THOMAS, JUDY, AND TUCKER, P.A.

Welcome to the December 2004 Thomas, Judy & Tucker, P.A. newsletter. If you prefer to have this newsletter e-mailed, please call our office at (919) 571-7055 and give us your e-mail address, or e-mail it to us at heather.dickson@tjtpa.com

NEW LAW BRINGS IMPORTANT CHANGES

Expensing of SUVs limited!

Gain from sale of residence with prior 1031 gain may not be excluded from income!

Need details? See the summary of this important legislation later in this newsletter!

WORKING FAMILIES TAX RELIEF ACT OF 2004

The good news is that the passage of this act extended many tax benefits that were scheduled to expire after this year. Without this Act, next year would have seen a drop in the child credit, a smaller 10% tax bracket, lower standard deductions for married couples, more income of married couples taxed at 25% rather than 15%, and more individuals being subject to the alternative minimum tax, as well as other items. The Act keeps these tax breaks at or above current levels.

HEALTH SAVINGS ACCOUNTS
By Chris Judy, Managing Partner

Are medical costs increasing? I know health insurance premiums are increasing since I pay the premium. However, I recently made an office visit and paid my $15 co-pay, but had no idea how much the visit really cost. You would think technology would bring medical costs down. If we start paying the first dollars of our health cost, rather than relying on insurance companies to negotiate the fees, I think we will see a decrease. Lasik eye surgery, which is often not covered by insurance, is a good example. The cost initially was $3,500 per eye; now the surgery is as low as $500 per eye. While health care in the US is among the best in the world, our system is broken. Not only are we seeing premiums soar, but also the doctors are burdened with excessive paperwork and claims that are being denied or drastically reduced.

Companies used to provide retirement plan contributions and health insurance as part of the overall employee compensation package. In 1974, 401(k) plans were introduced, then simplified in 1986. Now there are very few companies that have not converted their profit sharing plans to 401(k) plans. It is now the burden of employees to contribute to their own retirement on a pre-tax basis. Health insurance may be going down the same path.

President Bush has made health reform one of his top priorities. One of the strategies he is promoting is *Health Savings Accounts* (HSAs). These are high deductible plans allowing pre-tax contributions to be deposited with a qualified trustee. The amounts can be withdrawn tax free if used for qualified medical expenses.

Insurance companies are trying to determine the effects of the HSA plans and how to price the premiums. Jim Long and the Department of Insurance have only approved four group insurance plans that qualify as HSAs, but many more are on their way next year.

It takes consumers 3-5 years to change our buying habits. However, when we start paying the first dollars of our medical costs and when we have the ability to build up a pre-tax savings account for future medical costs, we may begin to see a reduction in those costs. We may be a year or two away from competitively priced HSAs, but look for them to have a significant impact on our health system.

NEW STAFF

- **Christyn DeBellis** has joined our firm as a staff member on our financial statement team. Christyn, a graduate of the University of Delaware, began her career with a CPA firm in Wilmington, Delaware. She relocated from Pennsylvania to the Raleigh area.
- We also welcome **Geri Lail** to the firm in the tax area. Geri, a CPA, brings with her several years of public accounting experience. She and her husband, Marty, make their home in Raleigh. They recently began their family with the birth of Jacob in September of this year.

GROWING FAMILIES

- **Kevin Miller** and his wife, Miken, became parents on July 27th 2004, with the birth of their daughter, Sadler Denise.
- **Debbie Henry** and her husband, David, have also added to their family. Their third child, Daniel Lee, was born June 18th 2004.

PROFESSIONAL ACCOMPLISHMENTS

- **Jay Sharpe** has been awarded the "Certified Fraud Examiner" (CFE) designation by the Association of Certified Fraud Examiners. The Association was organized in 1988 to reduce the incidence of fraud and white-collar crime. The CFE professionals must meet a stringent set of criteria, including strict character, experience and education requirements. As a CFE, Jay now has the necessary expertise to assist in many aspects of detecting and preventing white-collar crime, including obtaining evidence, taking statements and writing reports, and testifying to finds. Jay will be assisting our clients with any fraud related issues that arise. Congratulations, Jay!
- **Patsy Govert** has earned her designation as a "Certified Divorce Financial Analyst" (CDFA), issued by The Institute of Certified Divorce Financial Analysts. Patsy has completed a rigorous four-part curriculum, complete with exams, covering all aspects of divorce planning. Financial analysis early in the divorce process can often save those involved both time and money while reducing the apprehension and misunderstanding of the process. A CDFA can help avoid long-term financial pitfalls as well as help with post-divorce financial planning and budgeting. Congratulations, Patsy, on accomplishing this specialty!

