

## **CLIENT 2004 YEAR-END NEWSLETTER**

### **NEW TAX LAWS:**

There have been two new federal tax bills and a slew of California bills passed in the last few months. Many of the new tax laws are effective now and some are retroactive to the beginning of 2004. Here is a partial list of the changes. If you have questions about how these apply to you, please contact me to discuss them before the end of the year.

**SUV deduction changed** – The first-year deduction for a new SUV has been cut from \$102,000 to \$25,000. Although this change has already happened, there are other changes that make it more advantageous to buy that vehicle this year.

**Sales tax deduction** – You now have a choice of deducting sales taxes or state income taxes as an itemized “tax” deduction for Federal purposes. Therefore, timing is important when making payments of state estimated tax and buying cars, boats, and other big-ticket items. It may be advantageous to take an income tax deduction one year and a sales tax deduction the other year.

**Teacher credit gone** – California suspended this big credit for teachers. Teachers who planned on the credit in making estimated tax payments need to decide whether to pay the additional tax before the end of the year or on April 15. But luckily, teachers may still take the \$250 deduction for school supplies and expenses against income – for federal but not California purposes.

**Depreciation** – This year, you can take up to \$102,000 of the cost of certain business assets and 50% bonus depreciation of the remaining balance for qualified purchases before claiming regular depreciation. But the federal rules are complex and California has completely different rules. Consider if you should be buying machinery and equipment in 2004 or 2005.

**Manufacturer’s deduction** – Starting next year, the IRS will give special deductions to manufacturers. If your company is in the manufacturing sector, you may want to postpone purchases until next year.

**Donating vehicles** – The rules have really changed here. The old rules apply through December 31, 2004. After that, the charity must inform the donor of how much the charity received on the sale of the vehicle, which becomes the deduction amount.

**California amnesty** – If you have any outstanding California tax debts or a pending federal audit – or letters from IRS or the state – you may be able to save some money when you pay off the state. There is a limited California amnesty, but issues must be resolved during the amnesty period.

**California NOL** - California’s net operating loss deduction is back. If you had losses in prior years, you can take them this year but it’s important that you plan an income strategy to maximize use of the losses and minimize federal tax.

**Exchanging rentals and selling residences** - If you are working on a strategy of converting rental property received in a 1031 tax-deferred exchange into your personal residence, the rules have changed. You must now wait at least five years to sell any property you obtained in an exchange that is converted to a personal residence in order to take the \$250,000 single person/\$500,000 married couple income tax exclusion on the sale of that residence.

**Divorced parents and child's exemption credit** – The IRS has changed the rules for claiming a child as a dependent. Beginning in 2005, the divorce decree controls who gets the exemption. No matter who has custody of the child, as long as the parents together provide more than one-half the support the non-custodial parent claims the child if the divorce decree so provides. If the divorce decree is silent, the custodial parent may give the exemption to the other parent. If you are the non-custodial parent and your divorce decree doesn't give you the right to the exemption, you may want to talk to your family law attorney to resolve the tax deduction.

**Pension plans** – The maximum contribution to a profit sharing plan increased for 2004 to \$41,000. If you do not have a plan for your business, now is the time to set up a plan before the end of the year in order to maximize the amount you can set aside for your retirement. There are many great options and as long as the plan is established before year end, you don't have to contribute until next year when you file your tax return.

**Closing your company** – If you are closing down your corporation, LLC, or partnership, there is important paperwork that must be filed before the end of the year. If you miss the deadline, you will have to pay another \$800 to the state for next year. Filing the paperwork takes time, so we need to start on it now – not at the end of December.

## **YEAR-END GIFTS**

As the end of the year approaches, many of us turn our thoughts to gift-giving. While your generosity may know no bounds, the government's does. Here are some of the current rules for the tax benefits of gift giving.

- For 2004, you may give up to \$11,000 per person without incurring any federal gift tax liability, or even any need to report the gift. And you may make gifts of up to \$11,000 to as many people as you want. If you are married, you and your spouse can join to give up to \$22,000 to each recipient.
- Gifts can be made in cash, or in any other assets (valued at fair market value). In order for the gift to be considered made before the end of the year, it must be given outright to the recipient with no strings attached.
- In addition to the annual \$11,000 exclusion, you may currently give up to \$1 million over your lifetime without incurring any gift tax liability (however, you must file a gift tax return if you give more than \$11,000 to any one donee in any one year). By using this "lifetime credit" now, you transfer future increase in value on the gifted property out of your estate. If the recipient is in a lower income tax bracket than you, the income from the gifted property, including any gain on sale, may be taxed at lower rates.

- If you make payments of tuition for another person directly to a university or other qualified educational organization you may also exclude those payments from gift tax and reporting and they do not count toward your \$11,000 per person annual exclusion or lifetime credit. Contributions to a federally approved college savings plan count toward your annual gift tax exclusion, but you may “front-end-load” these plans by giving up to \$55,000 (\$110,000 for married couples joining in the gift) in a single year. The contribution will be considered to have been made over five years.
- If you make direct payments of medical expenses to a medical care provider on behalf of another person, the payments do not count toward your \$11,000 per person annual exclusion or your lifetime credit.
- Finally, remember that all outright gifts to your spouse (who is a U.S. citizen) are free of federal gift tax.
- TO COUNT AS A GIFT IN 2004, THE GIFT MUST BE COMPLETED IN 2004!

### **FOR THOSE CONSIDERING GIVING THEIR HOMES TO THEIR CHILDREN**

Many people think it's a good idea to put their child's name on the title to their home. Sometimes the parent adds the child's name to the title and sometimes the parent changes the title to the child's name. This is generally a very bad idea. Here are five reasons why:

1. **Gift tax return:** If you give your child a gift of equity in the home that exceeds \$11,000 in value, there may be a gift tax to pay and a gift tax return to file.
2. **No gain exclusion:** Tax law allows a taxpayer to exclude up to \$250,000 of the gain on the sale of a principal residence (\$500,000 for a married couple). However, the exclusion is only available if the seller owns and occupies the property for at least two out of the last five years (see above for exchange rental property that were converted into personal residences). If the child does not live in the home for that period, the gain on the child's share of the home is fully taxable.
3. **Equity subject to debts of the child:** Property is subject to the debts of its owners. If the child owns the home or is a partial owner, a creditor may file a lien on the property for any of the child's debts. Although your child may have excellent credit and good fiscal responsibility, your home could be lost if there is an accident or a lawsuit.
4. **You are now a renter:** If you give 100% of the property to a child, you are now at the mercy of the child. If the child decides to sell the property, you must move out. There is no guarantee that the child will continue to care for you.
5. **Medicaid problems:** Under some circumstances, the gift of the home to the child could be considered a gift for Medicaid purposes. If you give the home to the child and the child subsequently sells it, you could be ineligible for Medicaid benefits in the event of a long-term health crisis.

**What should you do instead?**

Usually a parent gives the home to the child to make sure that the child easily gets the home at the parent's death or so the child can manage the affairs of the parent. If this is the case, the parent will be better served by establishing a living trust, along with powers of attorney, so the child can manage the parent's affairs.

If the reason is to help the child buy his or her first house, a better way is to lend the child money with a low but reasonable interest rate, and set up a program to give annual gifts in the form of principal forgiveness.

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