

OVERVIEW OF TAX CHANGES IN THE 2004 WORKING FAMILIES ACT

As you may know, Congress recently passed the 2004 Working Families Act, (the Act) which provides a package of tax cuts for middle-income families and extends more than 20 expired business-related tax provisions. Here's what you need to know right now about this important new legislation.

■ **Family tax relief**

• **Child credit**

The child credit, which is \$1,000 per child for 2004, but was scheduled to drop to \$700 for 2005 through 2008 and to rise to \$800 for 2009, will stay at \$1,000 through 2010. Also, the 15% refundability percentage of the child credit is accelerated so it applies for tax years beginning after 2003 (instead of after 2004).

• **Marriage penalty relief**

Two provisions which provide a measure of relief from the marriage penalty are extended by the Act. The provision setting the basic standard deduction for joint filers at twice that of single taxpayers and the provision which increases the size of the 15-percent rate bracket for married couples filing joint returns, both of which were due to expire at the end of 2004, are extended through 2010.

• **10-percent bracket**

The scheduled reduction in the amount of income subject to the 10% tax bracket is repealed, effective through 2010.

■ **Extension of relief from the alternative minimum tax (AMT)**

In recent years, Congress has provided a measure of relief from the AMT by raising the AMT "exemption amounts," thereby reducing the likelihood of an AMT liability. However, this partial relief was set to expire for tax years beginning after 2004 and the exemption amounts were scheduled to revert to the lower amounts allowed under prior law. The Act preserves this partial relief from the AMT by extending the higher exemption amounts to 2005. Also, the availability of non-refundable personal credits to offset AMT has been extended through 2005 (instead of expiring after 2003 tax years).

■ **Uniform definition of child**

In a major tax simplification measure, the Act replaces a series of different eligibility tests for child-related benefits with a uniform definition of a child. For tax years beginning after 2004, the Act establishes a uniform definition of a qualifying child for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit and head of household filing status. Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child (1) has the same principal place of abode as the taxpayer for more than one-half of the taxable year; (2) has a specified relationship to the taxpayer; (3) has not yet attained a specified age; and (4) meets a support test.

- **Assistance to military families in combat zones**

The Act provides assistance to low-income military families in combat zones by (1) increasing the child credit for families by allowing them to include tax-free combat pay when calculating their refundable child credit; and (2) increasing the earned income credit (EIC) for military families in 2004 and 2005 by giving them the option to include combat pay when calculating the EIC. These provisions are expected to provide an additional \$199 million of assistance to military families in combat zones.

- **Extension of business-related tax relief**

The Act extended the life of more than 20 business related tax provisions. Each of the provisions is discussed below.

EXTENSION OF BUSINESS-RELATED TAX RELIEF IN THE 2004 WORKING FAMILIES ACT

The Act extended the life of more than 20 expired or expiring business-related tax provisions. The Act provides for a straight extension of the existing tax provisions, in most cases through December 31, 2005.

- **Research credit**

Under pre-Act law, the research credit terminated for amounts paid or incurred after June 30, 2004. Under the Act, the credit is extended for amounts paid or incurred after June 30, 2004, and before 2006.

- **Work opportunity tax credit**

Under pre-Act law, this credit did not apply for wages paid or incurred to a qualified individual who began work after 2003. Under the Act, the credit is extended for wages paid or incurred for individuals beginning work after 2003 and before 2006.

- **Welfare-to-work credit**

Under pre-Act law, this credit did not apply for wages paid or incurred to a

qualified individual who began work after 2003. Under the Act, the credit is extended for wages paid or incurred for individuals beginning work after 2003 and before 2006.

■ **Enhanced deduction for a corporation's qualified computer contributions**

Under pre-Act law, the enhanced deduction was not available for contributions made in tax years beginning after 2003. Under the Act, the enhanced deduction for qualified computer contributions is extended for contributions made in tax years beginning after 2003 and before 2006.

■ **Expensing of environmental remediation costs**

Under pre-Act law, the elective expensing option was not available for expenses paid or incurred after 2003. Under the Act, the election to treat qualified environmental remediation expenses is extended for expenses paid or incurred after 2003 and before 2006.

