News from the Hill

BY JASON DICKSTEIN
AEA GENERAL COUNSEL

2004 Tax Tips

As the year draws to a close, it is a good time for United States-based members to consider taxes. Every AEA member pays them and December is often your last chance to take steps to optimize your tax situation for the year. As we will discuss in this article, though, there are also some steps that can be taken after the current year has ended to minimize your FY 2004 taxes.

This article is divided into two sections—the first reminds AEA members of steps they can take to optimize their 2004 tax situation, and the second addresses recent tax legislation and how it may affect your taxes. Before implementing any of the advice in this column, be sure to discuss your particular factual situation with your tax accountant or attorney.

Section One: Optimize Your 2004 Taxes

TIP ONE: SEPs

One great way to share profits with employees during good times is by creating a Simplified Employee Pension fund, or SEP. The advantage of a SEP is that the funds placed in the employee's SEP accounts are deductible to the company (so the company does not pay income tax on them) and they are tax deferred to the employees (so the employees do not pay income tax on them until they withdraw the funds from the retirement account. Even better, earnings in the SEPretirement accounts are generally exempt from taxes.

It is easy to create a SEP. Form 5305-SEPis available on the IRS website at www.irs.gov/pub/irs-pdf/f5305sep.pdf, and it is a simple, one page form that can be completed in a matter of minutes in order to create the SEP. In completing this form, you get to decide what the eligibility parameters will be for the SEP. The form also explains what the legal limits of SEP eligibility are.

Once the SEPform is complete, you should take it to a local bank or brokerage house that services SEPs. You may establish SEP-IRA accounts for each of your eligible employees (remember, you established the eligibility criteria yourself when you completed the SEP form). Annual maintenance is easy—most of the paperwork is performed by the financial institution that holds the plan's SEP-IRAs.

Be sure to give each employee, who is eligible to be included in the SEP, a completed copy of the Form 5305-SEP and any other documents and disclosures listed in the instructions to the Form 5305-SEP.

Unlike other forms of tax-advantaged retirement accounts, the money that goes into this account does not come from the employees'pockets—it comes directly from the employer. Barring any other agreement (like a labor agreement with a union), the employer is 100 percent in control of the amount that is placed in the SEP accounts. The employer is required to divide SEP funds proportionally to the employees'income.

One positive feature of an SEP is that you can place money into the SEP until the tax deadline for the business. This means you can wait until early 2005 to place money into the SEP accounts, and still count that deposit against your 2004 taxes.

There are limits to how much money can be placed into an SEP, but they generally far exceed the amounts that can be placed in a personal IRA. Total contributions to each employee's SEP-IRA account cannot exceed the lesser of $41,000 for 2004 (subject to cost-of-living adjustments for later years) or 25 percent of pay. But this still allows a significant portion of a repair station's profits to be put away in employee SEP accounts.

With the constant fears that social security will not last, an SEP is a great way to award employee year-end bonuses that are tax-free and will help your employees save (allowing them to spend wages that they would have otherwise earmarked for retirement savings).

If you already have some other form of retirement fund for employees, then you should seek the advice of an accountant or attorney before changing to an SEP.

TIP TWO: Don’t Forget the Increased Expensing Limits

In 2004, a small business can take up to $102,000 of otherwise depreciable equipment that it purchased in 2004 and treat it as an expense (meaning that it can be deducted in the same tax year it was purchased, and does not have to be depreciated over time).

AEA members who made capital expenditures this year should be sure to take advantage of this provision.

If you are considering buying depreciable equipment soon, and have not yet reached your 2004 expensing limit of $102,000, then you might want to accelerate your purchases to this year.

Be sure to plan to purchase before this provision runs out! It is currently scheduled to expire at the end of 2005. Legislation that had passed the House and Senate (but not yet been made law) at the time this article was written would extend the increased expensing limits for an additional two years (through the end of 2007).

TIP THREE: Bonus Depreciation

For items that exceed the expensing limit (and for repair stations that do not meet the small business definition), there is also ‘bonus depreciation,’ which permits depreciation to be accelerated significantly from the normal depreciation schedules. Bonus depreciation permits 50 percent of the value to be depreciated in the first year as a bonus, and then the remainder of the value is depreciated according to a normal schedule (so in the first year, depreciation would be 50 percent of the value plus the amount determined under normal depreciation of the remaining 50 percent of the value of the article). Accelerated depreciation means quicker cash flow associated with your equipment investments.

The bonus depreciation rule expires after December 31, 2005. Equipment must be purchased and placed into service by this date.

AEA members should also remind their customers who have been delaying purchases about the tax advantages of using the increased expensing and bonus depreciation, and accelerating purchases of avionics to meet the current deadlines associated with these tax advantages. Purchasing RVSM equipment or software, to meet the January deadline, is one example of a purchase that might be depreciable, but could be subject to the increased expensing or bonus depreciation provisions.

