TJAGLCS Practice Notes

Tax Law Note

Update for 2005 Federal Income Tax Returns

This note highlights changes that might be relevant or of interest to military taxpayers. Its goal is to inform legal assistance attorneys of updates in inflation-adjusted income tax provisions and changes for the upcoming tax season, as well as provide information to help clients plan for future tax years. This note lists the changes generally in the order in which they appear on the Form 1040 tax return.

There were relatively few major changes to federal income tax laws and regulations for the 2005 tax year. Most changes related to relief afforded to victims of Hurricanes Katrina, Rita, and Wilma.[1] Definitions of dependents were updated to incorporate the new uniform definition of child.[2] Beginning 31 December 2005, taxpayers will be able to request an automatic six-month tax-filing extension, which replaces the four-month automatic extension and the two-month additional extension that taxpayers used to have to request.[3] From a professional responsibility standpoint, the Internal Revenue Service (IRS) published Treasury Department Circular No. 230, which governs the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and appraisers before the IRS.[4] Finally, beginning 31 December 2005, servicemembers in Turkey will no longer be entitled to the tax benefits associated with service in an area providing direct support to a combat zone.[5]

Key Changes for 2005

Uniform Definition of a Child

Beginning with tax year 2005, the Working Families Tax Relief Act of 2004[6] standardized the definition of a child for five common tax benefits: head of household filing status, dependent exemptions for children, the dependent care credit, the earned income tax credit, and the child and additional child tax credits.[7]

Exemptions

The test for claiming a child as a dependent has changed from a support to a residency one. For tax year 2004 and earlier, a child could be claimed as a dependent if the taxpayer provided more than one-half of the child's support.[8] Under the new definition of a qualifying child, the child must have the same principal place of abode as the taxpayer for more than one-half of the year.[9] Also, if a child provides more than one-half of his or her own support, then the child is not a qualifying child and cannot be claimed as a dependent.[10]

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1 Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, § 101, 119 Stat. 2016 (2005); *see also* Gulf Opportunity Zone Act of 2005, H.R. 4440, 109th Cong. (presented to the President on Dec. 19, 2005).

2 I.R.C. § 152 (LEXIS 2005).

3 T.D. 9229, 2005-48 I.R.B. 1051.

4 31 C.F.R., subtit. A, pt. 10 (2005).

5 American Forces Press Service, *U.S. Troops in Turkey No Longer Receive Tax Exclusion*, Nov. 10, 2005, http://www.defenselink.mil/news/Nov2005/2005t1110_3312.html.

6 Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, 118 Stat. 1166 (2004).

7 *Id*. § 201 (codified at I.R.C. § 152).

8 *See* I.R.C. § 152 (LEXIS 2004).

9 *Id.* § 152(c)(1)(B) (LEXIS 2005).

10 *Id.* § 152(c)(1)(D).

In situations in which more than one taxpayer can treat a child as a qualifying child (for example, if the child lives with both parents for more than six months and then lives with only one of them after a separation), there are tie-breaking rules to determine who is entitled to the dependent exemption.[11] If one of the taxpayers is the child's parent and the other is not, then the parent may claim the exemption.[12] If both taxpayers are the child's parents, then the one with whom the child resides the longest may claim the exemption.[13] If the child has resided the same amount of time with both parents, then the one with the higher adjusted gross income (AGI) may claim the exemption.[14] Finally, if neither taxpayer is the child's parent, then the one with the higher AGI may claim the exemption.[15]

Additional Exemption for Housing Hurricane Katrina Displaced Individuals

For 2005 and 2006, any natural person who houses a Hurricane Katrina displaced individual may claim an exemption of $500 for each displaced individual.[16] A displaced individual is a natural person whose principal place of abode on 28 August 2005 was in the Hurricane Katrina disaster area, and the person was displaced from that abode because of evacuation or damage to the abode.[17] The taxpayer must have provided the displaced person with housing free of charge in the principal residence of the taxpayer for a period of sixty consecutive days within the taxable year.[18] The total amount of the exemptions may not exceed $2,000, and the taxpayer may not have used the displaced person as an exemption for any prior tax year.[19]

