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TAX NEWS & TIPS

FALL 2005

Selling Your Home? Look Out For Traps

Tax problems? No way! Gain up to \$250,000 is completely tax free. (Couples can exclude a \$500,000 gain.) For most people this is true. Tax issues when selling your home are minor. For most people.

What if your gain is larger than the exclusion? Or you have only owned it for a short time? What happens for the newly married (or divorced)? What if you turned the home into a rental a couple of years ago? Or ran a business in the home?

The rules are simple. But, if you have a "what-if" case we need to talk *before* you sell. You could pay a big tax because you missed a detail or sold two weeks early.

3 Tests. Pass 3 simple tests to earn the \$250,000 exclusion:

1. Ownership. In the 5 years preceding the sale you must have owned the home for at least 2 years.

2. Principal Residence. In the 5 years prior to sale it must be your principal residence for at least 2 years.

3. Prior Exclusion. It must be at least 2 years since you claimed such an exclusion.

All Or Nothing. Miss any test by one day – lose the exclusion.

Special Exceptions. Each rule allows for job changes, medical issues, or unforeseen circumstances. If you qualify you can get a portion of the exclusion that depends on how much of the 2 years in each test you can meet.

Exclusion For People, Not For Homes. For a couple, if each spouse passes the tests, their return shows a \$500,000 exclusion. In fact, there's a case on record of four roommates owning a home

jointly. Each of the four is allowed to claim a \$250,000 exclusion when the home is sold.

The "What Ifs". Combinations arise that are not so simple.

Ownership. What if you have not owned for two full years? Without the Special Exception your gain will be taxed. Spouses get a special rule – both pass the test if either does. Recent marriages or prenuptial agreements are ignored.

Principal Residence. Spouses have no special rules. If newlyweds live in a home already used by one spouse, the spouse who moves into the home must live there for two years. In some cases couples sell, but only one spouse gets the exclusion. There is an exception for divorces – if the home is held in both names after the divorce, but one spouse must move out, that spouse is treated as if still living there.

Proving Residence. Your home is not a mailing address, it's where you *live*. In tough cases IRS looks at utility bills, voter records, car registration, work place, and the like. If you sell with barely two years under your belt, you might need records to verify you occupied the property. Receipts from moving companies, utility "turn-on" notices or other signals of when you move into or move out of the property would be helpful.

Combinations. Each test is separate. The first two tests cover a 5-year period. After living in a home for years, you might turn it into a rental. Up to 3 years later you could sell and still pass Test 2 to earn the exclusion.

Periods of time need not be the same. IRS gives an example of a person who buys the property in which they had rented for years. Before long they move out and rent to a tenant of their own. Two years

later they sell the property. They pass Test 1 – two years of owning. For Test 2 the 5-year period still contains 2 years in which they lived there! Claim the exclusion.

Larger Gains. What if your gain is even larger than the exclusion? First let me say to you – Congratulations! Second, you must review your basis (cost) carefully. I will help, of course. We need to be certain you account for all additional costs for improvements you added after your original purchase.

Business Use. What if you ran a business from the home or rented it out for a time? You still get the exclusion. The only hitch is you may not exclude any gain from the depreciation you deducted during the time in question.

The Message. Your head should be spinning from all the information. And, I didn't tell you everything! My point is simple. If you sold your home of many years for a modest profit, there is no problem. For any case with the smallest doubt, call me *before* you sell. Your call could save you thousands of dollars!

This Issue

- Selling Your Home? Look Out For Traps.
- Vehicle Donations: The Full Story
- Hybrid Cars Are HOT!
- I Get Questions
- Tax Freedom Day® – What's It Mean?
- Tips For You
- Your Tax Calendar

Vehicle Donations: The Full Story

The ad goes: "Donate your old car to us – you help the needy *and* get a valuable tax deduction!" Let's take a fresh look at donating cars, boats, or motor homes. Tax laws changed for 2005. IRS has published new rules for claiming the deductions.

Contribution vs. Savings. Many people seem to think this is some sort of game to make a profit at IRS expense. Guess again. Contributions are about *giving*. In fact, tax law does not define "contribution". The courts have described a contribution as "freely given, with no expectation of return."