NEW PER-DIEM RATES

Reimbursements of an employee's business travel costs (lodging, meal and incidental expenses) at a per-diem rate are payroll and income-tax free if properly substantiated and the daily rate does not exceed the federal per-diem rate for the locality of travel for that day. The rates have just been published by the General Services Administration (GSA) for the period October 1, 2004 to September 30, 2005. Under the optional "high-low" method, the high-cost-area per diem is $199 ($153 for lodging and $46 for meals and incidental expenses). The per-diem for other localities is $127 ($91 for lodging and $36 for meals and incidental expenses). There have also been some revisions in the definition of "incidental expenses" and additions and deletions to the localities identified as high-cost areas. All of the details are available on the GSA website at http://policyworks.gov/org/main/mt/homepage/mtt/perdiem/travel.htm.

BEWARE UNDERPAYMENT OF SALES AND USE TAX

The North Carolina Department of Revenue continues to develop better ways to identify underpayment of taxes. One technique being applied is to initiate sales and use tax audits for businesses that are filing income tax returns but no sales tax returns. It is certainly possible that no sales tax is due. However, many businesses make purchases on which use tax is due but never reported (generally purchases from out-of-state vendors). In many cases, a levy of use tax due for several years is the result of these audits. If your business does not file sales tax returns, it is recommended that you remit any use tax due on purchases where no sales tax was paid. Thus you will avoid any penalties and interest on underpayment of this tax, as well as possibly the time and expense of an audit.

2004 IRS & SSA TAX FORM CHANGES

	2003	2004	2005
Personal Exemption	$3,050	$3,100	$3,200
Child Tax Credit	$1,000	$1,000	$1,000
Earnings ceiling for Social Security			
Below Age 65	$11,520	$11,640	$12,000
Age 65 and above	Unlimited	Unlimited	Unlimited
Estate Tax Applicable Exclusion Amount	$1,000,000	$1,500,000	$1,500,000
Gift Tax Exclusion Amount	$1,000,000	$1,000,000	$1,000,000
Section 179 Deduction	$100,000	$102,000	$105,000
Self-Employed Health Insurance Deduction	100%	100%	100%
Retirement			
Max Deductible 401(k) and 403(b)			
Employee Contribution	$12,000	$13,000*	$14,000**
Traditional and ROTH IRA Contributions	$3,000^	$3,000^	$4,000^
Household wages are subject to FICA tax if wages are >	$1,400	$1,400	$1,400
Mileage			
Business	$.36/mile	$.375/mile	$.405 /mile
Charitable	$.14/mile	$.14/mile	$.14/mile
Medical / Moving	$.12/mile	$.14/mile	$.15/mile
Payroll			
Social Security	6.2%	6.2%	6.2%
Maximum taxed	$87,000	$87,900	$90,000
Medicare	1.45%	1.45%	1.45%
NC Taxable Wage base	$15,900	$16,200	$16,700

^ Over age 50, may contribute an additional $500
*** Over age 50, may contribute an additional $3,000**
**** Over age 50, may contribute an additional $4,000**

ELECTRONIC TAX ORGANIZER!

It's that time of year again! We will be mailing out individual tax organizers in January 2005. If you prefer to receive your tax organizer electronically, we would be glad to e-mail the organizer to you rather than mailing a paper version. To select this option, email Heather Dickson at heather.dickson@tjtpa.com prior to December 20, 2004. The organizer should be helpful in accumulating your 2004 tax information. Please fill out the organizer and return it to us as soon as you have received all of your 2004 tax information.

ELECTRONIC FILING REMINDER

This is a reminder that we offer electronic filing of your individual tax returns through our tax software provider. If your return shows a refund due, you can receive it substantially faster than if you were to file your return through the mail. In addition, both federal and state refunds can be deposited electronically into your bank account. If you owe additional tax, you can file your return electronically and still put off making the payment until April 15th . There are restrictions on some returns, but if you are interested in filing your return electronically please let us know when you bring in your tax information or indicate it on the tax organizer.

AMERICAN JOBS CREATION ACT

On Oct. 22, 2004, the President signed into law the American Jobs Creation Act of 2004. This massive tax law replaces the U.S. export tax regime with broad-based tax relief for domestic manufacturing, U.S. multinationals, and a wide variety of other businesses and industries. Here's what you need to know right now about the more widely applicable tax changes in this important new law:

➢ **New deduction for U.S. production activities.** The Jobs Act creates a new tax deduction for domestic production activities. The deduction is a percentage of the net income from these activities—3% in 2005-2006, 6% for 2007-2009, 9% after 2009—but it is subject to several limitations.

The new deduction is allowed for qualified production activities income, which is the domestic production gross receipts of a business net of related expenses. "Domestic production gross receipts" includes receipts from any lease, rental, license, sale, exchange, etc., of qualifying production property (i.e., tangible personal property, any computer software, and certain sound recordings) that was manufactured, produced, grown, or extracted in whole or in significant part by the business within the U.S. Also included are receipts from construction in the U.S., engineering and architectural services performed in the U.S. for construction projects in the U.S., and the domestic production of certain films.

