GALUSHA HIGGINS & GALUSHA

THE GALUSHA REPORT

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– *THIS EDITION* –

Working Families Tax Relief Act of 2004 1

Confusing Overtime Wage Rules 2

How to Close a Successful 1031 Real Estate Exchange. 2

Higher-Income Individuals. 3

Alternative Minimum Tax (AMT). 4

A Charitable Gift Annuity. . 5

New Rules Provide Flexibility for Section 179 Deductions 5

Bonus First-Year Depreciation Will End December 31, 2004 6

Retirement Plan Annual Limits 7

Montana Exemptions and Deductions Change 8

Our Offices 8

THE GALUSHA REPORT presents information on tax and business matters of general interest. Since the information is presented in summary form, we urge you to consult your tax or business advisor before taking action.

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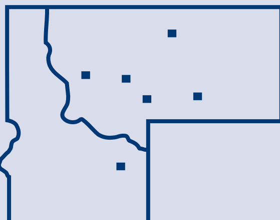

Working Families Tax Relief Act of 2004

On October 4, 2004, President Bush signed into law the Working Families Tax Relief Act of 2004. The Act includes an important simplification measure that the AICPA has been working to implement since the late-1990s — a uniform definition of a child. The new, uniform definition applies for the purposes of (1) the dependency exemption; (2) the child credit; (3) the earned income tax credit (EITC); (4) the dependent care credit; and (5) head-of-household filing status.

Extensions/Expansions of Popular Tax Benefits:

Extends Marriage Penalty Relief, Child Tax Credit Through 2010

- Marriage penalty relief is extended until 2010.
- The expanded 10% income tax bracket is extended until 2010.
- The $1,000 child tax credit is extended for one year (through 2005).

Assistance to Military Families

- Increases the child credit for military families by allowing them to include tax-free combat pay when calculating their refundable child credit.
- Increases the EITC for military families in 2004 and 2005 by giving them the option to include combat pay when calculating the EITC.

Extends AMT Relief Through 2005

- The $58,000 alternate minimum tax (AMT) exemption amount for married couples is extended for one year (through 2005).
- The $40,250 AMT exemption amount for single individuals is extended for one year (through 2005).
- It also extends expiring individual and business provisions through 2005.

Disclosure Changes

Congress has also extended and broadened the disclosure authority relating to terrorist activities by allowing an individual's name, mailing address and social security number to be disclosed to enforcement agencies. The bill also extends provisions allowing the disclosure of tax return information for student loan repayment administration.

See your tax accounting professional at Galusha, Higgins & Galusha, PC for a discussion of provisions that may be applicable to you.

Source: AICPA E-Alert 2004

Confusing OVERTIME WAGE *Rules*

On August 23, 2004, the U.S. Department of Labor began applying a new set of regulations that affect both workers and employers. The Fair Labor Standards Act (FLSA), which was first enacted in 1938, includes minimum wage, overtime pay and child labor protections for workers in the United States. The new rules, referred to as the 541 or Fair Pay regulations, deal with overtime wage payments.

The FLSA requires that covered employees in the United States be paid at least the federal minimum wage for each hour they work and overtime pay at one and one-half times the employee's regular rate of pay for all hours over 40 in a workweek. Exemptions apply to a variety of occupations and positions, including executive, administrative and professional employees.

All employees working in Montana and Idaho are covered by the Wage & Hour Laws enforced by the State's Department of Labor. The majority of workers are also protected by FLSA regulations as directed by the U.S. Department of Labor. Here is the tricky part: employers subject to both the federal and state rules must apply the stricter of the two laws to their wage payments.

Generally, under the new federal law, a salaried worker must receive at least $23,660 per year in order to meet any exemption from overtime pay. Often, state laws have a lower minimum salary level and may continue to have other requirements for overtime exemption that typically contain higher standards than the federal rules.

There are plans by Congress to amend or remove the new Fair Pay rules. However, the Bush administration supports the new standards. Meanwhile, individual states will look to their state legislature for recommendations on this issue.

Information is available from both the state and federal Departments of Labor. Visit the Montana Department of Labor/Labor Standards (Wage and Hour) Web page at *www.mtwagehourbopa.com*, or call 406-444-5600. You'll find the Idaho Department of Commerce and Labor at *www.cl.idaho.gov/portal*. View federal regulations at the U.S. Department of Labor Web site at *www.dol.gov/esa/whd* or call 1-866-4USWAGE.