Don’t count on a guaranteed extension of the bonus depreciation until the votes are counted in the November elections. Hopefully, the election will be settled by the time you read this column, but as this column is being written, the candidates are neck-and-neck and running hard for the November 3 finish line. While provisions like bonus depreciation are a key feature of President Bush’s tax theory, which promotes business spending in an effort to make the economy robust, Senator Kerry has pledged to rescind provisions like these if he is elected in order to pay for health care and social security reform.

For a full discussion of increased expensing and bonus depreciation, take a look at our article on expensing and bonus depreciation on the AEA website at www.aea.net/AvionicsNews/ANArchives/NewsHillAug03.pdf.

Section Two: Tax Law Changes

In October, as Congress moved to close up business and end the 108th Congress, the President signed into law a bill that extends certain tax provisions. Many of the important provisions of that tax bill will affect AEA members and their employees on their personal taxes returns.

Tax Relief Extenders

The most important thing that the October bill does is extend certain provisions that would have otherwise expired. Most of the extenders that affect the AEA community relate to personal taxes, rather than business taxes. These three extenders are all extended through 2010, which is when a great many tax relief provisions will expire.

Marriage penalty relief has been extended. Prior to imposition of relief, the ‘marriage penalty’ was the name given to a peculiarity of the tax code under which a married couple paid more taxes under the ‘married filing jointly’ tax tables, than they would have paid if they had remained unmarried.

This peculiarity arose because the ‘married filing jointly’tax tables were originally based on a presumption of a single income family (the norm when the income tax system was devised); thus no one originally notice that the combination of two relatively equal incomes permitted two single people to pay more of their taxes at a lower incremental rate than if they got married and paid together. As the two-income family has arisen as a more common schema in American family life over the past few decades, more and more people recognized this disparity.

Rather than applying permanent solutions to the faulty underlying premises in the tax code, though, Congress was forced to remedy this problem with a temporary fix. The reason had to do with budgeting rules —temporary solutions to the tax code

Continued on following page

NEWS FROM THE HILL

Continued from page 47

can be excepted from the rules in a way that makes it impossible to filibuster the solutions. Permanent changes, though, are subject to the filibuster rules which means that a minority of the Senate can hold tax relief 'hostage' as they demand other concessions from those who deem tax relief to be important. The extension of this marriage penalty relief provision means that the tax code is balanced so that a married couple does not pay more than their fair share.

Congress has also reauthorized the expanded 10 percent income tax bracket. This subjects the first $14,000 of a family's taxable wages to a 10 percent tax rate rather than the original 15 percent tax rate. This expiring benefit was extended.

Congress has also extended the $1,000 child tax credit, which was due to expire. Unlike deductions, a credit applies equally no matter what your tax bracket (although the child tax credit does phase out and become unavailable for higher income levels). If you were in the 25 percent tax bracket last year, then a $1,000 deduction is only really worth $250 (25 percent of $1,000). A person in the 15 percent tax bracket with a $1,000 deduction really only gets a benefit worth $150. A $1,000 credit, on the other hand, is really worth $1,000, and for someone in the 15 percent tax bracket (between $14,000 and about $57,000 in family taxable income), it would be worth the equivalent of a $6,666.67 deduction! Also, if your tax credits exceed your tax liability for 2004, then you may be entitled to a refund of some of those credits (this means that you can make money from the tax system). In 2004, the formula for calculating the maximum refund of tax credits that can be paid out to any taxpayer was changed and the maximum was increased by 50 percent: up to 15 percent of the amount by which your 2004 taxable earned income exceeds $10,750 (the maximum used to be 10 percent of that value).

Finally, many AEA members are members of the reserves and have been an important part of our nation's military actions in recent years. Those who served their country in 2004 will be happy to know that Congress has made some positive changes concerning combat pay. Combat pay continues to be excluded from income for tax purposes (it is not taxable); however, sometimes a taxpayer has a reason to want to count combat pay towards certain calculations. The new law permits combat pay to be counted as income when calculating the Child Tax Credit and it also gives the taxpayer the option of counting or ignoring combat pay as income when figuring the Earned Income Tax Credit. In the case of a refund to the taxpayer of child tax credits, for example, this can mean that the taxpayer is entitled to a greater refund (remember: maximum refund of the child tax credit is based on 15 percent of your income minus $10,750). Counting combat pay as income when calculating these credits does not change the exclusion of combat pay from taxable income.

Conclusion

As this article was being written, a corporate-tax bill was quickly sailing through Congress. I hope to be able to report on the elements of that bill that will affect AEA members in next month's article.

Happy 101st Anniversary of powered flight! ❑