Fairness and logic say if you give an item worth \$100, you have a \$100 deduction. If you are in the 25% tax bracket you save \$25 on your taxes. This is identical to making a \$100 cash contribution to a charity. The *net* cost of the gift is \$75 after taxes, but it is still a gift. Your profit is in your heart, not your wallet.

Valuation Abuses. IRS said many folks claimed far more for vehicles than what they were worth. They showed Congress cases in which a value near \$5,000 was claimed on tax returns when the charity got only a few hundred dollars for the vehicle. So Congress changed the law.

Current Law. The new rules apply to cars, boats, motor homes, and aircraft. If you claim more than \$500 for your contribution:

(a) **Timely Substantiation** from the charity is required, and

(b) **Value claimed** may not exceed the gross sales price the charity receives from the sale.

Substantiation from a charity must identify the charity, the giver, and the item completely. It must give Tax I.D. Numbers for you and the charity, VIN for a vehicle (and equivalent identification for boats or aircraft).

"Timely" generally means within 30 days of the later of the contribution or the charity's disposition of the item. There's a special exception for 2005 – gifts through September 1 are OK if substantiation is received by October 1.

Value. The substantiation shows the amount of the gross sale proceeds

from selling the item. Generally this limits your deduction. Suppose you donate a vehicle that often sells on car lots for \$2,000. The charity sells it at a wholesale auction for \$800. Your deduction is only \$800.

This may sound wrong or unfair. But, it is the law. Moreover, charities rarely see these donated vehicles. An agent with experience in auto sales does all the work for them. Pick-up, paperwork, sale – everything. The charity gets a check reduced by these costs and by the agent's fee. If the car sells for \$800 at the wholesale auction, the charity probably collects about \$500. Imagine if the law only let you deduct the *net* proceeds!

Form 1098-C was released by IRS. Most charities will be using the form to report these cases. Keep the Form! I'll need to see it. If you lose it your contribution is limited to \$500!

Not a Normal Sale by Charity. IRS gives 3 cases in which the charity

does not simply sell the item to a third party. They allow for the charity (1) making use of the vehicle in a significant way to further their charitable function, (2) selling well below market value to a needy individual, or (3) making significant improvements to the vehicle before sale. The charity will mark a check box on Form 1098-C to signal such a case. These are quite rare.

In such cases, there will be no statement of sales proceeds. *You* must justify a value for the vehicle. Statements about its condition, photos, or evidence of similar sales would be helpful. IRS points out clearly that if using a "pricing guide" to set values, the guide must show prices for a similar model (age, mileage, condition, warranty, etc.) sold in the same general area. If the guide distinguishes between private party, trade-in, and dealer retail price, IRS will accept the private party price, but *not* the dealer retail price.

Hybrid Cars Are HOT!

You get a \$2,000 deduction for simply buying a new hybrid vehicle. Popularity is on the rise. Nearly 100,000 sold last year.

Hybrid cars combine a familiar gasoline engine with an electric motor. The electric motor charges while idling or coasting. It then can offer an "assist" when the charge is high. These vehicles offer very high fuel economy.

But they're more expensive to make (*and* to buy). Congress wants to promote conservation and take steps to protect the environment. They give buyers an incentive by way of a tax deduction. It's called the Clean-Fuel Vehicle Deduction.

Hot! \$2,000 Deduction. For 2005 you get a \$2,000 deduction for buying a new hybrid vehicle. Only the original purchaser can get the deduction. The vehicle must be purchased rather than leased. And it must be "placed in service" (driven) in 2005. The deduction was set to decline in 2005, but was extended. Buy the vehicle in 2006 and the deduction drops to \$500. After 2006 the deduction is scheduled to expire. If the car is used partly for business you must pro-rate your deduction between the personal and business use. Part of your deduction is taken on your business schedule, the rest on your Form 1040.

Hot! More Models Approved.