Heidi Yakawich, Accountant — Helena office

How to Close a Successful 1031 Real Estate Exchange Without Getting the Boot

Real estate exchanges under Section 1031 have been a popular tax-deferral vehicle in recent years. There are many reasons for using this technique, including the ability to avoid recognizing capital gains while having the means to acquire more attractive real estate.

In a nutshell, a Section 1031 exchange allows a taxpayer to dispose of real estate and acquire other real estate of similar or greater value without recognizing capital gain on the sale of the first property, as long as certain specific rules are met. These rules include time limits for the identification of and subsequent acquisition of the replacement property, as well as rules regarding the receipt and disbursement of the sale proceeds of the property being sold. The real estate must be income producing or held for investment, not used personally.

A Section 1031 exchange is only effective if the taxpayer has a gain on the property he is selling. If selling property at a loss, Section 1031 prevents the recognition of the loss. This article will only discuss gain transactions and how to avoid the problem of "boot."

The term "boot" arises when one of two people exchanging like-kind properties is giving up property of greater value. This person receives the property of lesser value plus some cash or other non-like-kind property "to boot." Thus, the term "boot" has become recognized as the legal term for the extra items received in an exchange of properties. It even appears in the Internal Revenue Code.

Most exchange transactions do not occur simultaneously between the same two property owners. Often, three people are involved in a 1031 exchange: the seller desiring an exchange, the purchaser of the property to be exchanged, and the seller of the replacement property. In this situation, a qualified intermediary is hired to act as the agent for the first seller. The intermediary has the responsibility of facilitating the closings for the seller, receiving and holding the sale proceeds, and disbursing the proceeds to acquire replacement property. Therefore, the intermediary is largely responsible for making sure the paperwork for the exchange is properly worded to avoid the problems caused by boot. The intermediary must make sure that he receives and disburses all cash

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involved in an exchange according to the agreements so that no unintended boot is created.

If the taxpayer/seller receives any of the sale proceeds during the time that the exchange transactions are being handled, he may trigger a taxable gain. This may also cause the 1031 exchange to fail. Any cash received by the taxpayer/seller in an exchange transaction is called boot. The taxable gain is the lesser of the amount of cash received (boot) or the actual realized gain on the property.

The taxpayer/seller may only want to exchange part of the sales proceeds for new property. If so, he will receive boot in the amount of the difference in values, after closing costs. In order for the gain on the transaction to be properly recognized as a partial exchange, the 1031 exchange documents should be properly modified to allow the seller to receive these proceeds, otherwise it would appear that the seller had an unrestricted right to receive any of the sale proceeds. This would invalidate the exchange.

If the amount of boot that the taxpayer receives is greater than the actual gain on the sale, it may not be necessary to use a 1031 exchange. There would be no tax benefit from an exchange over a regular sale, because all of the gain would be taxable anyway. The seller could save on the additional costs to prepare the exchange paperwork. He would also not be required to meet the time requirements for identifying and purchasing replacement property. Therefore, before pursuing a 1031 exchange, you should consult with your tax advisor to see if it is appropriate.

The funds received from the sale of the first property will be net of closing costs. Since closing costs, such as commissions, fees, and title insurance, are "true disposition expenses," the fact that these expenses are paid for on behalf of the seller out of the sale proceeds does not create boot.

Often, there will be other receipts and payments handled on behalf of the seller at closing which do create boot. These include, but are not limited to, prorated property taxes, utilities, rents, security deposits and accrued interest. In order for these items not to create the problem of boot for the seller, they may be handled in a special way.

If these items are expenses, such as taxes, utilities or interest which the seller is entitled to deduct, he should arrange to pay them outside of the closing or reimburse the intermediary for them. If the items are income, such as rents or rent deposits, he should arrange to collect them outside of the closing. Another way to handle these items is to modify the 1031 agreement to allow the seller to receive a part of the proceeds equal to those amounts. That way, they can be paid without creating boot.

Another situation that creates boot involves debt. Boot is created if the seller somehow ends up with less debt after the exchange than he had prior to the exchange. The difference in the debt is mortgage boot, similar to receiving that equivalent amount in cash. You should review all aspects of the exchange transaction with your tax advisor — including any mortgages on the properties being exchanged — to determine if mortgage boot exists and how you might avoid it.