■ **Credit for producing electricity from certain renewable resources**

Under pre-Act law, the credit was not available for facilities placed in service after 2003. Under the Act, the renewable electricity production credit is extended, effective for facilities placed in service after 2003 and before 2006.

■ **Suspension of the net-income limitation on percentage depletion for marginal wells**

Under pre-Act law, the 100%-of-taxable-income limit did not apply to so much of the depletion allowance as is determined under the rules relating to oil and gas produced from marginal properties for any tax year beginning before 2004. Under the Act, the suspension of the 100%-of-net-income limit for marginal wells is extended for tax years beginning after 2003 and before 2006.

■ **Credit for qualified electric vehicles**

Under pre-Act law, the otherwise allowable credit was reduced by 25% (25% phase-down) for property placed in service in 2004, 50% (50% phase-down) if placed in service in 2005 and 75% (75% phase-down) if placed in service in 2006. The credit does not apply for vehicles placed in service after 2006. Under the Act, the otherwise allowable credit for a qualified electric vehicle is available in full for vehicles purchased in 2004 and 2005. In other words, the Act repeals the 25% phase-down of the credit for 2004 and the 50% phase-down for 2005.

■ **Deduction for qualified clean fuel property**

Under pre-Act law, the deduction limits were reduced by 25% (25% phase-down) for property placed in service in 2004, 50% (50% phase-down) if placed in service in 2005, 75% (75% phase-down) if placed in service in 2006 and 100%, if placed in service after 2006. Under the Act, the otherwise allowable deduction for qualified clean fuel property is available in full for 2004 and 2005. In other words, the Act repeals the 25% phasedown of the deduction for 2004 and the 50% phase-down for

2005.

■ **Indian employment tax credit**

Under pre-Act law, the employer's wage credit for employment of certain Native Americans would have expired on December 31, 2004. The Act extends the wage credit through tax years beginning before January 1, 2006.

■ **Accelerated depreciation for business property on Indian reservations**

Under pre-Act law, special depreciation recovery periods apply to qualified Indian reservation property placed in service after December 31, 1993, and before January 1, 2005. The Act extends the eligibility for the special depreciation periods to property placed in service before January 1, 2006.

■ **District of Columbia Enterprise Zone; first-time D.C. home buyer credit**

Under pre-Act law, the District of Columbia Enterprise Zone designation expired on December 31, 2003. Also, the credit for first-time homebuyers of a principal residence in D.C. expired for property purchased after December 31, 2003. The Act provides a two-year extension of (1) the D.C. Zone designation and related tax incentives; and (2) the first-time D.C. homebuyer credit.

■ **Qualified Zone Academy Bonds (QZABs)**

Under pre-Act law, a total of \$400 million of QZABs were only authorized to be issued annually through 2003. The Act authorizes \$400 million of QZABs to be issued annually in 2004 and 2005.

■ **New York Liberty Zone Bonds**

Under pre-Act law, an aggregate of \$8 billion in tax-exempt private activity bonds was authorized for the purpose of financing the construction and repair of infrastructure in New York City and had to be issued before January 1, 2005. The Act extends the authority to issue Liberty Zone bonds through December 31, 2009.

■ **Parity in application of certain limits to mental health benefits**

The Act extends through December 31, 2005, the rules prohibiting group health plans providing both medical and surgical benefits and mental health benefits from imposing aggregate lifetime or annual dollar limits on mental health benefits are not also imposed on substantially all medical and surgical benefits.

■ **Archer medical savings accounts (MSAs)**

Under pre-Act law, no new contributions could be made to Archer MSAs after 2003, except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. The Act extends Archer MSAs through 2005.

■ **Non-refundable personal credits allowed against regular and AMT tax**

liability

Under pre-Act law, for tax years beginning after 2003, the combined total of non-refundable personal credits (other than the adoption credit, the child credit and the credit for elective deferrals and IRA contributions (the saver's credit) could not be used as an offset against AMT. Under the Act, for tax years beginning in 2004 and 2005, all of the otherwise allowable non-refundable personal credits (not just the adoption credit, child tax credit and saver's credit) may reduce AMT.

