Hahn Loeser + Parks LLP

2004 Year-end Tax Planning Advisory Notice

As you begin to focus on holiday social activities, we encourage you also to spend time implementing, prior to year-end, certain financial measures aimed at improving your overall tax position. When performing such year-end tax planning for both business and individual purposes, you should consider the impact of the 2004 American Jobs Creation Act (the "Act") and The Working Families Tax Relief Act of 2004, both signed into law during the past year, and normal year-end strategies aimed at deferring the recognition of income and accelerating the reporting of deductions for income tax purposes, with full consideration of your tax liability as calculated under the alternative minimum tax ("AMT") system.

We have set forth below a summary of some of the issues that should be addressed as part of your year-end tax planning. After you have reviewed our summary, you are welcome to consult with a member of Hahn Loeser's Taxation & Employee Benefits Section for assistance with the year-end tax planning process.

Personal Income Tax Planning

Retirement Planning

Employees and self-employed individuals who aren't active participants in an employer-maintained retirement plan can set aside and deduct up to $3,000 for 2004 (and $4,000 for 2005) for contributions to an individual retirement account ("IRA"). In certain cases, these contributions may be allowable but not fully deductible, depending on the taxpayer's adjusted gross income ("AGI"). The contributions for 2004 may be made up until April 15, 2005.

A taxpayer may elect to recharacterize an IRA contribution, i.e., treat a contribution to one type of IRA (Roth IRA or traditional IRA) as made to another type of IRA. While contributions to a Roth IRA are not deductible, qualified distributions from a Roth IRA are not included in income. An IRA contribution for a tax year may be recharacterized as late as six months after the unextended due date for filing the tax return for that year.

Individuals who are age 70½ or older must plan to take the appropriate retirement plan distribution in order to satisfy the minimum distribution rules and avoid certain penalties. For those who attained age 70½ last year, the distribution for 2004 must be made no later than April 1, 2005. Nevertheless, it might be advisable to take the distribution in 2004 if a higher income tax bracket is anticipated for next year. Distributions to those who attained age 70½ in earlier years must be made by December 31st.

Current and Future Education Funding

Individuals with AGI not exceeding $130,000 if married filing jointly or $65,000 if single may be able to deduct up to $4,000 in education-related expenses ($2,000 for those with AGI up to $160,000 if married filing jointly or $80,000 if single). The Hope Scholarship Credit or Lifetime Learning Credit may also be available, but cannot be claimed if the deduction for education costs is also taken. The Hope Credit is available only for qualified expenses of the first two years of undergraduate education. The Lifetime Learning Credit is available for qualified expenses of any post-high school education at "eligible education institutions." These credits reduce taxes dollar-for-dollar, but begin to phase out when 2004 AGI exceeds $85,000 for married filers and $42,000 for other taxpayers. The credits phase out completely when AGI exceeds $105,000 and $52,000, respectively.

The annual gift tax exclusion is $11,000 for 2004. For purposes of funding a Section 529 Qualified Tuition Program, a taxpayer is allowed to front-load the contributions by electing to spread the gift over five years for gift tax purposes. Therefore, in 2004 you can make a gift of up to $55,000 to a Section 529 plan for each designated beneficiary without incurring gift tax liability ($110,000 if a gift-splitting election is made by a husband and wife), assuming no other 2004 gifts to that beneficiary. For Ohio income tax purposes, taxpayers may deduct up to $2,000 per beneficiary for contributions to the Ohio Tuition Trust Authority's CollegeAdvantage 529 Savings Plan. Married taxpayers may also deduct, for Ohio income tax purposes, up to a maximum of $2,000 per beneficiary whether their filing status is married filing joint or married filing separate.

Capital Gains and Losses

Individuals should consider selling appreciated stock prior to year-end. Capital gains are subject to a maximum of 15% on gains from the sale of qualifying assets, e.g., common stock, held more than one year. In addition, qualifying dividends received by individuals during 2004 will be taxed at the capital gains rates. Taxpayers should also consider "harvesting" unrealized capital losses on stocks held in their portfolios by selling stocks and using the capital losses to offset capital gains recognized during the year up to $3,000 ($1,500 for married separate filers).

Sales Tax Deduction

The Act allows individual taxpayers who itemize deductions to deduct sales and use taxes, rather than state and local income taxes, in 2004 and 2005. This provision could benefit taxpayers who live in a state without an income tax, e.g., Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Prior to year-end, taxpayers should determine the years they will itemize deductions and in what year or years the election to deduct sales tax, rather than state and local income taxes, would be most beneficial, possibly resulting in the need to defer a large purchase until 2005.

Charitable Giving

Effective in 2005, the Act limits the deduction for a charitable contribution of a used automobile or other motor vehicle to the amount of the recipient charity's gross proceeds from its subsequent sale of the donated item. Under the pre-Act rules, which are still applicable in 2004, the contribution deduction equals the fair market value of the donated item at the time of the gift. Accordingly, individuals who itemize deductions should consider accelerating contributions of a used motor vehicle to 2004 in order to realize a larger income tax benefit.