When the deduction began three years ago only two vehicle models had been approved. Recently IRS seems to add to the list nearly every month. The 2005 models which have already been approved for the deduction are:

Ford Escape SUV
Honda Insight
Honda Civic Hybrid
Honda Accord Hybrid
Toyota Prius

IRS recently approved the first of the 2006 models. The first is:
Lexus RX 400h

Right Car For You? Your choice of a vehicle will be based on many factors. The tax deduction for a hybrid is a single factor. The value depends on your tax bracket. With a fairly common bracket of 25%, you would save \$500 on the car after taxes. You don't need to itemize your deductions, and there are no "floors" for the deduction. But remember, the deduction drops to \$500 in 2006, then expires.

Note: As this was written in late July, Congress was considering an Energy Bill. One of the provisions would increase the tax savings on hybrids in 2006. Wait and see.

I Get Questions

Here are some of the common tax questions that keep popping up.

Q New Home Loan Fees. We bought our first home, but the interest and taxes for 2005 still won't be big enough to let us itemize. Will we lose the benefits of the loan fees?

A No. While you may only deduct mortgage interest and property taxes in the year you pay them, loan fees are a bit different. These are considered to be pre-paid interest. They are normally deducted over the life of the loan. A special exception allows you to deduct "points" or "loan fees" when you purchase a home, but you may choose the method of deducting them over the loan's term. This will give you a small extra deduction each year. When the loan is paid or refinanced in a later year you may deduct the balance of these fees.

Q Parking Tickets. If my employee or a customer gets a parking ticket while doing business with me, I often offer to pay the cost. May I deduct this?

A Sorry – No Dice. I salute your generosity. However, I can't help out with a tax deduction. Tax law never allows a deduction for an illegal activity. A parking ticket seems minor, but it is a violation of local law. No deduction.

Q Helping Our Aging Parents. My parents have a fixed income. I began helping out with direct cash payments to them. Can I get any deductions for this?

A Maybe – Maybe Not. You have opened a very large topic here. I'll describe some basics, but I think we should talk this over. There are some possibilities:

Dependency. One or both of your parents might qualify as your dependent. Tests are very tough. Generally a dependent cannot have income over \$3,200 in 2005. In cases of low income this does not include Social Security. Also, you must provide more than half the parent's support. This will take some time and calculations before we can be sure. If this still sounds promising, please call me.

Multiple Support. You didn't mention it, but are other siblings also proving help? We may be able to

Tax Freedom Day[®] – What's It Mean?

We've all seen articles about "Tax Freedom Day[®]" arriving in April or May. The term was coined by *The Tax Foundation*, which publishes studies on economics and taxation. Their annual report can be read in detail at their website – www.taxfoundation.org.

All Taxes for All Americans. The term comes from looking at all taxes we pay – Federal income tax, state income tax, property tax, sales & excise tax, even corporate income tax. (Exxon or Sears or General Motors have income taxes, and we consumers pay the bill in the form of increased prices.) Compare the total taxes collected with total personal income. The resulting percentage shows how much of our income goes to pay for government programs. For 2005, they estimate 29.7% of Americans' personal income goes back into some form of taxes. *The Tax Foundation* converts that percentage into a date. On April 17 we concluded 29.7% of Year 2005.

Any statistic can be misleading. Many Americans pay far less tax, others pay more. The figures vary somewhat from state to state. Some states have higher property tax, some have no sales tax, some have no income tax. *The Tax Foundation* says the percentage or "date" has fallen somewhere between April 15 and May 3 for the past 25 years.

Bigger Meaning. However you choose to look at the figures, they represent the costs of running our government, our society. About 1/3 of what is earned in America is re-directed into programs run by governments rather than by individuals.

My Focus: Your Taxes. I work with some of the taxes, but not all of them. Like yourself, I know bits and pieces about the others. Within my working areas I must apply the law.

My Job. We all have our own opinions of whether governments should be doing certain jobs. But, my first job is to see that you pay the correct amount of tax. Not one cent more. I try to share enough information to help you recognize cases where you need help *before* you make important tax decisions. I can't change the laws, but I know how to work with them. I'd like your personal Freedom Day to come as early as possible!

combine the amounts *all* of you pay in order to help *one* of you get a dependency exemption.

