

## RECENT TAX LAW CHANGES OF SIGNIFICANCE

### 1. Income Tax Rate Structure

For 2005, the first \$7,300 of taxable income for single (S), \$10,450 for head of household (HH) and \$14,600 for married filing jointly (MFJ) is taxed at 10%. The marriage penalty does not exist in the 15% bracket but begins in the upper portion of the 25% bracket. The 2005 upper bracket rates are 25, 28, 33 and 35%.

### 2. Domestic Production Activities Deduction (DPAD)

The DPAD begins this year. For many farmers, Qualified Production Activities Income (QPAI) is net Schedule F income added to the gain from the sale of raised animals used for dairy, breeding or sporting purposes. The amount of the deduction will be the *smallest* of three calculations:

- a. 3% of QPAI
- b. 3% of an individual's adjusted gross income or the taxable income of an entity
- c. 50% of total Form W-2 wages of an employer (probably box 5 wages which show what's subject to Medicare).

This 3% deduction increases to 6% in 2007 and 9% after 2009. This deduction will not reduce self-employment tax. It is calculated on Form 8903 and carries to the front of Form 1040 on line 35.

### 3. Direct Expensing & Additional First-Year Depreciation

The amount that can be direct expensed under section 179 is \$105,000 in 2005 with a phaseout beginning at \$420,000 of qualified property placed in service.

For most property the 30% or 50% bonus or special depreciation is not available. Certain long production property purchased before January 1, 2005 and placed in service before January 1, 2006 might qualify. See chapter 7 of the Farmer's Tax Guide, Publication 225, and chapter 3 of How to Depreciate Property, Publication 946.

### 4. Child Tax Credit

This remains at \$1,000 through 2010 for each qualifying child under 17. Phase-out begins at \$75,000 modified AGI for singles and \$110,000 for MFJ at a rate of \$50 per \$1,000 income.

### 5. Adoption Credit

This credit is estimated at \$10,630 for 2005. Phase-out range is \$159,450 to \$199,450.

### 6. Coverdell Education Savings Accounts (ESAs)

These used to be called Education IRAs. The contribution limit remains at \$2,000 on behalf of any beneficiary by the due date of the tax return (without extensions). Contributions can't be made after the beneficiary turns 18. Phases out ratably from \$190,000 to \$220,000 for MFJ or \$95,000 to \$110,000 for Single. Distributions may be used for Qualified Higher Education Expenses including room and board or Qualified Elementary and Secondary School Expenses.

## **7. Qualified Tuition Programs (QTP or Section 529 Plan)**

Allows nondeductible contributions and tax free distributions if used for qualified expenses. While contributions are not deductible for federal income taxes, Michigan's maximum annual deduction is \$10,000 for MFJ and the account balance limit is \$235,000 for each beneficiary.

## **6. Increase in Pension and IRA Contribution Limits**

For 2005 IRA limit is \$4,000, SIMPLE limits increased to \$10,000 and the SEP maximum is \$14,000. In 2005 individuals 50 and over can add \$500 to the IRA, \$2,000 to SIMPLE limit and \$4,000 for a SEP. In 2005 a nonrefundable saver's credit up to \$1,000 (\$2,000 for MFJ) is allowed for contributions to a qualified retirement plan by lower-income taxpayers. Credit is reduced to zero as AGI increases to \$50,000 for MFJ or \$25,000 for single.

## **7. Estate and Gift Tax Credit**

The estate tax exclusion is \$1,500,000 with a top rate of 47% in 2005 (\$2,000,000 and 46% in 2006). The lifetime gift tax exclusion remains at \$1,000,000. The annual gift exclusion amount is indexed and remains at \$11,000 per person for 2005 (\$12,000 in 2006).

## **8. Alternative Minimum Tax Exemption Amounts**

The AMT exemptions in 2005 are \$58,000 for MFJ and \$40,250 for single. The AMT is a required calculation to determine if you owe more tax than determined normally.

## **10. Income Averaging for Farmers**

Starting with tax years beginning December 31, 1997, individuals may use income averaging on only their farm income over the prior three-year period or base years. Negative taxable income can be used from the base years. The alternative minimum tax is coordinated with farm income averaging so that income averaging will not increase AMT. Whatever AMT is owed before using farm income averaging, the same AMT will be owed after income averaging.