■ Foreign tax credit

The total amount of the foreign tax credit a taxpayer may claim is limited based in part on the taxpayer's U.S. tax liability. For tax years beginning in 2003, an individual's U.S. tax for this purpose was determined without regard to nonrefundable personal credits. The Act adds tax years beginning in 2004 and 2005 to those years in which an individual's U.S tax liability isn't reduced by non-refundable personal credits, for purposes of computing the foreign tax credit.

■ Above-the-line educators' deduction

Under pre-Act law, the deduction was not available for tax years beginning after 2003. Under the Act, the above-the-line deduction for qualifying expenses of eligible educators is extended for tax years beginning during 2004 or 2005.

**EXTENSION OF RELIEF FROM THE AMT IN
THE 2004 WORKING FAMILIES ACT**

The Act extended the life of several popular tax breaks which had expired or were scheduled to expire at the end of 2004. The following will provide details regarding two key provisions of the new law which extend partial relief to individual taxpayers from the AMT.

■ Brief overview of the AMT

The AMT is a parallel tax system originally intended to insure all taxpayers with substantial income pay a reasonable amount of tax. To accomplish this, various deductions allowed for regular tax purposes are disallowed for AMT purposes - for example, the deduction for state, local and property taxes. Taxpayers who may be subject to the AMT must calculate their regular tax liability and their AMT liability. If AMT liability is greater, that's what they owe the Federal government. Originally enacted to make sure wealthy Americans did not escape paying taxes, the AMT has started to ensnare more middle-income taxpayers due to the fact the AMT parameters are not indexed for inflation.

■ Extension of increased AMT exemption amounts through 2005

In recent years, Congress has provided a measure of relief by raising the AMT "exemption amounts" - allowances which reduce the amount of "alternative minimum taxable income" (AMTI), reducing or eliminating AMT liability. However, these exemption amounts are phased out for taxpayers whose AMTI

exceeds specified amounts.) Under 2003 tax legislation applicable to tax years beginning in 2003 and 2004, the exemption amount was increased to \$40,250 (from \$35,750) for unmarried individuals who aren't surviving spouses; to \$58,000 (from \$49,000) for married couples filing a joint return and surviving spouses; and to \$29,000 (from \$24,500) for married individuals filing separately. However, this partial relief was set to expire for tax years beginning after 2004 and the exemption amounts were scheduled to revert to the amounts allowed under pre-2003 law.

The Act preserves the partial relief from the AMT by extending the 2003 increases in the exemption amount to 2005. Thus, for 2005, AMT exemption amounts are as follows:

- Married individuals filing jointly and surviving spouses, \$58,000, less 25% of alternative minimum taxable income (AMTI) exceeding \$150,000 (zero exemption when AMTI is \$382,000).
- Unmarried individuals, \$40,250, less 25% of AMTI exceeding \$112,500 (zero exemption when AMTI is \$273,500).
- Married individuals filing separately, \$29,000, less 25% of AMTI exceeding \$75,000 (zero exemption when AMTI is \$191,000).

■ **Non-refundable personal credits may be used to offset AMT through 2005**

Under the regular tax, the amount of nonrefundable personal credits allowed in a tax year is subject to a limitation based on tax liability. For tax years beginning in 2003, all the nonrefundable personal credits were allowed to the extent of the full amount of the individual's regular tax and AMT. Thus, individuals could use these credits to offset AMT liability as well as regular tax liability. Under pre-2004 Working Families Act law, this rule didn't apply in tax years beginning after 2003. For those years, the non-refundable personal credits (other than the adoption credit, the child tax credit and the saver's credit) could not be used as an offset against AMT. The adoption credit, child tax credit and the saver's credit were each subject to separate limitations which permitted the AMT offset.

The Act extends the rule allowing the non-refundable personal credits to the full extent of the regular tax and the AMT, so it applies for tax years beginning in 2004 and 2005. Thus, in 2004 and 2005, all of the otherwise allowable non-refundable personal credits (not just the adoption credit, child tax credit and saver's credit) may reduce AMT.