Income

Tax-Favored Withdrawals from Retirement Plans for Hurricane Victims

Victims of Hurricanes Katrina,[20] Rita, and Wilma[21] may take a qualified hurricane distribution of up to $100,000 from their retirement plans without incurring the ten percent penalty for early withdrawal imposed by I.R.C. § 72(t). A qualified hurricane distribution is one taken by a person who sustained an economic loss by reason of the hurricane and whose principal place of abode was located in one of the hurricane disaster areas.[22] The distribution must be taken after the hurricane struck and before 1 January 2007.[23] In the case of any qualified hurricane distribution, any amount required to be included in gross income shall be included ratably over the three-taxable-year period beginning with the taxable year of the distribution.[24] Finally, individuals who receive a qualified hurricane distribution may re-contribute to the qualified retirement plan up to the entire distribution amount at any time during the three-year period beginning the day after the distribution.[25]

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[11] *Id*. § 152(c)(4).

[12] *Id.* § 152(c)(4)(A)(i).

[13] *Id.* § 152(c)(4)(B)(i).

[14] *Id.* § 152(c)(4)(B)(ii).

[15] *Id.* § 152(c)(4)(A)(ii).

[16] Katrina Emergency Tax Relief Act of 2005; Pub. L. No. 109-73, § 302, 119 Stat. 2016 (2005).

[17] *Id.*

[18] *Id.*

[19] *Id*.

[20] *Id.* § 101.

[21] The Gulf Opportunity Zone Act of 2005, H.R. 4440, 109th Cong. § 201 extends certain emergency tax relief for Hurricane Katrina to Hurricanes Rita and Wilma victims (signed by the President on 21 December 2005).

[22] Katrina Emergency Tax Relief Act of 2005 § 101; H.R. 4440, 109th Cong. § 201 (2005).

[23] Katrina Emergency Tax Relief Act of 2005 § 101; H.R. 4440, § 201.

[24] Katrina Emergency Tax Relief Act of 2005 § 101; H.R. 4440, § 201 (The taxpayer may also elect to include the entire distribution in income in the year of distribution.).

[25] Katrina Emergency Tax Relief Act of 2005 § 101; H.R. 4440, § 201.

Itemized Deductions

General Sales Tax Deduction

For tax year 2005, individuals will again be able to choose whether to deduct state and local income taxes or state and local sales taxes.[26] Taxpayers should compare the amount spent on sales tax, especially when a large purchase was made, to the amount of state income taxes withheld and also consider the amount of any state income tax refund that must be included as income in the following year. Taxpayers who do not pay state income tax or who have a low state income tax liability are likely to benefit from this provision. Taxpayers have the choice of deducting the exact amount of sales tax paid (based on accumulated receipts) or the Optional State Sales Tax Tables provided in IRS Publication 600.[27] If the Optional State Sales Tax Tables are used, then the amount of the deduction is based on the state where the taxpayer actually resides, not necessarily where he or she is domiciled.[28] Taxpayers who live overseas for the entire year are not entitled to the deduction.

Vehicle, Boat, and Plane Donations—Gifts to Charity

Beginning 1 January 2005, the deduction rules for contributions of used motor vehicles, boats, and planes to charities changed. The deduction is now limited to the actual sales price of the vehicle when the donee charity sells it, unless (a) the charity makes a significant intervening use of the vehicle (such as using it to deliver meals on wheels); (b) the charity makes a material improvement to the vehicle (major repairs that significantly increase its value and not mere painting or cleaning); (c) the charity donates or sells the vehicle to a needy individual at a significantly below-market price provided the transfer furthers the charitable purpose of helping a poor person in need of a means of transportation; or (d) the fair market value of the vehicle is $500 or less.[29] To claim the deduction, the donor must get an acknowledgement from the donee organization within thirty days of the contribution or disposition by the charity.[30] Internal Revenue Service Form 1098-C may be used to satisfy the acknowledgement requirement.

Calculating Taxable Income and Tax Payments and Credits

Additional Child and Earned Income Tax Credit for Katrina Victims

To be entitled to the Child Tax Credit (CTC) or the Earned Income Tax Credit (EITC), a taxpayer must have a certain level of earned income.[31] The devastation caused by Hurrican Katrina destroyed or interfered with many taxpayers' ability to earn income. Therefore, those who lived in the Hurricane Katrina disaster area or who were displaced because of Hurricane Katrina may make an election to calculate their additional CTC or the EITC, or both, for 2005 using their earned income from 2004.[32] Qualified individuals can only make this election if their earned income for 2005 is less than their earned income for 2004.[33]

Lieutenant Colonel Noël Woodward

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26 I.R.C. § 164 (LEXIS 2005).