"Domestic production gross receipts" don't include gross receipts from selling food or beverages at a retail establishment.

Complex allocation rules will apply if only part of a business's gross receipts are domestic production gross receipts. The deduction is available to regular (C) corporations, passthrough entities such as S corporations and partnerships, and to sole proprietorships, estates, and trusts.

➢ **Robust expensing tax breaks extended for two more years.** A business or practice that buys machinery and equipment generally deducts its cost over a number of years via depreciation. The expensing election permits a business or practice to expense (that is, deduct immediately rather than depreciate over several years) a certain amount of the cost of tangible depreciable personal property purchased and placed in service during the year. The maximum annual expensing amount is $100,000 (adjusted for inflation), and the maximum annual expensing amount begins to phase out dollar-for-dollar when the business or practice places in service during the tax year expensing-eligible property in excess of $400,000 (adjusted for inflation). Before the 2004 Jobs Act, these rules only applied for tax years beginning in 2003 through 2005. After 2005, the maximum expensing amount was scheduled to drop to $25,000, and the expensing phaseout figure was set to drop from $400,000 to $200,000. Under the 2004 Jobs Act, the $100,000/$400,000 amounts (adjusted for inflation) will stay in place through tax years beginning before 2008. The 2004 Jobs Act also extends through 2007 several other expensing breaks (allowing most software to be expensed, and allowing taxpayers to revoke expensing elections on amended returns without the IRS's consent).

➢ **New 15-year writeoff for qualifying leasehold improvements and qualifying restaurant property.** Effective for property placed in service after Oct. 22, 2004, and before Jan. 1, 2006, the Jobs Act allows 15-year straight line depreciation for qualifying leasehold improvements and qualified restaurant property. In general terms, qualifying leasehold improvements are interior improvements made under a lease to commercial property (such as an office building or warehouse), and placed in service more than three years after the building was first placed in service. Certain structural improvements don't qualify, nor do expansions. Also, improvements made by a building owner usually won't produce a fast writeoff for a subsequent owner. Qualified restaurant property is any improvement to a building if the improvement is placed in service more than three years after the date the building was first placed in service and more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. In general, qualifying leasehold improvements and qualifying restaurant property were written off over 39 years under prior law.

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➢ **Liberalized S corporation rules.** Effective for tax years beginning after 2004, the Jobs Act makes it easier for businesses to qualify for S corporation status. Among the more important liberalizations is an increase in the maximum number of shareholders from 75 to 100 and allowing family members to be counted as one shareholder for purposes of determining the maximum number of shareholders.

➢ **Limited expensing writeoff for heavy SUVs.** Heavy SUVs—those with a gross vehicle weight rating (GVWR) of more than 6,000 pounds—are not subject to the "luxury auto" depreciation dollar caps and lease income inclusion amount rules. Under the rules that applied before the 2004 Jobs Act, this meant that the entire cost of a heavy SUV used 100% for business could be written off under the expensing rules. Effective for vehicles placed in service after Oct. 22, 2004, only $25,000 of the cost of a heavy SUV (under 14,000 pounds gross vehicle weight) may be expensed.

➢ **Revised rules for start-up and organizational expenses.** For amounts paid or incurred after Oct. 22, 2004, a taxpayer can elect a current deduction for up to $5,000 of start-up expenses in the tax year in which the active trade or business begins. However, this $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenses exceeds $50,000. The remainder of the start-up expenses can be claimed as a deduction ratably over a 180-month period. Before the 2004 Jobs Act, no current deductions were allowed for start-up expenses. However, a taxpayer could have elected to treat start-up expenses as deferred expenses and deducted the expenses equally over a period of not less than 60 months (beginning with the month in the active trade or business began).

Similar provisions apply to corporate organizational expenses and partnership organizational expenses. For amounts paid or incurred after Oct. 22, 2004, a corporation or partnership can elect a current deduction for a limited amount ($5,000) of organizational expenses in the tax year in which the active trade or business begins. However, this $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of organizational expenses exceeds $50,000. The remainder of the organizational expenses can be claimed as a deduction ratably over a 180-month period.

➢ **Sales tax deduction.** Taxpayers who itemize deductions will have a choice of claiming a state and local tax deduction for either sales or income taxes on their 2004 and 2005 returns. This new law will primary benefit individuals in states with sales taxes but with limited or no individual income taxes. The IRS will provide optional tables for use in determining the deduction amount, relieving taxpayers of the need to save receipts throughout the year. Sales taxes paid on motor vehicles and boats may be added to the table amount, but only up to the amount paid at the general sales tax rate. Taxpayers will check a box on Schedule A, Itemized Deductions, to indicate whether the deduction is for sales or income taxes.