**EXTENSION OF FAMILY TAX RELIEF IN
THE 2004 WORKING FAMILIES ACT**

The Act includes a package of tax breaks aimed primarily at middle-income taxpayers. Core elements of the new law include keeping the per child tax credit at \$1,000 instead of letting it drop to \$700 in 2005, continuing an expanded 10 percent income bracket which affects virtually all taxpayers and retaining provisions to provide tax relief for married couples. Here are the

details.

■ **\$1,000 child tax credit extended**

The child credit applies to each child who is under age 17 as of the end of the year. The child must be a U.S. citizen or resident and must be claimed as the taxpayer's dependent. Not everyone qualifies. Taxpayers with income over certain threshold levels cannot claim the credit. For 2004, the credit is as much as \$1,000 a year for each eligible child. But this was scheduled to drop to \$700 in 2005. Under the new law, the \$1,000 maximum is retained through 2010.

■ **Higher 15-percent refundability rate for child credit is accelerated to beginning of 2004**

Under pre-Act law, the child tax credit was refundable to the extent of the greater of:

- 10% (15% for tax years beginning after 2004) of earned income above \$10,750 for 2004, or
- for a taxpayer with three or more qualifying children, the excess of his social security taxes for the tax year over his earned income credit for the year.

Under the Act, the 15% refundability percentage is accelerated to apply to tax years beginning after 2003. Thus, for tax years beginning in 2004, the child credit is refundable to the extent of the greater of:

- 15% of earned income above \$10,750, or
- for a taxpayer with three or more qualifying children, the excess of his social security taxes for the tax year over his earned income credit for the year.

■ **Marriage penalty relief extended**

The marriage penalty refers to tax-law oddities which force millions of two-income married couples each year to pay more in Federal income taxes together than they would owe if each spouse were single. In recent years, the law has provided a degree of relief from the marriage penalty in two ways. First, the basic standard deduction for a married couple filing a joint return has been increased so it equals twice the basic standard deduction for an unmarried individual filing a single return. Second, it increases the size of the 15-percent rate bracket for married couples filing joint returns. Under pre-Act law, however, these provisions were due to expire at the end of 2004. The Act extends both these provisions through 2010. Thus, for 2005 through 2010, the basic standard deduction for married taxpayers filing jointly will be twice the basic standard deduction of single taxpayers and the basic standard deduction for married taxpayers filing separately will be equal to the basic standard deduction of single taxpayers. Likewise, for 2005 through 2010, the endpoint of the 15% tax bracket for joint returns will be twice the endpoint of the 15% tax bracket for single returns.

■ **10-percent tax bracket extended**

Under pre-Act law for 2005, the low 10% tax bracket was to apply to the first \$6,000 of income for single filers, \$12,000 for joint filers and with no inflation adjustments. That was down from the 2004 levels of \$7,000 and \$14,000, with inflation adjustments - \$7,150 for singles, \$14,300 for married filing jointly. Under the Act, the reduction in these amounts is repealed, and the inflation adjustments are continued. Thus, for 2005 through 2010, the 10% bracket applies to:

- the first \$7,000 (as adjusted for inflation) of taxable income for single individuals and married taxpayers filing separately;
- the first \$14,000 (as adjusted for inflation) of taxable income for married joint return filers and surviving spouses, and
- the first \$10,000 of taxable income for heads of households, with all such taxable income levels indexed based on inflation increases occurring since 2002.

The new 10% bracket minimum income levels for 2005, as adjusted for inflation, are calculated to be:

- \$7,300, for single filers and married filing separate;
- \$14,600 for married filing jointly; and
- \$10,450 for heads-of-households.

UNIFORM DEFINITION OF CHILD IN THE 2004 WORKING FAMILIES ACT

Following is a major tax simplification measure in the Act which makes filing easier for just about anyone with a child. Under pre-Act law, a series of different eligibility tests for child-related benefits were a source of complexity for a significant number of taxpayers and for the Internal Revenue Service. Also, they were a source of errors for taxpayers. For more than a decade, tax experts have recommended a uniform definition of a child as a major tax simplification measure. Now, with the passage of this tax legislation, those recommendations have been acted on and, beginning in 2005, a simplified, uniform definition of child will apply to child-related tax benefits. Here are the details.