Boot can also occur with the acquisition of the replacement property. Expenses directly associated with the acquisition of property can be paid from the sale proceeds. Other expenses not considered to be true acquisition expenses should not be paid from the sale proceeds, otherwise they are considered to be boot. Examples of these expenses include loan application fees, mortgage insurance and any fees required to receive a loan. This type of boot could invalidate the exchange.

Finally, if the seller of the replacement property offers the 1031 purchaser credits on the closing statement that cause the 1031 purchaser to receive cash at closing, this creates boot. This boot may be construed to be excess cash from the 1031 exchange, which would invalidate the exchange. To avoid this, the credit amounts should be handled outside of the closing between the seller of the replacement property and the 1031 purchaser.

Some of the problems with boot may only be determined if the tax return in which the seller reports a 1031 exchange is examined by the IRS. However, if the IRS determines that boot exists, the examiner can nullify the exchange and cause the seller to recognize capital gain. So it is important in all 1031 exchanges that the agreements are properly worded and that the intermediary handle his responsibilities according to those agreements.

If you are considering entering into a 1031 exchange, be sure to consult with your tax advisor. Have your advisor review the drafts of your 1031 documents and closing statements. With careful planning, your exchange won't be booted into a taxable sale.

Margaret L. Woo, CPA — Helena office

Higher-Income Individuals: *Deductions and Exemptions*

Phase-out of federal itemized deductions

Higher-income individuals should be aware that their federal itemized deductions and personal exemptions may phase out if their adjusted gross income (AGI) exceeds a certain amount. Each year, the "threshold" amount for itemized deductions is adjusted for inflation. In 2004, the threshold amount is $142,700 for single taxpayers, married taxpayers filing jointly, and head of household; and $71,350 for married taxpayers filing separately. After tax year 2005, the phase-out of itemized deductions will be eliminated over a five-year period, providing tax laws do not change.

AGI is gross income less "above-the-line" deductions. Examples of gross income include salaries, wages, interest, dividends, business income, and capital gains. Common examples of "above-the-line" deductions include business deductions (including depreciation), losses from sale or exchange of property, rent and royalty deductions, contributions to retirement plans, alimony, moving expenses, cash contributions to medical and health savings accounts, and interest on education loans.

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Not all of the itemized deductions are subject to the phase-out rules. Medical expenses, investment interest expenses, casualty or theft losses, and allowable wagering losses are itemized deductions that are not applicable to phase-out.

Phase-out of federal personal exemptions

Individual taxpayers, as a general rule, are allowed to claim a personal exemption for themselves, and their spouse, if filing a joint return. Providing certain tests are met, taxpayers may also claim exemptions for qualifying dependents. High-income taxpayers are subject to phase-out of personal exemptions if AGI exceeds certain amounts. See the table below for inflation-adjusted 2004 threshold amounts.

Filing Status	Amount of AGI
Married filing joint and surviving spouse	$214,050
Head of household	$178,350
Single *(not surviving spouse or head of household)*	$142,700
Married filing separate	$107,025

For individuals with substantial income who have dependents with taxable income, it may be beneficial for the dependent to claim his own exemption. After tax year 2005, the personal exemption phase-out will be eliminated over a five-year period. High-income taxpayers will no longer be subject to personal exemption phase-out beginning in tax year 2010, providing tax laws do not change.

To take full advantage of your itemized deductions and personal exemptions, AGI needs to be reduced below the thresholds described above. This means utilizing any "above-the-line" deductions for which you qualify. Contributions by employees to 401(k) plans, qualified cafeteria plans, and IRAs reduce AGI. Contact your GH&G tax advisor for more information and planning strategies concerning "above-the-line" deductions and itemized deductions.

Chrisy Irey, Accountant — Helena office

After tax year 2005, the phase-out of itemized deductions will be eliminated over a five-year period, providing tax laws do not change.

Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) is an extra tax some people have to pay on top of the regular income tax. The original idea behind this tax was to prevent people with very high incomes from using special tax benefits to pay little or no tax. But for a variety of reasons, the AMT reaches more people each year, including some people who don't have very high incomes and some people who don't have a lot of special tax benefits. Some things that can contribute to AMT liability are ordinary items that appear on many tax returns, such as a deduction for state income tax, interest on a second mortgage, or even your personal and dependency exemptions.