Living With You? If your parent lives with you, you provide substantial value in lodging costs. Dependency is more likely. There is another possibility. You may get Dependent Care Credits if you pay for in-home care or nursing. I can help figure it out. Last, but not least, you might be a Head of Household for tax filing. This gives you lower tax rates.

Medical Costs. You may be able to claim medical expenses paid for the parent. Usually the parent must be your dependent. A special exception allows you to ignore their income for this single purpose of medical costs.

Tip of The Iceberg. I hope you can see there are far too many rules to describe here. If you are paying any substantial amount on your parents' behalf, please call me.

Q Large Gift To Kids. We want to help our married son buy a home. How much can we give with no tax to him?

A No Tax To Son – Maybe A Problem For You!

There is no tax upon receiving a gift. The giver might face a gift tax. You can avoid all gift tax issues if your gifts in any year stay below the IRS exclusion amount. For 2005, anyone can give up to \$11,000 during the calendar year to anyone else with no tax issues for either party. You may give your son up to \$11,000 for 2005. You may also give \$11,000 to your daughter-in-law if you wish. Your spouse may do the same. That makes a total of four gifts equaling \$44,000. If that's not enough, call me.

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We'll Print
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Mailing Flap

You Add Postage
Or
We'll Print Your
Bulk Permit

You Add Your Client Address

Tips For You

Softer W-4 Withholding Rules.

Your Form W-4 tells employer how to calculate your withholding tax. You name a marital status and claim a number of allowances. If you have very large deductions you can claim a large number of allowances and your withholding will decline.

IRS has had problems with tax protestors in the past. Because of this, employers were forced to send IRS a copy of Forms W-4 claiming exempt status, or with more than 10 allowances. IRS would sometimes contact employer saying withholding must be calculated with a single allowance. It can take months to reverse this action. IRS has dropped the requirement. You won't be automatically scrutinized by IRS for knowing your tax bill will be small.

I don't ever recommend that you claim exempt status. But, there is no longer a danger in claiming a large number of exemptions if this will result in the proper amount of withholding.

Sales Tax vs. State Tax. 2005 is the second (and last) year you may choose to deduct either state income tax or state sales taxes when you itemize your deductions. Some of you live where one or the other of these does not exist. For most Americans there will be a choice to make. State income tax you paid is

easy to calculate. The sales tax option is more difficult.

Maximizing Sales Tax. You normally use a figure found in IRS tables for your particular state, income, and household size. I doubt it is worth the effort to save receipts of taxable purchases unless there are several large items bought this year. However, we can add to the table amounts for the sales tax when you purchase a motor vehicle, boat, aircraft, or materials to build or remodel your home. Put the records of such purchases in a safe place. You'll need them at tax time.

Deducting Education Costs.

Each year at "back to school" time I am bombarded with questions on schooling and taxes. There are several levels here:

Pre-school & kindergarten. You may qualify for dependent care credits if the care of the youngster allows you to work. For a couple, both spouses must be employed.

Grade school & high school. Generally there are no deductions allowed for basic education.

College & beyond. There are special deductions or credits here. Only tuition and fees are counted. Costs of books, travel, lodging, and so on are ignored. Your savings decline as your income rises.

Job Skills Improvement. You may be able to claim an itemized deduction for the costs. Now you include all costs, not simply tuitions. If the education or training would

qualify you for a new occupation, however, you may not claim a deduction.

In-Home Day Care Providers.

If you run a day care center at home IRS uses an allowance for meals and snacks. No need to keep receipts. The 2005 figures for each meal or snack served are

Breakfast – \$1.04

Lunch or dinner – \$1.92

Snacks – \$0.57

You must record names of the children, hours of care, and meals and snacks provided. The allowance often exceeds actual costs, but you are still allowed to use it.

Your Tax Calendar

Aug. 15	First extensions to file 2004 Form 1040 expired.
Sept. 15	3 rd quarter estimated tax payments due.
Oct. 17	Final extensions to file 2004 Form 1040 expire.
Nov. 1	3 rd qtr. payroll returns due. (Nov 10 if tax paid in full and on time.)
Dec. 31	Last chance for deductions in 2005.
Jan. 16	4 th quarter estimated tax payments due.