■ Pre-Act law

Under pre-Act law, five widely applicable provisions provided benefits to taxpayers with children: (1) the dependency exemption; (2) the child credit; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. Each provision had separate criteria for determining whether the taxpayer qualified for the applicable tax benefit with respect to a particular child. The separate criteria included factors such as the relationship (if any) the child had to bear to the taxpayer, the age of the child, and whether the child had to live with the taxpayer. Thus, with respect to the same child, a taxpayer had to determine

eligibility for each benefit separately, and a child who qualified a taxpayer for one provision did not automatically qualify the taxpayer for another provision.

■ **New law**

For tax years beginning after 2004, the Act establishes a uniform definition of a qualifying child for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit and head of household filing status. Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of four tests: (1) the child has the same principal place of abode as the taxpayer for more than one-half of the taxable year; (2) the child has a specified relationship to the taxpayer; (3) the child has not yet attained a specified age; and (4) the child has not provided more than half of his or her support for the year.

If a child would be a qualifying child with respect to more than one individual (e.g., a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit for the child, then the following "tie-breaking" rules apply:

- if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent;
- if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child of: (1) the parent with whom the child resides for the longest period of time, or (2) if the child resides with both parents for the same amount of time, of the parent with the highest adjusted gross income; or
- if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

The Act retains the pre-Act rule which allows a custodial parent to release the claim to a dependency exemption (and, therefore, the child credit) to a non-custodial parent. Thus, under the Act, custodial waivers which are in place and effective on the date of enactment will continue to be effective after that date if they continue to satisfy the waiver rule. In addition, the Act retains the custodial waiver rule for purposes of the dependency exemption (and, therefore, the child credit) for decrees of divorce or separate maintenance or written separation agreements which become effective after the date of enactment.

**ASSISTANCE TO MILITARY FAMILIES IN COMBAT
ZONES IN THE 2004 WORKING FAMILIES ACT**

Following are key provisions in the Act which provide assistance to low-income military families in combat zones. The important changes include (1) increasing the child credit for families by allowing them to include tax-free combat pay when calculating their refundable child credit; and (2) increasing the EIC for military families in 2004 and 2005 by giving them the

option to include combat pay when calculating the EIC. These provisions are expected to provide an additional \$199 million of assistance to military families in combat zones. Here are the details.

■ **Inclusion of combat pay in calculation of refundable child credit**

Individuals with gross income below certain levels may claim a child tax credit on their tax returns of \$1,000 for each qualifying child under age 17. The credit is generally limited by the taxpayer's tax liability. However, the credit is refundable (i.e., even if the tax is reduced to zero, any part of the credit in excess of the tax will, in effect, be refunded to the taxpayer) to the extent of 15 percent of the taxpayer's taxable earned income in excess of \$10,750 (with indexing for inflation). Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's taxable earned income in excess of \$10,750.

The Act provides that, beginning in 2004, combat pay, which is otherwise excluded from gross income, is treated as earned income which is taken into account when computing taxable income for purposes of calculating the refundable portion of the child credit. This change will enable certain armed forces members with combat pay to qualify for child tax credit refundability.

■ **Inclusion of combat pay in calculating EIC**

The EIC is a tax credit for low-income workers. For eligible individuals, the EIC is calculated as a certain percentage of the amount of the individual's earned income for the tax year that doesn't exceed the statutory earned income amount. Earned income generally includes wages, salaries, tips and other employee compensation which is allowable to include in gross income. Thus, it does not include nontaxable combat pay. This rule prevented combat pay from increasing a military family's earned income to the point that the family was phased out of the credit. It also precludes otherwise eligible individuals from claiming the credit if their only "income" is tax-free combat pay. Thus, in certain cases, it would be in the family's interest to have combat pay treated as earned income, resulting in a higher credit. In recognition of this, the Act provides that taxpayers are permitted to elect to treat combat pay, which is otherwise excluded from gross income, as earned income for purposes of the earned income credit. This election is available with respect to taxable years 2004 and 2005.

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