The AMT provides an alternative set of rules for calculating your income tax. In theory, these rules determine the minimum amount of tax that someone with your income should be required to pay. If you're already paying at least that much because of the "regular" income tax, you don't have to pay AMT. But if your regular tax falls below this minimum, you have to make up the difference by paying AMT.

The U.S. Treasury estimates that more than three million taxpayers will have AMT liability this year. This compares to 600,000 taxpayers who were subject to the AMT just seven years ago. This increase was due in large part to the 2003 Tax Act's acceleration of the 2001 Tax Act. The subsequent individual income-tax-rate changes resulted in less regular tax for many taxpayers. Changes included the addition of 10% and 25% tax brackets, as well as the elimination of the Marriage Tax Penalty (the doubling of the single taxpayer's tax-rate ranges for married taxpayers). The AMT rates of 26% and 28% were not adjusted, thus AMT tax became higher for many taxpayers than regular tax. The number affected by AMT is projected by the U.S. Treasury to reach 16 million by 2005 if changes made by the 2003 Tax Act are allowed to expire. According to some experts, the government's current financial position does not bode well for a reprieve from AMT in the foreseeable future.

The U.S. Treasury estimates that more than three million taxpayers will have AMT liability this year.

If you think AMT may affect you, please contact your GH&G tax advisor before December 31, 2004.

Justin Mosness, CPA, CVA — Helena office

A Charitable Gift Annuity: Giving and Receiving

Clients of mine, a husband and wife, recently experienced a significant taxable event when they sold some rental units that were close to being fully depreciated. To state the obvious, they were facing some sizable taxable gains.

During my visit with them about how to manage the tax bite from the sale, I learned they had been supporting a favorite charity for years. They thought now might be the time to make a major gift to the charity, but also indicated the potential need for income during their retirement years. The question we began to wrestle with was how to save taxes, increase retirement income, and make a generous gift to charity.

At first, it seemed like a contradiction ... getting income by giving something away.

When I pointed out that giving plans exist that generate big tax deductions *now* (when they needed them the most) and can pay an income for their retirement years, they became more than just interested. They established a $200,000 charitable annuity with their favorite charity.

Most people don't realize that they can give to charity while also generating significant tax benefits and retaining the earning power of the gifted asset. The general rule in charitable giving is that if you keep or receive any benefit from the asset you give to charity, you will be denied any income tax benefits. Simply stated, the "partial interest rules" say that you can't have your cake and eat it, too.

Fortunately, there are exceptions. The government (both federal and state) encourages charitable giving by allowing philanthropic people to make a gift, keep the income, and receive large tax benefits now. Various charitable split interest trusts, charitable gift annuities and life estates are among the techniques that accomplish such objectives. These are often referred to as Planned Gifts.

In Montana, the law is especially rewarding in that a tax credit, not just a deduction, is allowed if a Planned Gift is made and the stipulation in the Planned Gift vehicle creates a permanent endowment. The credit can be as high as $10,000 per taxpayer.

To illustrate, consider what my clients did. They funded a joint and survivor charitable gift annuity with their charity of choice in the amount of $200,000. At ages 64 each, they are entitled to $11,200 per year for as long as either spouse lives, with over one-half of the income tax-free on the state and federal levels. Additionally, they generated a federal tax deduction in the amount of $50,574 and a Montana income tax credit in the amount of $20,000.

As you can guess, the savings went a long way toward offsetting taxes that would have otherwise been paid on the sale of the rental units. And, they established a permanent endowment at their favorite charity.

During these times of low interest rates and stock market volatility, a Planned Gift with a fixed, guaranteed rate of income is an economically worthy consideration. Just make sure that the charity has the financial stability to fulfill its part of the contract. A charitable gift annuity is not insurance (like annuities issued by commercial insurance companies). The last legislative session passed a bill requiring charities to possess certain financial minimums before they are qualified to offer charitable gift annuities to their constituents.

It is also important to understand that the distributions from a charitable gift annuity cease, in the case of a joint annuity, at the time of the second death.

If you 1) have donative intent, 2) want meaningful tax deductions — and credits — now, and 3) want an ongoing income stream starting now or in the future, you may want to talk to your Galusha representative and the charity of your choice on how to structure a charitable gift annuity. These annuities offer an ideal way to help yourself and others too.

