TJAGLCS Practice Note

Tax Law Note

Update for 2004 Federal Income Tax Returns

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The Working Families Tax Relief Act of 2004 (WFTRA)[1] and the American Jobs Creation Act of 2004 (AJCA)[2] made changes in federal income tax law that will effect returns for tax year 2004. One change is specifically applicable to military members who have served in a combat zone or qualified hazardous duty area who may have lost their eligibility for the Earned Income Credit because of their service in the combat zone (and resultant lack of earned income). These service members may now elect to include combat zone pay in income to qualify for the Earned Income Tax Credit.[3] Congress also took action to extend several tax benefits, including the educator expense deduction, which had been set to expire in 2003.[4] 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 tax numerology and changes for the upcoming tax season, as well as provide information to help their clients plan for future tax years. This note generally lists the changes in the order in which they appear on the Form 1040 tax return.

Key Changes for 2004

Income

Sale of Personal Residence Acquired in a Like-Kind Exchange—Schedule D, Form 1040

Taxpayers who convert rental residential real property to a principal residence should be aware that a change in the tax law may limit their ability to exclude gain on the sale of the residence if they obtained the property through a like-kind exchange. Generally, an individual taxpayer can exclude up to $250,000 on the sale of a home.[5] Those whose filing status is married filing jointly may exclude up to $500,000.[6] For sales after 22 October 2004, the AJCA does not allow the exclusion if the taxpayer sells the home within five years of acquiring the property through a like-kind exchange.[7]

Expense Limit for Certain Sport Utility Vehicles—Schedule C, Form 1040

For small business taxpayers who purchased a Hummer or were planning to purchase one, Congress changed the law that allowed vehicles over 6,000 pounds used for business purposes to be entirely depreciated in the year of purchase. Under the AJCA, the first-year depreciation deduction for such vehicles purchased after 22 October 2004 is now limited to $25,000 (the limit for vehicles purchased before 23 October 2004 was $100,000).[8] First-year expensing limits for other assets will remain at $100,000 (adjusted annually for inflation) until 2008.[9] Before the AJCA, this amount was scheduled to revert to $25,000 in 2006.

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[1] Pub. L. No. 108-311, 118 Stat. 38 (LEXIS 2004).

[2] Pub. L. No. 108-357, 118 Stat. 1418 (LEXIS 2004).

[3] WFTRA § 104 (amending I.R.C. § 32(c)(2)).

[4] *Id.* § 307.

[5] I.R.C. § 121.

[6] *Id*.

[7] AJCA § 840 (amending § 121(d)).

[8] *Id.* § 910 (adding subpara. (6) to I.R.C. § 179(b)).

[9] *Id.* § 201 (amending I.R.C. § 179(b), (c), and (d)).

Itemized Deductions

Sales Tax Deduction—Line 5b, Schedule A, Form 1040

For their 2004 and 2005 tax returns, individuals will have a choice whether to deduct state and local income taxes or state and local sales taxes on their income tax returns.[10] For residents of states that do not have a state income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming), this is a benefit because it creates a deduction where there was none before. Taxpayers should compare the amounts spent on sales tax, especially when a large purchase was made, to the amount of state income taxes paid. Taxpayers will have the choice of tracking the actual amount of sales tax paid (which means keeping receipts) or using tables provided by the Treasury Department.[11] Taxpayers may also use the Optional State Sales Tax Tables and then add on the sales tax from large purchases, such as for an automobile or boat.[12] I.R.S. Publication 600 will contain the Optional State Sales Tax Tables.[13] Because the AJCA was passed so close to the end of the year, it is not likely that these tables will be available before the tax year 2004 filing season begins in 2005. For residents of states that have an income tax, there is not likely to be a benefit from this change, and these taxpayers will generally be better off deducting state and local income taxes. However, if a state has low income taxes and high sales taxes, then the change may be beneficial. The taxpayer should calculate the deduction both ways to see which is more beneficial.