Other Itemized Deductions

To the extent that an individual taxpayer projects that he still has capacity to deduct itemized deductions in 2004, he should consider the following:

- Pay contested taxes this year and take the related deduction this year, and continue to contest them in 2005.
- Settle an insurance or damage claim this year in order to maximize the casualty loss deduction this year.
- Extend subscriptions to professional journals, pay union or professional dues, enroll in (and pay tuition for) job-related courses to bunch into 2004 miscellaneous itemized deductions subject to the 2%-of-AGI floor, if it is projected that this category of deductions will be available.
- Using a credit card to make payments that qualify as itemized deductions, such as charitable contributions, before year-end allows the taxpayer to take the deductions in 2004, even if the credit card balance is not paid until 2005.

Employee Planning

Taxpayers who work as employees should consider taking any or all of the following measures to reduce their current and future years' tax liabilities relating to compensation income:

- During the 2005 benefits election period, increase the amount set aside for 2005 with respect to the employer's health flexible spending account in order to effect tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids, and for the purchase of glasses.
- Depending on what tax brackets are anticipated for 2005, it could be beneficial to arrange with the employer to defer bonus payments until 2005.
- If the taxpayer is projecting that he will be subject to penalties for underpayment of estimated income tax, he should consider increasing his withholding for the remaining pay periods in 2004.

Business Planning

Timing of Income and Expense Recognition

Because it is generally better, from a time value of money perspective, to pay taxes in future years rather than in the current year, taxpayers should consider deferring the recognition of income. Cash-basis taxpayers might consider delaying year-end billings and accelerating the payment of deductible expenses. A separate reason to defer the recognition of income is to reduce AGI below the designated threshold amounts in order to make certain tax breaks available, e.g., individual taxpayers with 2004 AGI in excess of $142,700 begin losing part of their itemized deductions, to the extent of 3% of the excess.

Depreciation

Under Section 179 of the Internal Revenue Code of 1986, business owners may deduct up to $102,000 of the cost of new or used qualifying property, including purchased software, placed in service during 2004. The deduction cannot exceed net income and is reduced dollar-for-dollar to the extent the amount of qualifying property placed in service during the year exceeds $410,000. Accordingly, business owners should determine the extent that they have already taken advantage of Section 179 during 2004 and then decide if additional purchases of tangible business property should be accelerated prior to year-end.

Taxpayers should also consider that 50% first-year bonus depreciation on new business assets, other than real property, expires after 2004. Under the bonus depreciation rules, 50% of the cost of qualifying property is deductible in the year the property is purchased and placed in service.

Because property placed in service on the last day of the tax year will qualify for both Section 179 treatment and bonus depreciation, it is not too late to consider making capital acquisitions prior to year-end in order to take advantage of these tax-saving opportunities in 2004.

Shifting Family Business Income to the Next Generation

Business owners might consider using children or grandchildren subject to lower income tax rates as employees prior to year-end, e.g., college students during their winter break. The shifted income, which must be "reasonable" in amount, will be subject to the student's lower income tax bracket. Providing children with earned income enables them to make IRA contributions. The family should, however, also consider whether increasing the child's income for 2004 might reduce his or her eligibility for college tuition financial aid in future years.

AMT Planning

All taxpayers should attempt to ascertain whether they might be subject to AMT, causing them to lose certain tax benefits, during 2004 and 2005. Generally, the amount of AMT that an individual taxpayer will pay is equal to the excess of his "tentative" minimum tax over his regular income tax. The tentative minimum tax is equal to 26% or 28% (depending on bracket) of the taxpayer's AMT "taxable excess," i.e., his regular taxable income modified by certain statutory preferences and adjustments, including a reduction for the statutory exemption amount. Among the items that are treated as preferences that must be taken into account are tax-exempt interest, state and local income taxes, percentage depletion in excess of basis, a portion of the gain excluded on certain stock in small business corporations, certain accelerated depreciation deductions, excess intangible drilling costs and certain tax shelter farm losses.

An individual taxpayer who is consistently subject to AMT should attempt to spread out preferences over two or more years rather than compressing them into one year in order to maximize utilization of the AMT exemption amounts, i.e., the $150,000 (for joint filers) and $112,500 (for single filers) levels at which the exemption phase-out begins and the $175,000 "taxable excess" level at which the 28% rate begins to apply. This strategy could, for example, result in an individual delaying the payment of real estate taxes until 2005 in order to avoid AMT in 2004 and thereby realize the full tax benefit of the deduction.

Hahn Loeser & Parks LLP
Taxation & Employee Benefits Section

Jeffrey M. Folkman, Co-Chair
3301 Bonita Beach Road, #308
Bonita Springs, Florida 34134
239-949-6981
jmfolkman@hahnlaw.com

Edward A. Weinstein, Co-Chair
3300 BP Building
200 Public Square
Cleveland, Ohio 44114-2301
216-274-2372
eweinstein@hahnlaw.com