

 Fact Sheet

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Highlights of 2005 Tax Law Changes

FS-2006-1, January 2006

A new uniform definition of a qualifying child, special rules for car donations, higher standard mileage rates and expanded retirement savings incentives are among the changes individual taxpayers will find when they sit down to prepare their 2005 federal income tax return.

More information about the changes, summarized below, can be found on the IRS Web site (IRS.gov) and in various IRS documents, including the instructions for Form 1040 (<http://www.irs.gov/instructions/i1040gi/index.html>).

In addition, IRS fact sheet FS-2006-6 outlines the special tax relief available to taxpayers affected by last year's hurricanes.

Automatic Six-Month Tax-Filing Extension Available

Taxpayers who are unable to meet the regular tax-filing deadline can request an automatic six-month extension, without a reason or even a signature. In the past, automatic extensions for individual taxpayers were only available for four months. A tax-filing extension does not extend the tax-payment deadline. See Form 4868 and its instructions for more information.

New Rules for Donating Vehicles, Boats, and Aircraft

Beginning in 2005, the charitable contribution deduction for a vehicle donated to charity, is generally limited to the gross proceeds from its sale. This rule applies if the claimed value of the donated vehicle is more than \$500.

Form 1098-C (or other form of written acknowledgment of the donation) from the organization must be attached to the taxpayer's return. Among other things, the acknowledgment generally must include the gross proceeds of the sale, the vehicle identification number, and a statement certifying the vehicle was sold in an arm's length transaction between unrelated parties. This acknowledgment must be provided within 30 days after the date of the sale of the vehicle (or by Oct. 1, 2005, whichever is later).

The taxpayer generally can deduct the vehicle's fair market value (FMV), if:

- The organization makes significant intervening use of or materially improves the vehicle,
- The organization gave or sold the vehicle to a needy individual at a price significantly below FMV in direct furtherance of its charitable purpose of relieving the poor and distressed or underprivileged who are in need of a means of transportation, or
- The claimed deduction is \$500 or less.

For donations made after June 3, 2005, the FMV cannot exceed the private party sales price listed in a used vehicle pricing guide.

If the organization had a significant intervening use of or materially improved the vehicle, the acknowledgment must include a certification of the intended use of or material improvement to the vehicle and the intended duration of that use and a certification that the vehicle will not be transferred in exchange for money, other property, or services before completion of that use or improvement. The acknowledgment must be provided within 30 days after the date of the contribution (or by Oct. 1, 2005, whichever is later).

If the organization gave or sold the vehicle to a needy individual at a price significantly below FMV, the acknowledgment must include a certification that the donee organization will sell or transfer the qualified vehicle to a needy individual at a price significantly below fair market value and that the sale (or transfer) will be in direct furtherance of the donee organization's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation. The acknowledgment must be provided within 30 days after the date of the contribution (or by Oct. 1, 2005, whichever is later).

These rules do not apply to donations of inventory.

Income-Based Limits Lifted for Cash Donations Made in Late 2005

Most cash contributions made to charity after Aug. 27, 2005 and before Jan. 1, 2006 are exempt from the income-based limits that normally apply. Thus, individual taxpayers who make large contributions during this period may be able to deduct them up to 100% of their adjusted gross income (AGI), instead of 50% of AGI — the limit that usually applies. Also, the phase-out of the charitable contribution deduction that affects higher-income taxpayers is suspended for cash donations made during this period.

Contribution Limits Raised for IRAs and other Retirement Plans

For 2005, the contribution limit for Roth and traditional IRAs rose to \$4,000 or \$4,500 for those age 50 or over. In 2004, the comparable limits were \$3,000 and \$3,500, respectively.

The \$10,000 phase-out range for IRA deductions for those covered by a retirement plan begins at income of \$50,000 (\$70,000 if married filing jointly or a qualifying widow(er)). It still begins at \$0 for a married person filing a separate return. Use the worksheet in the tax package to figure the IRA deduction

(<http://www.irs.gov/instructions/i1040gi/ar02.html#d0e6119>).

The elective deferral (contribution) limit for employees who participate in 401(k), 403(b) and most 457 plans rose to \$14,000 (\$17,000 for 403(b) plan participants for whom the 15-year rule applies). For SIMPLE plans, the limit rose to \$10,000. The catch-up contribution limit for persons age 50 or older rose to \$4,000 for 401(k), 403(b) and 457 plans and to \$2,000 for SIMPLE plans.