Vehicle Donations, *Gifts to Charity—Line 16, Schedule A, Form 1040 (and Form 8283)*

If a taxpayer was considering donating a vehicle to charity and taking as a charitable deduction the fair market value of the vehicle (based on something like the Kelley Blue Book[14]), then he will have to think again. The amount of the allowable charitable deduction will now depend on how the donee organization uses the vehicle. If the charity sells the vehicle without using it or improving it, then the amount of the deduction will be limited to the amount for which the charity actually sold the vehicle.[15] The charitable organization is required to provide an acknowledgment to the taxpayer with the use or sales information.[16] The Treasury Department has not yet promulgated regulations detailing procedures on how the acknowledgment will be provided. Along with the acknowledgment requirement, Congress also created a penalty scheme for fraudulent acknowledgments with respect to donations of motor vehicles, boats, and airplanes.[17]

Calculating Taxable Income and Tax Payments and Credits

Refundable Child Credit and Earned Income Credit for Military Taxpayers Serving in Combat—Lines 67 and 65, Form 1040; Lines 42 and 41 , Form 1040A

Income earned by military members in a combat zone (CZ) or qualified hazardous duty area (QHDA) is generally excluded from gross income.[18] However, to be entitled to the Child Tax Credit (CTC) or the Earned Income Tax Credit (EITC), a taxpayer must have certain levels of earned income.[19] Before the WFTRA, some junior military members who served in a CZ or QHDA were unable to take advantage of these tax credits because all of their pay was excluded from the definition of income for federal tax purposes. These taxpayers would not have a tax liability because of their low income. The WFTRA now makes it possible for service members to elect to include in gross income what they earn in a CZ or QHDA, so that they can qualify for the EITC.[20] Although the election is not applicable to the CTC, the amount of the CTC that is refundable has been increased from ten percent to fifteen percent the amount that exceeds a threshold amount.[21] This means that those who have a CTC amount greater than their tax owed could get a refund up to fifteen percent of the amount by which their 2004 taxable earned income exceeds $10,750, meaning a larger refund for many taxpayers.

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[10] *Id.* § 501.

[11] *Id*. § 501(a) (amending I.R.C. § 164).

[12] *Id.* § 501.

[13] 2004 Instructions for Schedule A and B (Form 1040), p. A-3, *available at* www.irs.gov/formspubs (last visited Dec. 13, 2004).

[14] Kelley Blue Book, *available at* www.kbb.com (last visited Dec. 13, 2004).

[15] AJCA § 884 (amending I.R.C. § 170(f)).

[16] *Id*.

[17] *Id*. § 884(b) (creating I.R.C. § 6720).

[18] I.R.C. § 112.

[19] *Id.* § 32.

Uniform Definition of a Child

Beginning with tax year 2005, the WFTRA makes uniform the definition of a child.[22] Before the WFTRA, there were different definitions of a child for head of household and dependency determinations, and also for qualification for the dependent care credit, the child tax credit, the earned income credit.

Extension of Expiring Family Tax Provisions

In the WFTRA, Congress extended several tax provisions into 2005 and beyond.[23] The Child Tax Credit of $1,000 per child was extended until 2010.[24] The marriage penalty relief in the standard deduction and fifteen percent tax brackets (continuing the standard deduction and tax brackets for married filing jointly couples at twice the amounts for those of single taxpayers) was also continued 2010.[25] The WFTRA continues at current levels and allows for inflation adjustment through 2010 of the ten percent rate tax bracket levels.[26] These are $14,000 for married filing jointly filers; $10,000 for heads of household; and $7,000 for single taxpayers.[27] Finally, current higher Alternative Minimum Tax exemption and phase-out levels were continued through 2005.[28]

Planning for Tax Year 2005

Increases in Individual Retirement Arrangement (IRA) and Uniformed Services Thrift Savings Plan (TSP) Contributions Limits

In 2005, the contribution limits for IRAs will increase to $4,000 per individual.[29] Other contribution limitations still apply, e.g., earned compensation must exceed the amount of IRA contributions. The maximum amount a military taxpayer may contribute to the TSP increases to $14,000 and 10% of base pay per month (from $13,000 and nine percent per month for 2004).[30]

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[20] *Id*. § 104.