➢ **Sale of Personal Residence Acquired in a Like-kind Exchange**. Taxpayers who convert rental property to a principal residence should know that a tax law change may limit their ability to exclude gain on the sale of that residence if they obtained the property through a like-kind exchange. Generally, a taxpayer can exclude up to $250,000 of gain on the sale of a home, provided the individual has owned and used it as a principal residence for two out of the five years before the sale. The exclusion is $500,000 for a married couple if both meet the use test. The American Jobs Creation Act of 2004 does not allow any exclusion if the taxpayer sells the home within five years of acquiring the property through a like-kind exchange. The new law applies to sales after October 22, 2004.

Please keep in mind that these are only the highlights of the most important changes in the new law. Give us a call at your earliest convenience for more details on how you may be affected by this important tax legislation.

IS YOUR HEALTH CARE POWER OF ATTORNEY IN COMPLIANCE WITH HIPAA?

The federal law known as "HIPAA" protects the privacy of Americans. However, it may limit the ability of loved ones to utilize a Health Care Power of Attorney that was in place before the HIPAA rules. You may want to review these forms with your attorney to be sure that, if needed, they will be accepted by your medical providers.

SALES TAX AUDIT?

If your company is selected for a sales tax audit, we will be glad to provide assistance and expertise that may both facilitate the process and improve the results of the audit. Please call us if we can provide this support for your company.

AFRs FOR DECEMBER 2004

The Applicable Federal Rates for December 2004 have been announced. Selected rates are as follows:

	Compounding		
Term	Monthly	Quarterly	Annual
Short-term (0-3 years)	2.45%	2.45%	2.48%
Mid-term (4-9 years)	3.50%	3.51%	3.56%
Long-term (over 9 years)	4.59%	4.60%	4.68%

YEAR-END PLANNING

While 2004 is substantially over, there are still opportunities to decrease your individual or corporate tax liabilities for the year. These may include making certain deductible payments before year-end, maximizing depreciation deductions through year-end purchases or a cost segregation study, or taking full advantage of tax deferral opportunities. Please call our office to schedule a review of the particular planning ideas appropriate to your situation.

RECENT COURT CASES COULD SPELL TROUBLE FOR FAMILY LIMITED PARTNERSHIPS

Family Limited Partnerships (FLPs) have been used in estate planning as an effective tool for transferring ownership of assets to heirs. FLPs have enabled property owners to contribute assets to an FLP, then gift interests in the partnerships without paying gift tax if the gifts were below the annual exclusion ($11k/person/year). A further benefit has been to discount the value of the gift due to minority interest or lack of marketability, enabling a larger value to pass to heirs and a greater reduction to a taxable estate.

Some FLPs were more of an estate plan than with an investment in a business; designed only to avoid estate tax with no bona fide business purpose. The IRS has begun to successfully attack FLPs in court in an attempt to bring the assets transferred back into the decedent's estate. The third Circuit Court stated that a good faith transfer to a FLP must provide the transferor with some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form. Court cases have indicated that property must be included in a decedent's estate if before death the decedent possessed or enjoyed either the right to the income of the property or the right to designate persons to possess or enjoy the property or its income. The most vulnerable FLPs appear to be those containing real estate with no active business and having related shareholders.

There are steps to minimize the risk. In establishing a FLP, sufficient assets should be retained to continue current life style. FLPs need to establish and use separate bank accounts and maintain adequate books and records. Minutes of meetings need to be recorded and preserved. If a taxpayer continues to live in a personal residence transferred to a FLP, fair market value rent needs to be paid, not just accrued. Distributions need to be paid prorata and not just when the initial contributor has a bill to pay. Documenting business reasons for a transfer and avoiding actions that treat the transferred assets as if the contributing partner still owned them outright will help establish a bona fide transaction.

It appears that the IRS will continue to pursue cases against FLPs that it feels it can win. Complying with formalities is no guarantee that the government will respect a FLP, but absence of complying with the formalities will virtually guarantee failure.

2004 SPCA OF WAKE COUNTY SERVICE PROJECT

One day each year, Thomas, Judy and Tucker, P.A. closes our office to provide volunteer services for a local organization. This year we closed on October 29th and spent the day at the new SPCA of Wake County facility, where we worked on many landscaping and cleanup projects. The SPCA of Wake County is a non-profit animal welfare organization. Jay Sharpe, on our financial statement team, is on the finance committee of the organization. While we all had different skills to offer on the project, we really enjoyed the opportunity to be involved with such a worthwhile organization.

Please do not hesitate to get in touch with us if you have any questions about the above.

Very truly yours,

THOMAS, JUDY & TUCKER, P.A.