27 U.S. DEP'T. OF TREAS., IRS PUB. 600, OPTIONAL STATE SALES TAX TABLES (2004), *available at* www.irs.gov/pub/irs-pdf/p600.pdf (The 2005 version, if any, is not yet available by the IRS.).

28 *Id*.

29 I.R.C. § 170(f).

30 *Id*.

31 *Id.* § 32.

32 Pub. L. No. 109-73, § 406, 119 Stat. 2016 (2005).

33 *Id*.

Appendix

There are six different marginal tax brackets for tax year 2005, and they are 10%, 15%, 25%, 28%, 33%, and 35%.[34]

1. Married Individuals Filing Joint Returns and Surviving Spouses:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	14,600	10%
14,600	59,400	$1,460 + 15% of amount over $14,600
59,400	119,950	$8,180 + 25% of amount over $59,400
119,950	182,800	$23,317.50 + 28% of amount over $119,950
182,800	326,450	$40,915.50 + 33% of amount over $182,800
326,450		$88,320 + 35% of amount over $326,450

2. Unmarried Individuals (other than Surviving Spouses and Heads of Households):

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	7,300	10%
7,300	29,700	$730 + 15% of amount over $7,300
29,700	71,950	$4,090 + 25% of amount over $29,700
71,950	150,150	$14,652.50 + 28% of amount over $71,950
150,150	326,450	$36,548.50 + 33% of amount over $150,150
326,450		$94,727.50 + 35% of amount over $326,450

3. Heads of Households:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	10,450	10%
10,450	39,800	$1,045 + 15% of amount over $10,450
39,800	102,800	$5,447.50 + 25% of amount over $39,800
102,800	166,450	$21,197.50 + 28% of amount over $102,800
166,450	326,450	$39,019.50 + 33% of amount over $166,450
326,450		$91,819.50 + 35% of amount over $326,450

4. Married Individuals Filing Separate Returns:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	7,300	10%
7,300	29,700	$730 + 15% of amount over $7,300
29,700	59,975	$4,090 + 25% of amount over $29,700
59,975	91,400	$11,658.75 + 28% of amount over $59,975
91,400	163,225	$20,457.75 + 33% of amount over $91,400
163,225		$44,160 + 35% of amount over $163,225

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[34] I.R.C. § 1(a)(-(d), (i)(2); Rev. Proc. 2004-71, 2004 I.R.B. 970.

5. Estates and Trusts:

Taxable Income		Marginal Tax Rate
Over	*But Not Over*	
$1	2,000	15%
2,000	4,700	$300 + 25% of amount over $2,000
4,700	7,150	$9,755 + 28% of amount over $4,700
7,150	9,750	$1,661 + 33% of amount over $7,150
9,750		$2,519 + 33% of amount over $7,150

The 2005 Standard Deduction amounts are:

a. Married filing jointly or qualifying widow(er) – $10,000.
b. Single – $5,000.
c. Head of household – $7,300.
d. Married filing separately – $5,000.[35]

Otherwise allowable itemized deductions are reduced if AGI in 2005 exceeds:

a. Married filing separately - $72,975;
b. All other returns - $145,950.[36]

The 2005 Personal and Dependent Exemption deduction amount is $3,200.[37] The 2005 Phase-Out Amounts for personal exemptions are:

Taxpayer	**Begins After**	**Fully Phased Out***
Married filing jointly	$218,950	$341,450
Single	$145,950	$268,450
Head of Household	$182,450	$304,950
Married filing separately	$109,475	$170,725[38]

*Phase-out occurs at rate of 2% for each $2,500 or part of $2,500 ($1,250 in both cases for married filing separately) by which the taxpayer's adjusted gross income exceeds the "Begins After" amount.

To begin planning for tax year 2006, the following inflation-adjusted items are provided from Rev. Proc. 2005-70:[39]

The 2006 Standard Deduction amounts are:

a. Married filing jointly or qualifying widow(er) – $10,300.
b. Single – $5,150.
c. Head of household – $7,550.
d. Married filing separately – $5,150.

The 2006 Personal and Dependent Exemption deduction amount is $3,300.

[35] I.R.C. § 63(c)(2); Rev. Proc. 2004-71, 2004 I.R.B. 970.

