

TAXOLUTIONS



►► *ideas on taxes*

PRESIDENTIAL PANEL RECOMMENDS EXTENSIVE CHANGES TO THE TAX CODE

President Bush's Advisory Panel on Federal Tax Reform unveiled in November a comprehensive set of proposals for reforming and simplifying the U.S. tax code. The panel's recommendations for individual taxpayers include eliminating the alternative minimum tax (AMT), restructuring income tax rates, reducing taxes on U.S. stock market investments, eliminating tax deductions for state and local taxes, and limiting the tax deductions for home mortgages and employer-provided health insurance. Congress is expected to start considering the panel's reform proposals, and others put forward by legislators and the president, in early 2006.

The panel, chaired by former Senators Connie Mack and John Breaux, produced two separate options for overhauling the tax code: the "Simplified Income Tax Plan" and the "Growth and Investment Tax Plan." The first plan focuses on simplifying the existing income tax system, changing or eliminating certain tax breaks and lowering rates. The second option largely builds on the first plan but provides more substantial incentives for business investment.

Describing the parallel tax system known as the AMT as overly complex

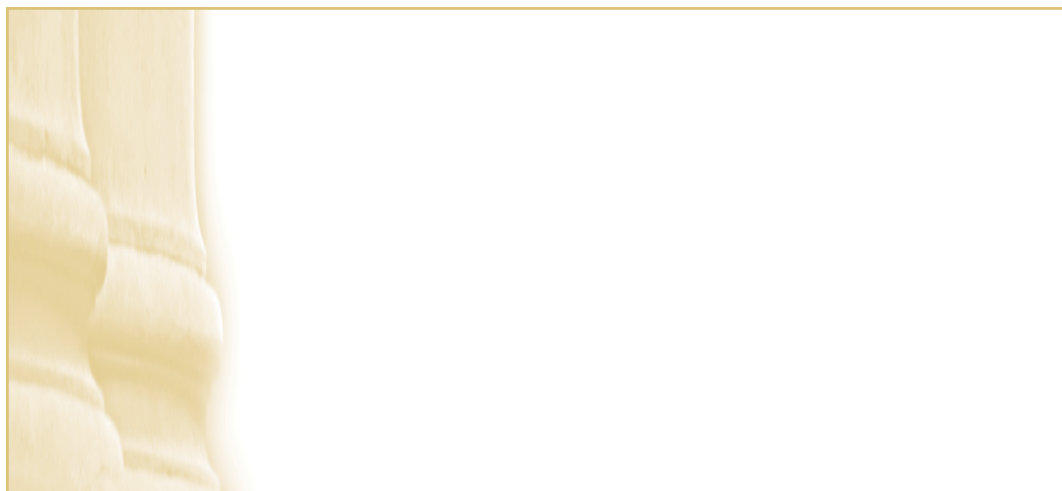
and ineffective in limiting the availability of certain tax benefits, the panel called for the outright repeal of the tax. Originally intended to prevent wealthy taxpayers from claiming too many deductions, the AMT increasingly applies to middle-income taxpayers, especially those with several children who live in high-tax areas. The panel estimates that, if the AMT is left unchanged, as many as 52 million taxpayers would be required to perform the complex AMT liability calculations by 2015.

The panel further proposes lowering the top income tax rate and consolidating the individual marginal tax rates from

the current six to four, in the case of the Simplified Income Tax Plan; and from six to three, in the case of the Growth and Investment Tax Plan. The first plan would have rates of 15%, 25%, 30%, and 33%, while the second plan would have rates of 15%, 25%, and 30% (see tables on page 2). Income brackets for married couples would be double those for individual taxpayers, thus mitigating the "marriage penalty."

Both plans call for a consolidation of the standard deduction, personal exemption, child tax credit, and head of household filing status into a single Family Credit. Providing a uniform benefit for all

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Simplified Income Tax Plan (2006)

<i>Tax Rate</i>	<i>Single Filers</i>	<i>Joint Filers</i>
15%	Up to \$39,000	Up to \$78,000
25%	\$39,001–\$75,000	\$78,001–\$150,000
30%	\$75,001–\$100,000	\$150,001–\$200,000
33%	\$100,001 or more	\$200,001 or more

Growth and Investment Tax Plan (2006)

<i>Tax Rate</i>	<i>Single Filers</i>	<i>Joint Filers</i>
15%	Up to \$40,000	Up to \$80,000
25%	\$40,001–\$70,000	\$80,001–\$140,000
30%	\$70,001 or more	\$140,001 or more

taxpayers, the Family Credit would not phase out at higher incomes, and taxpayers would be able to claim the Family Credit regardless of whether they itemize deductions. The Earned Income Tax Credit (EITC) and the refundable child tax credit for lower-income families would be similarly merged into a single Work Credit.

