

Tax Letter

March 2006, Vol 6 - Federal v California

Dear clients and friends:

Since 2001, the Internal Revenue Code was primarily or secondarily impacted, affected (or infected) by no less than ten major legislation. To name a few, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the Job Creation and Worker Assistance Act of 2002, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, the Working Families Tax Relief Act (WFTRA) of 2004, the American Jobs Creation Act (AJCA) of 2004, the Energy Tax Incentive Act of 2005, the Katrina Emergency Tax Relief Acts (KETRA) of 2005, and the Golf Zone Opportunity Act (GO Zone) of 2005. The provisions directly or indirectly affecting our pockets had been discussed, analyzed, and reported by all sorts of media through out the land, including this monthly Tax Letter.

However, the California Legislature did not think so. Based on the combined wisdom of the California Legislators, they chose to conform to some and not conform to the others. To provide a complete analysis of the Conformities and Non Conformities by the State of California will take an in depth and lengthy exposition. In order to service our clients and friend, with our limited resources, Cho F. Chan, CPA, Inc. would like to present a limited version.

"A" KEY CONFORMITIES

- (1) Uniform definition of a child: California fully conforms to Federal WFTRA-04 definition of and tests for a Qualifying Child. This is important not only for the claiming of an exemption, but for the filing status as a Head of Household.
- (2) Luxury auto rules: With minor differences, California conforms to the Federal \$14,700 cost division. Any auto costing more than \$14,700 in 2005 is a Luxury auto. This amount may be adjusted annually by the IRS.
- (3) Heavy SUV definition and limitation: California conforms to the Federal definition and exclusion of any vehicle weighing in excess of 6,000 pounds from Luxury auto category. Any passenger auto weighing more than 6,000 pound and less than 14,000 pounds may be in the Heavy SUV category. In this category the IRC Section 179 first year expensing amount, if 100% for business use, will be limited to \$25,000.
- (4) Vehicles weighting more than 14,000 pounds: California conforms with Federal for not requiring these vehicles to observe the first year depreciation limitation.
- (5) Start-up costs expensing rule: California conforms to Federal AJCA-04 provision that allows an election to expense up to \$5,000 of start-up costs and \$5,000 of organizational expenses. Caution: for Federal this applies to amounts paid or incurred on or after 10/23/2004, for California it is effective on January 1, 2005.

- (6) Non business bad debt: California conforms to the Federal requirement to establish a bad debt, and the treatment of a non business bad debt as short term capital loss.

"B" KEY NON CONFORMITIES

- (1) MSA v HSA: California does not conform to the Federal Health Saving Account (HSA). Taxpayer who missed the 12/31/2005 deadline to set up Medical Saving Account (MSA), and set up HSA in 2006 will receive no tax relief in California. Although Federal regulations allow tax free roll-over of funds from the old MSA to the new HSA. California will tax the roll over amount plus 10% penalty.
- (2) IRC Section 179 first year expensing rule : Up to and including 2007, Federal rules allow a maximum \$100,000 write-off for qualified properties. California allows only a maximum \$25,000. However, California allows, but not the Federal, an additional first year write-off up to \$2,000 for C corporations . (R&TC 24356).
- (3) Student loan interest: California does not conform to Federal rules for student loan interest. For California, up to and including 2006, taxpayer must use the old rules which limit the deduction to interest paid in the first 60 months from the beginning of student loan repayment date. If your student loan repayment began on or before 1/1/2000, for California, no student loan interest will be allowed for 2005 and 2006.
- (4) Educational expenses : California does not conform to the Federal tuition expenses deduction against Adjusted Gross Income (AGI), and neither the HOPE education credits nor the Lifetime Learning credits are allowed. Further, California does not allow a Federal deduction of \$250 for non reimbursed educator's expenses in the classroom.
- (5) Domestic production activity deduction: California does not conform to the IRC Section 199 deduction allowed for production activities within the United States. This section was added to the Internal Revenue Code by the American Jobs Creation Act (AJCA) of 2004.
- (6) Katrina, Rita and Wilma : All Federal legislations passed since August 2005 for the victims and/or redevelopment of the Gulf Coast areas, with limited exceptions, will not be applicable in California.
- (7) Energy conservation: All incentives provided by the Federal Energy Tax Incentive Act of 2005 are not applicable in California. California had its own solar energy tax credits which expired on 12/31/2005.

If you need any further information please give us a call at **415-381-0681**, or visit our web site at **www.chochan.com**.

Sincerely,

Cho F. Chan, CPA, Inc.