Hugh A. McWhorter, CPA — Helena office

New Rules Provide *Flexibility* for Section 179 Deductions

Past tax laws increased the amount of Code Section 179 (Sec. 179) expense allowable in tax years beginning in 2003, 2004 and 2005. The 2004 inflation-adjusted maximum amount that may be expensed is $102,000, and is reduced for each dollar of investment in qualifying Sec. 179 purchases in excess of $410,000. The deduction is completely phased out at $512,000 for 2004. The maximum Sec. 179 expense will revert to $25,000 (and $200,000 investment limit) for tax years beginning in 2006, if current tax laws are not changed.

In general, Sec. 179 is the amount a taxpayer can elect to currently expense certain qualifying personal property, such as machinery, equipment, computers, furniture, single-purpose agricultural or horticultural structures, and certain qualifying livestock. The property must be placed in service (ready and available for a specific use) by the taxpayer's year-end to qualify for that year. Land, land improvements, buildings and structural components generally do not qualify. There are also specific limitation rules for vehicles. Sec. 179 is not permitted if the business use is 50% or less. The Sec. 179 election also cannot exceed the taxable income from the business. Unlike the bonus depreciation, new or used property qualifies for the election. This current expense is in lieu of depreciating the expensed amount over its life.

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The IRS has recently issued temporary and proposed regulations, which provide greater flexibility for small businesses to elect or revoke all or part of the Sec. 179 election for the tax years beginning in 2003, 2004 or 2005. In the past, the election could be made by a taxpayer on his original tax return, or made or revoked in a very limited timeframe. Otherwise, the change could only be made with the IRS consent. A taxpayer should now be able to make or revoke the election for the above-mentioned years on an amended return, as long as the statute of limitations has not expired. Once the taxpayer revokes the election, it may not be changed later for the part revoked. An election can be made to increase the Sec. 179 election, if the specific amount of the asset was not previously revoked. The following is an example provided by the IRS.

Example 1: Taxpayer, a sole proprietor, owns and operates a jewelry store. During 2003, taxpayer purchased and placed in service two items of Sec. 179 property — a cash register costing $4,000 (5-year MACRS property) and office furniture costing $10,000 (7-year MACRS property). On his 2003 federal tax return filed on April 15, 2004, taxpayer elected to expense the full cost of the cash register under Sec. 179 and, with respect to the office furniture, claimed the depreciation allowable. In November 2004, taxpayer determines it would have been more advantageous to make an election under Sec. 179 to expense the full cost of the office furniture rather than the cash register. Pursuant to paragraph (c)(1) of this section, taxpayer is permitted to file an amended federal tax return for 2003 revoking the Sec. 179 election for the cash register, claiming the depreciation allowable in 2003 for the cash register, and making an election to expense the cost of the office furniture under Sec. 179. The amended return must include an adjustment for the depreciation previously claimed in 2003 for the office furniture, an adjustment for the depreciation allowable in 2003 for the cash register, and any other related adjustments to taxable income or to the tax liability. In addition, once taxpayer revokes the Sec. 179 election for the entire cost basis of the cash register, taxpayer can no longer expense under Sec. 179 any portion of the cost of the cash register.

Confusing? Yes, indeed. However, these regulations provide many options in utilizing the Sec. 179 expense. Small business owners will have additional time to ensure the election is to their advantage. The taxpayer may not have been aware of the advantages or disadvantages of the election at the time they filed their original return. Perhaps the taxpayer wasn't even aware of the election, and they may be able to file an amended return and claim the expense. On the other hand, the taxpayer may have made the election and unknowingly limited their exemptions or deductions, reduced their coverage under the Social Security system or, made various tax credits unusable. The taxpayer may also find that having depreciation deductions in future years is more beneficial than the Sec.179 deduction claimed in a prior year.

Contact your tax professional at Galusha Higgins & Galusha, PC for further information to determine whether this election or other factors will benefit your individual tax situation.

Ralene Glenn, CPA — Helena office

Bonus First-Year Depreciation
Will End December 31, 2004

Are you planning a major improvement or fixed asset purchase in the next couple of years? If so, make sure you consider the possible tax benefits of doing so before the end of this calendar year.

By making a major improvement or fixed asset purchase this year, you can take advantage of a first-year depreciation allowance. In addition to the Section 179 deductions, taxpayers are entitled to a first-year depreciation allowance equal to 50% of the depreciable basis of property.