Tax breaks that encourage saving for retirement, medical expenses, and education would also be drastically simplified. The current wide array of tax-advantaged savings plans would be substituted with three basic account types designed to minimize confusion among taxpayers.

The proposed “Save at Work” plan would take the place of 401(k)s, 403(b)s, SIMPLE 401(k)s, SIMPLE IRAs, and other employer-sponsored defined contribution plans. Contributions to these retirement accounts would be made using pre-tax dollars under the panel’s Simplified Income Tax proposal, but with after-tax dollars under the Growth and Investment plan.

The “Save for Retirement” plan would be established in lieu of IRAs, Roth IRAs, nondeductible IRAs, and deferred compensation plans for executives. Contributions to these accounts would be made with after-tax dollars, but earnings growth and distributions would

be tax free. The panel suggests an annual contribution limit of \$10,000 for these accounts, with no income thresholds. Penalties would exist for early withdrawals, but no minimum distribution requirements would be imposed.

Education savings options—such as 529 plans and Coverdell ESAs—and medical savings accounts—including Flexible Spending Arrangements (FSAs) and Health Savings Accounts (HSAs)—would be replaced by the “Save for Family” plan. These plans would be funded with after-tax dollars but would allow for tax-free earnings growth and tax-free distributions for qualified expenses.

Arguing that the mortgage interest deduction, in its existing form, encourages overinvestment in housing at the expense of other types of investments, the panel proposes replacing this deduction with a new “home credit,” which would equal 15% of mortgage interest paid on a loan secured on the taxpayer’s principal residence. No deduction for interest on mortgages for second homes and home equity loans would be allowed.

This home credit, according to the panel, would benefit the 46% of mainly lower-income homeowners who do not currently receive a tax break on their mortgages, but it would limit deduc-

tions for more affluent taxpayers with larger home loans. The debt amount that could be used to reduce taxes would be capped between \$227,000 and \$412,000, depending on average local house prices. Under current rules, interest on mortgages of up to \$1 million may be written off.

Claiming that workers with “Cadillac” health insurance plans tend to overuse medical services, the panel proposes limiting the amount of health insurance an employer may provide tax free to \$5,000 for individuals and \$11,500 for families. Currently, all premiums paid by both the employer and the employee into a company-sponsored health plan are excluded from taxation. The purchase of individual health insurance, which is not deductible under existing rules, would receive the same tax treatment as employer-provided health benefits. The panel further recommends that most other employer-provided fringe benefits, such as educational assistance and group life insurance plans, no longer be excluded from taxation.

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Tax Code Changes?



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Another suggested change is the elimination of the deduction for state and local taxes. This proposal would have the greatest impact on people living in high-tax states, such as New York and California.

Recommending that taxpayers be entitled to deduct only charitable contributions exceeding 1% of income, the panel also proposes making this deduction available to taxpayers who do not itemize. Taxpayers over the age of 65 would be permitted to make tax-free gifts from their IRAs directly to qualified charities.

While the Growth and Investment Tax Plan suggests taxing capital gains and dividends at a flat rate of 15%, the Simplified Income Tax Plan calls for reducing the maximum capital gains tax rate for investors selling stock of U.S. corporations to 8.25% and the tax rate on dividends of U.S. companies paid out of domestic earnings to 0%. Interest received would be taxed at regular income rates under the Simplified Income Tax Plan, but at 15% under the Growth and Investment Tax Plan.

To make filing easier, the panel proposes shortening the 1040 form to fit on a four-

by-six card printed on both sides. Taxpayers with more complex finances would, however, continue to use the longer forms when filing.

It is impossible to predict to what extent the presidential panel's recommendations will be adopted, but it appears likely that some legislative action on tax reform will be taken in the near future. As these initiatives could have a considerable impact on your individual financial situation, it is important to stay in touch with us as events on Capitol Hill unfold. ■

SECTION 199: A NEW TAX BREAK FOR U.S. COMPANIES

Enacted in response to rulings by the World Trade Organization (WTO), the American Jobs Creation Act of 2004 (AJCA) phased out the extraterritorial income (ETI) regime and other export tax benefits, replacing them with a new set of tax incentives. The centerpiece of AJCA is Section 199, which allows U.S. manufacturers to write off a wide range of domestic production activities.