Standard Mileage Rates Increased

In 2005, for the first time ever, the IRS adjusted the standard mileage rate during the year to reflect increases in the price of gasoline. From Jan. 1 to Aug. 31, the standard mileage rate for business use of a car, van, pick-up or panel truck was 40.5 cents a mile, compared to 37.5 cents a mile in 2004. Effective Sept. 1, the rate increased to 48.5 cents a mile.

From Jan. 1 to Aug. 31, the standard mileage rate for the cost of operating a vehicle for medical reasons or as part of a deductible move was 15 cents a mile, up from 14 cents in 2004. On Sept. 1, the rate rose to 22 cents. The rate for providing services to charitable organizations is set by law and remains at 14 cents a mile.

New Deduction for Domestic Production

A new deduction of up to 3 percent of qualified production activities income derived from domestic production can be claimed on Line 35, Form 1040. Use Form 8903 to figure the deduction.

Uniform Definition of a Qualifying Child

Beginning in 2005, a new definition of a qualifying child ordinarily applies for the dependency exemption, head of household filing status, earned income tax credit (EITC), child tax credit and credit for child and dependent care expenses. Relationship, residency, age and support tests are used to determine if someone is a qualifying child. In general, all four tests must be met. However, the support test does not apply to the EITC.

Under the relationship test, a child must be the taxpayer's child (including an adopted child, stepchild or foster child), brother, sister, stepbrother, stepsister or a descendent of one of these relatives. An adopted child includes one lawfully placed with the taxpayer for legal adoption, even if the adoption is not final. A foster child is one placed with the taxpayer by an authorized placement agency or by court order.

Under the residency test, a child must live with the taxpayer for more than half of the year. Temporary absences for special circumstances (such as for school, vacation, medical care, military service, or detention in a juvenile facility) count as time lived at home.

Under the age test, a child must be under a certain age, which varies with the tax benefit. For the dependency exemption, head of household and EITC, the child must be under 19, under 24 if a student (enrolled full time during any part of five calendar months), or any age if permanently and totally disabled. For the child tax credit, a child must be under 17. For

the credit for child and dependent care expenses, a child must be under 13 or any age if permanently and totally disabled.

Under the support test, a child cannot have provided over half of his or her own support.

A child who meets the tests to be a qualifying child of more than one person can be claimed by only one person (unless the exception for divorced or separated parents applies). If more than one person claims the same qualifying child, the IRS will use the tie-breaker rule to determine who gets the tax benefit.

If only one of the persons is a child's parent, the parent gets the benefit. If both are parents, it goes to the parent with whom a child lived longer. If a child lived with each parent for the same amount of time, the parent with the higher AGI gets the benefit. If no parents are involved, the person with the highest AGI gets the tax benefit.

Inflation Adjustments for 2005

Personal exemptions and standard deductions rose, tax brackets were widened and more than three dozen individual and business tax provisions were adjusted to keep pace with inflation. A complete rundown of these changes can be found under "Inflation-Adjusted Tax Items for Tax Year 2005," on the IRS Web site at <http://www.irs.gov/newsroom/article/0,,id=118033,00.html>. Popular items adjusted include the following:

- The value of each personal and dependency exemption is \$3,200, up \$100 from 2004. Most taxpayers can take personal exemptions for themselves and an additional exemption for each eligible dependent. An individual who qualifies as someone else's dependent cannot claim a personal exemption, and personal and dependency exemptions are phased out for higher-income taxpayers.
- The standard deduction is \$10,000 for married couples filing a joint return and qualifying widow(er)s (a \$300 increase over 2004), \$5,000 for singles and married individuals filing separate returns (up \$150) and \$7,300 for heads of household (up \$150). Higher amounts apply to blind people and senior citizens. The standard deduction is often reduced for a taxpayer who qualifies as someone else's dependent. Nearly two out of three taxpayers take the standard deduction, rather than itemizing deductions, such as mortgage interest, charitable contributions, and state and local taxes.
- The maximum earned income tax credit is \$4,400 for taxpayers with two or more qualifying children, \$2,662 for those with one child and \$399 for people with no children. Available to low and moderate income workers and working families, the EITC helps taxpayers whose incomes are below certain income thresholds, which in 2005, rose to \$37,263 for those with two or more children, \$33,030 for people with one child and \$13,750 for those with no children. One in six taxpayers claim the EITC, which unlike most tax breaks,

is refundable, meaning that people can get it, even if they owe no tax and even if no tax is taken out of their paychecks.