## **11. Capital Gains**

Capital gains rates for sale of capital assets held for 12 months or longer (24 months for breeding cattle and horses) are 5% for that portion of capital gains between taxable income and the top of the 15% bracket (\$29,700 single and \$59,400 married). The rate is 15% for that portion of long-term capital gains which exceeds the top of the 15% ordinary bracket. The tax rate on collectibles remains at a maximum of 28% and at a maximum of 25% for unrecaptured code section 1250 gain (buildings).

## **12. Sale of Residence**

Residential sales, including the residence portion of a farm sale, after May 6, 1997, will be tax free on gains up to \$500,000 for a joint return, or \$250,000 for a single return. Eligibility includes occupying as a principal residence two of the last five years. Hence, a person or couple could use these provisions every two years. Prior carryover rules on exchange of a residence and the one-time \$125,000 exclusion for those over 55 were repealed. Business property such as farm buildings and farmland used in a trade or business cannot be included in this exclusion. Portions of the principal residence depreciated for a home office are subject to recapture.

### 13. Self-employed Health Insurance Deduction

The deduction of health insurance costs for the self-employed increased to 100% in 2003. SE tax is still paid on this since it is deducted after the SE calculations.

### 14. Long-term Care Insurance and Services

Qualified long-term care expenses (\$240 per day maximum) and long-term care insurance premiums will be treated as medical expenses and therefore are deductible as an itemized deduction, but only to the degree all itemized medical expenses exceed 7.5% of adjusted gross income. The 2005 annual deduction for premiums is limited by age.

Age	Not more Than 40	More than 40 Not more than 50	More than 50 Not more than 60	More than 60 Not more than 70	More than 70
Limit	\$270	\$510	\$1,020	\$2,720	\$3,400

### Farmland Preservation Credit in Michigan

Public Act 421 of 2000 reduced property taxes that cannot be claimed for credit from 7% of household income to 3.5% of household income. The Farmland Preservation Tax Credit Claim and Schedule can be e-filed in many cases.

### 15. Tax on Dividend Income

Dividends from a domestic or qualified foreign corporation is taxed at 15% or 5%, similar to long term capital gains. This does not include dividends from credit unions or farmer’s cooperatives.

### 16. Earned Income Credit (EIC)

The EIC is available to workers with qualifying children and for childless workers.

<b>EARNED INCOME RATES, INCOME RANGES AND PHASEOUTS FOR 2004</b>
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#### Earned Income or AGI Range for Taxpayers Not Filing as “Married Filing Jointly” (for 2004)

Qualifying Children	Credit Rate (%)	Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	\$ 5,220 – 6,530	\$6,530 – 11,750	7.65	\$399
One	34.00	7,830 – 14,370	14,370 – 31,030	15.98	2,662
Two or more	40.00	11,000 – 14,370	14,370 – 35,263	21.06	4,400

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## **17. Livestock Replacement**

Producers selling livestock due to weather events may get four years to buy replacements rather than two years from the end of the tax year of the event. This is retroactive to 2002 events. This extension to four years applies to areas eligible for federal assistance due to weather events. The two year rule still exists for areas not declared a disaster area. Also, for weather related conditions, other farm property can be substituted if it is not feasible to reinvest with property similar or related in use to the converted livestock.

## **18. Reforestation Expenses**

Effective for expenses paid or incurred after October 22, 2004, taxpayers may elect to deduct up to \$10,000 of reforestation expenses with the balance amortized over 84 months.

## **19. CCC Loans**

An election to treat CCC loans on crops as income can be made by reporting the income on line 7a of Schedule F of Form 1040. A statement should be attached to the return showing the details of the loan. After making this election you must generally report all CCC loans in the year of election and later years the same way - as income. However, you can obtain an automatic consent to change the method of your accounting to count the loans as loans rather than income by filing a Form 3115.

## **20. Nonbusiness Energy Property Credit**

For property placed in service after 2005 and before 2008, a taxpayer can claim a lifetime nonrefundable credit of up to \$500 for qualifying improvements to the home. Limited to \$200 for windows, the improvement is 10% of the cost of energy efficient building envelope components which meet the criteria established. Residential energy property expenses which meet established criteria may include up to \$50 for an advanced main air circulating fan, \$150 for a natural gas, propane, or oil furnace or hot water boiler, and/or \$300 for energy efficient property like pumps and air conditioners. More details will be available next year.