Expected to be worth \$76 billion to U.S. companies over the next decade, the Section 199 deduction applies to more than just traditional manufacturers. The definition of "manufacturer" under AJCA was broadened to include areas such as film and sound production, utilities, construction, engineering services, architectural services, agriculture, and software development. The deduction first became available in 2005 and phases in over five years.

The deduction is available to C corporations, S corporations, partnerships, sole proprietorships, cooperatives, estates, and trusts. For pass-through entities, this deduction applies at the shareholder or partner level.

Calculating the Section 199 Deduction

To determine eligibility for the Section 199 deduction, companies must calculate their qualified production activities income (QPAI). This is done by offsetting domestic production gross receipts (DPGRs) attributable to qualified production activities conducted in the U.S. with the sum of the following:

- The cost of goods sold allocable to such receipts;
- Other deductions, losses, or expenses directly allocable to such receipts; and
- A ratable portion of deductions, expenses, and losses not directly allocable to such receipts or to another class of income.

$$\text{DPGRs} - \text{Expenses} = \text{QPAI}$$

For 2005 and 2006, Section 199 provides for a 3% deduction equal to the lesser of a company's QPAI or taxable income for the year. The deduction increases to 6% for 2007–2009 and then rises again to 9% for 2010 and thereafter.

The Section 199 deduction is limited to a maximum of 50% of the W-2 wages paid by the company during the taxable year. When calculating wages paid, all members of an expanded affiliated group are treated as a single corporation.

More about Gross Receipts

Domestic production gross receipts are defined as the gross receipts of the taxpayer derived from any of the following:

- A sale, exchange, lease, rental, or license of qualifying production property that was manufactured,

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produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;

- A sale, lease, rental, or license of a qualified film produced by the taxpayer;
- A sale or exchange of electricity, natural gas, or potable water produced by the taxpayer in the United States;
- Construction activities performed in the United States; and
- Engineering or architectural services performed in the United States for construction projects located in the United States.

Not to be included in domestic production gross receipts are the sale of food or beverages prepared by the taxpayer at a

retail establishment and property that is leased, licensed, or rented to a related party.

Some companies will have gross receipts from transactions that do not fit the DPGR definition. For the purposes of claiming the Section 199 deduction, the IRS requires taxpayers to accurately identify the gross receipts that qualify as DPGRs and those that do not. To satisfy IRS rules, companies may need to consider adopting new accounting procedures. Software programs are available to help companies track their receipts and allocate them accurately.

In some cases, businesses will find their current tax planning strategies do not allow them to take maximum advantage of the Section 199 deduction. Call us for specific guidance. We can help you

maximize your deduction and minimize any compliance issues, simplifying the process of integrating this new opportunity with your current tax and financial strategies. ■

5-Step Section 199 Deduction Checklist

1. Identify qualifying production activities.
2. Upgrade internal processes and procedures to ensure your technology supports your accounting requirements.
3. Gather data to calculate QPAI.
4. Organize supporting documentation to substantiate your deduction.
5. Call us for advice.

IRS Announces Improvements in Enforcement and Services in 2005

The Internal Revenue Service (IRS) made progress in its enforcement activities in 2005, while continuing to enhance and modernize its services to taxpayers, according to IRS Commissioner Mark W. Everson. The commissioner attributed these improvements, in part, to stepped-up efforts by the agency to train its employees to comply with the IRS reform legislation enacted in 1998.

The IRS increased its auditing activities in a number of taxpayer categories over the year, Everson reported. The total number of individual returns audited increased more than 20% to 1,216,000 in 2005, from 1,008,000 in 2004, representing the largest number of audits conducted since 1998. Revenues taken in as a result of the agency's collection, examination, and document matching activities grew by 10% in 2005, to a record \$47.3 billion.

While observing that the audit coverage rate of individuals with incomes in excess of \$100,000 remained too low at 1.58%, Everson noted that the number of audits of higher income taxpayers rose to more than 221,000 in 2005, the highest number in a decade.

After years of decline, the number of small business audits completed in 2005 increased sharply to 17,867, from 7,294 in 2004, the commissioner reported. Over the same period, audits of corporations with assets of more than \$10 million grew 14% to 10,878, representing a coverage rate of 20%.

Collection activities, levies, and liens were up to their pre-1998 levels in 2005, Everson added. The number of seizures by the IRS was small but increased from the previous year. Due to a decline in the number of narcotics and money laundering cases, criminal prosecutions recom-

mended to the Justice Department fell 6% in 2005.

The IRS also continued to improve its level of customer service during the year, Everson emphasized. More than half of all individual returns were filed electronically, and customer satisfaction with the agency's toll-free service hit a record 95% in 2005.