[36] I.R.C. § 68; Rev. Proc. 2004-71, 2004 I.R.B. 970.

[37] I.R.C. § 151; Rev. Proc. 2004-71, 2004 I.R.B. 970.

[38] *Id.*

[39] 2005 I.R.B. 47.

Administrative and Civil Law Note

Thrift Savings Plan Update

I'm living so far beyond my income that we may almost be said to be living apart.[1]

Recent changes affect the Thrift Savings Plan (TSP). Open seasons have been eliminated, and additional investment options are available to servicemembers.

The Basics

The TSP is a retirement savings and investment plan sponsored by the Federal Government. Congress established the TSP in the Federal Employees' Retirement System Act of 1986.[2] The TSP, which was originally only for Federal civilian employees, was offered to servicemembers as a result of the National Defense Authorization Act for Fiscal Year 2001.[3]

The TSP is a defined contribution plan that is similar to private sector 401(k) plans.[4] The amount available from the TSP at retirement will depend upon how much the servicemember contributed during his working years and the earnings on those contributions.[5]

Servicemembers may elect to contribute a percentage of their basic pay, incentive pay, or special pay and must indicate into which fund(s) the money is invested. The TSP offers several different investment funds: Government Securities Investment ("G" Fund); Fixed Income Index Investment ("F" Fund); Common Stock Index Investment ("C" Fund); Small Capitalization Stock Index Investment ("S" Fund), and International Stock Index Investment ("I" Fund). If a servicemember does not make a contribution allocation, all contributions will be invested in the G Fund.

Recent Changes

The TSP now offers professionally managed life cycle funds that diversify investments throughout the five existing TSP funds through various asset allocations.[6] Fund allocations are tailored to different groups of participants according to their projected date of retirement or the date when individuals plan to withdraw their money.

In addition, open seasons have been eliminated, and servicemembers can now enroll or change their contribution amount at any time.[7] New contribution elections are effective the first full pay period after they are filed. There is also a new election form, TSP-U-1, which is a combination of both the Uniform and Federal service forms.[8]

Beginning January 2006, there will be no limit on the percentage of pay servicemembers can contribute to the TSP.[9] Tax-deferred contributions are still limited by the Internal Revenue Service's elective deferral limit, which is currently

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1 E.E. Cummings (1894-1962), *available at* www.quotations.com/money.htm (last visited Dec. 20, 2005).

2 Federal Employees' Retirement System Act of 1986, Pub. L. No. 99-335, 100 Stat. 514 (1986) (codified at 5 U.S.C. §§ 8431-8840 (2000)).

3 Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001, Pub. L. No. 106-398, 114 Stat. 1654 (2000).

4 I.R.C. § 401(k) (LEXIS 2005); Thrift Savings Plan, What is the Thrift Savings Plan?, http://www.tsp.gov/uniserv/features/chapter01.html (last visited Dec. 13, 2005) [hereinafter TSP Website].

5 TSP Website, *supra* note 4.

6 Thrift Savings Plan, *L Funds* (2005), http://www.tsp.gov/rates/fundsheet-lfunds.pdf.

7 *See* TSP Website, *supra* note 4, at What's New, http://www.tsp.gov/curinfo/plannews.html.

8 *See* Thrift Savings Plan, TSP-U-1, Thrift Savings Plan Election Form (July 2005), *available at* http://www.tsp.gov/cgi-bin/byteserver.cgi/uniserv/forms/tsp-u-1.pdf.

9 TSP Website, *supra* note 4, at What's New, http://www.tsp.gov/curinfo/plannews.html.

$15,000 per tax-year.[10] The IRS elective deferral limit does not apply to tax exempt pay (*i.e.* combat pay); however, the IRS still limits the total amount of contributions to a plan to $44,000 for tax-year 2006.[11]

For more information, servicemembers can visit the TSP website, http://www.tsp.gov/, or contact their local service representative.

Captain Anita J. Fitch

[10] *See id*; I.R.C. § 402(g) (LEXIS 2005); *see also* Thrift Savings Plan, *Annual Limit on Elective Deferrals* (2005), http://www.tsp.gov/forms/oc91-13w.pdf.

[11] News Release, Internal Revenue Service, IRS Announces Pension Plan Limitations for 2006 (Oct. 14, 2005) (stating that the limitation for defined contribution plans under 26 U.S.C. § 415(c)(1)(A) is increased for 2006 from $42,000 to $44,000).