[21] WFTRA § 102, § 104 (amending I.R.C. 24(d)(1)(B)(i)).

[22] *Id*. § 201.

[23] *Id*. § 101.

[24] *Id*. § 101(a).

[25] *Id*. § 101(b), (c).

[26] *Id*. § 101(d).

[27] I.R.C. § 1(i)(1)(B).

[28] WFTRA § 103(a) (amending I.R.C. § 55(d)(1)).

[29] I.R.C. § 219(b)(1).

[30] *Id.* § 402(g).

Appendix

There are six different marginal tax brackets for tax year 2004, and they are 10%, 15%, 27%, 30%, 35%, and 38.6%.[31]

a. Married Individuals Filing Joint Returns and Surviving Spouses:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	14,300	10%
14,300	58,100	$1,440 + 15% of amount over $14,300
58,100	117,250	$8,000 + 25% of amount over $58,100
117,250	178,650	$22,787.50 + 28% of amount over $117,250
178,650	319,100	$39,979.50 + 33% of amount over $178,650
319,100		$86,328 + 35% of amount over $319,100

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

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	7,150	10%
7,150	29,050	$715 + 15% of amount over $7,150
29,050	70,350	$4,000 + 25% of amount over $29,050
70,350	146,750	$14,325 + 28% of amount over $70,350
146,750	319,100	$35,717 + 33% of amount over $146,750
319,100		$92,592.50 + 35% of amount over $319,100

c. Heads of Households:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	10,200	10%
10,200	38,900	$1,020 + 15% of amount over $10,200
38,900	100,500	$5,327 + 25% of amount over $38,900
100,500	162,700	$20,725 + 28% of amount over $100,500
162,700	319,100	$38,141 + 33% of amount over $162,700
319,100		$89,753 + 35% of amount over $319,100

d. Married Individuals Filing Separate Returns:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	$7,150	10%
7,150	29,050	$715 + 15% of amount over $7,150
29,050	58,625	$4,000 + 25% of amount over $29,050
58,625	89,325	$11,393.75 + 28% of amount over $58,625
89,325	159,550	$19,989.75 + 33% of amount over $89,325
159,550		$43,164 + 35% of amount over $159,550

[31] *Id.* § 1(a)(-(d), (i)(2); Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

e. Estates and Trusts:

Taxable Income		**Marginal Tax Rate**
Over	*But Not Over*	
$1	$1,950	15%
1,950	4,600	$292.50 + 25% of amount over $1,950
4,600	7,000	$955 + 28% of amount over $4,600
7,000	9,550	$1,627 + 33% of amount over $7,000
9,550		$2,468.50 + 35% of amount over $9,550

The 2004 Standard Deduction amounts are as follows:[32]

a. Married filing jointly or qualifying widow(er)—$9,700.

b. Single—$4,850.

c. Head of household—$7,150.

d. Married filing separately—$4,850.

Reduction of Itemized Deductions.[33] Otherwise allowable itemized deductions are reduced if AGI in 2004 exceeds:

a. Married filing separately—$71,350.

b. All other returns—$142,700.

2004 Personal Exemptions.[34]

a. Personal exemption deduction—$3,100.

b. 2004 Phase Out Amounts for personal exemptions:[35]

Taxpayer	**Begins After**	**Fully Phased Out***
Married filing jointly	$214,050	$336,550
Single	$142,700	$265,200
Head of household	$178,350	$300,850
Married filing separately	$107,025	$168,275

*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.

32 I.R.C. § 63(c)(2); Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

33 I.R.C. § 68.

34 *Id.* § 151.

35 *Id.* § 151(d)(3).