For example, if a taxpayer purchases office furniture for $400,000 for her business, the following illustrates how first-year bonus depreciation works. The taxpayer first takes 50% of $400,000, or $200,000. The $200,000 first-year depreciation is then subtracted from the $400,000 original cost basis, leaving an adjusted basis of $200,000. The general first-year depreciation rate is then applied to the $200,000, yielding a further reduction of $28,580. The result is a total first-year depreciation deduction of $228,580, or $171,420 more than under the general rule.

You must also be the first person to use the property. Eligible property for bonus depreciation includes:

- Most depreciable property with a recovery period of 20 years or less, computer software that is depreciated over three years, and qualified leasehold improvement property; and
- Property that has been purchased between May 6, 2003, and December 31, 2004, and placed in service before January 1, 2005.

The bonus depreciation allowance is allowed without proration based on the length of the year in which the property is placed in service. For example, property placed in service on December 31, 2004, is eligible for the entire 50% bonus depreciation.

Unlike the Section 179 deduction, there is no business-taxable income limit. Therefore, you can claim this deduction even if your business shows a loss. This loss can either be carried back to previous years in order to create a refund or carried forward to future years with income.

Bonus depreciation offers an opportunity for you to accelerate tax depreciation and reduce your current tax liability. But if you want to take advantage of this incentive, you'll have to do it this year. Please contact your GH&G tax advisor for more information and other planning ideas.

Ashlee Benson, Accountant — Helena office

Retirement Plan Annual Limits

The following is a summary of the individual limits applicable to various retirement plans in 2004 and 2005.

	2004	2005
Qualified Plan Compensation*	$205,000	$205,000
401(k), 403(b) and SARSEP plans maximum employee deferral	$13,000	$14,000
457 plan maximum employee deferral	$13,000	$14,000
SIMPLE plan maximum employee deferral	$9,000	$10,000
Over 50 years of age catch-up contribution for 401(k), 403(b), SARSEP, and 457 plans	$3,000	$4,000
Over 50 years of age catch-up contribution for SIMPLE plans	$1,500	$2,000
Defined Benefit plan maximum annual contributions*	$165,000	$165,000
Defined Contribution plan maximum annual contributions*	$41,000	$41,000

**The figures for 2005 are projected amounts and are subject to change.*

Ryan Kettel, CPA — Helena office

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Montana Exemptions and Deductions Change AFTER 2004

Montana individual income tax relief, as provided by Montana law, is applicable to tax years beginning after 2004.

Current legislation cuts personal income tax rates. Previously, the personal income tax rates were arranged in 10 brackets, ranging from the first $1,000 of taxable income being taxed at 2% to taxable income over $35,000 being taxed at 11%. The new rates are in seven brackets as follows:

- **the first $2,300 of taxable income is taxed at 1%;**
- **the next $1,800 at 2%;**
- **the next $2,100 at 3%;**
- **the next $2,200 at 4%;**
- **the next $2,400 at 5%;**
- **the next $3,100 at 6%; and**
- **any taxable income over $13,900 at 6.9%.**

Personal income tax exemptions have been increased by $1,100, and the personal income tax deductions for federal income taxes paid now are capped at $5,000 per individual or $10,000 per married couple.

The legislation raises the minimum personal income tax standard deduction for a single taxpayer from $665 to $1,580, and the maximum standard deduction is increased from $1,500 to $3,560. Taxpayers filing joint returns and taxpayers filing as heads of households on their federal income tax returns receive a minimum standard deduction that is twice the amount of the minimum standard deduction for a single return, or 20% of adjusted gross income, whichever is greater, to a maximum standard deduction of twice the amount of the maximum standard deduction for a single return. The previous standard for these taxpayers was a $1,330 minimum standard deduction and a $3,000 maximum standard deduction.

Montana Capital Gains Credits

The legislation also offers an income tax credit in the amount of 1% of a taxpayer's net capital gains for tax years 2005 and 2006 and 2% of the taxpayer's net capital gains for tax years beginning after 2006.

Justin Mosness, CPA, CVA — Helena office

Visit the GH& G Web site at *www.ghg-cpa.com* to learn more about our services and the industries we serve. Online links provide easy access to "RSM McGladrey Advantage," an industry-leading newsletter targeted for the executive leadership of mid-sized companies. You'll also find links to "Fundamentals," a quarterly publication keeping not-for-profit and governmental entities abreast of the latest industry news and information, and many other newsletters of interest.

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