to repeal, rates will be pegged to the top estate tax rate. Being subject to the GST tax (48% in 2004 and 47% in 2005) can potentially undermine an otherwise well-planned estate.

Fortunately, every citizen or resident of the U.S. has a generation-skipping exemption ($1,500,000 for 2004) that may be allocated during one's lifetime or upon death. The exemption is scheduled to remain at $1,500,000 for 2005.

One estate planning tool designed to take advantage of the GST tax exemption is a generation-skipping trust. Whether you establish a generation-skipping trust during your lifetime or at death, assets will also be subject to gift or estate taxes. Therefore, the tax consequences of when the trust is established must be compared. If the trust is established with a lifetime gift, the total transfer tax cost to you is the gift tax and the GST tax. If the transfer takes place at death, the total transfer tax is the estimated estate tax on your estate (assuming no lifetime gift) plus the GST tax. If the trust takes advantage of the GST exemption, then there would not be any GST due as the amount in the trust would be covered by the exemption.

With proper planning, substantially more than the amount of the GST tax exemption might ultimately pass to future skip generations free from GST tax. Call us for help evaluating your specific tax situation. ■

Roth IRAs for Kids

Getting teenagers to take an interest in financial planning matters can be a hard sell for parents. But if you can persuade your youngsters to invest at least part of the money they earn from babysitting or bagging groceries in a Roth Individual Retirement Account (IRA), they may thank you later.

Although it is a retirement account, a Roth IRA can be opened at any age by anyone with earned income below $110,000 for single filers, and $160,000 for joint filers. Contributions to a Roth IRA are nondeductible, but earnings within the account accumulate tax free, and qualifying distributions are also tax free. Because children seldom make enough to owe tax on their income, they are usually better off with a Roth IRA than a tax-deferred traditional IRA. In 2005, your child may contribute $4,000 (or earned income, whichever is less) to a Roth IRA. This contribution limit applies until 2008, when up to $5,000 may be invested in a Roth IRA. Thereafter, the contribution limit will increase for inflation in $500 increments.

The reward for getting an early start on saving for retirement can be substantial. Suppose your 15-year-old daughter were to use $1,000 she earned from tutoring jobs to purchase a Roth IRA. If she makes no additional contributions and the funds grow 8% annually, she will be able to withdraw over $50,000 tax free at age 65. Or, suppose your son opens a Roth IRA when he is 15-years-old, and contributes $2,000 for 10 years. The estimated value of his tax-free fund balance at age 65 will exceed $700,000, if the annual growth rate is 8%.

A Roth IRA offers the greatest gains if the account is left untouched until the holder reaches the age of $59\frac{1}{2}$, when money can be withdrawn tax free. The IRS does, however, permit early, penalty-free Roth IRA withdrawals to pay for education or a first-time home purchase, though taxes will be levied on some types of early withdrawals.

Before you rush to open a Roth IRA for your child, there are a few issues you should consider. Bear in mind that you cannot stop your child from withdrawing money from the account whenever he or she wants after the child reaches the age of majority, which is 18 in most states. If you are uncertain about your child's ability to handle money, opening an account in his or her name may not be the best choice.

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You should also be aware that the only type of income that can be sheltered tax free in a Roth IRA is taxable compensation income. In general, paying your children for doing chores around the house does not qualify as compensation income, as this is an intrafamily transaction that is not usually reported to the IRS. If you own your own business, however, you are permitted to hire your minor children to do certain jobs. Provided you pay your children a fair market wage for the services they perform, the money they earn would be considered compensation income and could be deposited in a Roth IRA.

It is essential to keep careful records of how the money placed in a Roth IRA was earned, even if a teenager's working arrangements were informal (e.g. babysitting or lawn mowing for neighbors), and he or she did not earn enough to owe income tax. Severe penalties could apply if the IRS determines that the funds deposited in a Roth IRA were not matched by compensation income.

The good news is that, if your teenager goes out and blows his paychecks on a new cell phone and skateboard, all is not lost. If, for example, your son earned $2,500 over the course of the summer but spent the money, you could still deposit the amount equivalent to his taxable earnings into a Roth IRA on his behalf. ■