

TAX & BUSINESS STRATEGIES

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Tax Law Tweaks That May Help

The recently enacted "Working Families Tax Relief Act of 2004" and "American Jobs Creation Act of 2004" introduced a variety of tax benefits for individuals and businesses. Some of the benefits and significant changes have been outlined below.

Tax rate relief extension – The \$1,000 child tax credit, the full elimination of the "marriage penalty" in the standard deduction and the 15% tax bracket, and the full increase in the size of the 10% tax bracket have all been extended through 2010.

Manufacturer's tax deduction – A somewhat complicated deduction for "qualified production activities income" will apply to certain C corporations, flow-through business entities (S corps and partnerships) and sole proprietors. When fully phased in by 2010, the maximum possible 9% deduction will effectively reduce the top income tax rate for manufacturing businesses, from 35% to roughly 32%. "Manufacturer" is defined broadly to include such companies as construction, architectural and engineering, oil and gas, and film and music firms.

New SUV write-off limitations (IRC Section 179) – The maximum expense deduction available under Sec. 179 goes down to \$25,000 from \$100,000 (plus inflation adjustment) for most SUVs weighing between 6,000 and 14,000 pounds. This change applies to SUVs purchased and placed into service after October 22, 2004. SUVs weighing more than 6,000 pounds placed in service before then can qualify for the full IRS Section 179 maximum. In either case, the deduction actually allowed is limited to the cost of the SUV multiplied by the percentage of business use in the year the SUV is purchased and put into service, if less than the maximum amount.

While limiting the maximum Sec. 179 deduction for SUVs, Congress extended the \$100,000 maximum Section 179 deduction available for other assets through 2007; it will continue to be indexed for inflation. Section 179 allows businesses to immediately expense up to the entire cost of certain business assets.

New sales tax deduction in lieu of state and local income taxes – This deduction allows federal taxpayers who itemize their deductions to choose between a deduction for state and local income taxes paid or state and local sales taxes paid. Taxpayers in states without state income tax will potentially benefit the most from this law change. Enacted only for years 2004 and 2005, legislators from the no-income-tax states are attempting to make this a permanent change.

Tighter limits on deferred compensation arrangements – These changes affect deferral elections, distribution restrictions, accelerated payment restrictions and *(Continued on page 3)*

Dear Client:

The 2004 tax season is well on its way with many important changes brought about by the recently enacted "Working Families Tax Relief Act of 2004" and "American Jobs Creation Act of 2004." This newsletter highlights some of the tax benefits that were introduced, which includes the new sales tax deduction and the immediate deduction for start-up and organizational expenditures of up to \$5,000 for small, start-up businesses. Read on to see if you qualify for these tax breaks!

This edition also discusses retirement plan contributions and some of the ways a taxpayer can benefit. With the April 15 deadline fast approaching, your time to maximize retirement and other special-purpose plan contributions for 2004 is limited. This is a topic of interest for those individuals who have one of the following:

- Traditional IRA
- Roth IRA
- SEP-IRA (Simplified Employee Pension)
- Solo 401(k) Plan
- Health Savings Account (HSA)
- Coverdell Education Savings Account

For specific details on any of the plans or accounts listed above, please contact our office. We can discuss the appropriate course of action for your individual circumstances.

Other new guidelines worth mentioning include the rules for tax deductions for charitable contributions. Stringent rules are now in place for determining the value of donated property, the records that the donor must keep and the documentation required by the IRS. If you plan on making a charitable donation, it's best to keep updated with the recent changes.

Make the most of this tax season and prepare for the next one to come. Keep your tax liability at a minimum by taking advantage of all tax-planning opportunities.

We're here to find a solution to your tax planning needs. Let us know how we can assist you.

Changes for Charitable Donations

With your 2004 tax returns almost behind you, it's time to review the rules for tax deductions for charitable contributions as they relate to 2005. Some haven't changed, but there are a few important new wrinkles to be aware of.

Charitable contributions are part of itemized deductions, claimed on Schedule A of IRS Form 1040. If you claim the standard deduction instead of itemizing, you do not get a tax deduction for your charitable donations.

Contributions to religious, charitable, scientific, educational, literary and other institutions that are incorporated or recognized as organizations by the IRS may be deducted. Sometimes these organizations are referred to as 501(c)(3) organizations, after the code section that allows them to be tax-exempt. Gifts to state and local government, the federal government, qualifying veterans and fraternal organizations, and certain nonprofit cemetery companies may also be deductible. Gifts to other kinds of nonprofits, such as business leagues, social clubs and homeowner's associations, as well as gifts to individuals, cannot be deducted.

Stricter rules now apply for determining the value of donated property, for the records that the donor must keep and for the documents that must be filed with the IRS. The new rules are intended to prevent taxpayers from taking overly generous deductions for such donations. For cash contributions less than \$250, a canceled check, credit card or cash receipt will suffice. For contributions of \$250 or more, documentation from the charity containing the details of the donation is required.

For donations of cars (and other vehicles including boats and airplanes), the donor's income tax deduction generally is limited to the amount a charity receives after selling the vehicle. Charities are required to provide the donor a receipt stating the sales price. Vehicles worth \$500 or less are exempt from the rule, as are vehicles that are materially improved or significantly used by the charity itself. The deduction for the latter vehicles is the same as under previous law, which allowed deductions based on fair market value, with a written appraisal required for donated property valued at over \$5,000. Even if the charity does not immediately sell the vehicle, it still must provide the donor with a written acknowledgement and certify its intended use of the vehicle.

Additionally, deductions for donations of intellectual property (including patents and most copyrights) are also more limited than in the past.

Individual taxpayers may not deduct the value of their own time or donated services. However, a taxpayer may deduct 14 cents a mile for the unreimbursed use of his or her car for charitable purposes, or actual expenses, such as gasoline, may be deducted. With either method, any parking fees or tolls paid may also be included. Actual lodging expense while away from home overnight performing charitable services may be deducted, as long as the lodging is necessary and not for personal pleasure. Meal expenses during the away-from-home volunteer service are also 100% deductible.

One exception to the norm is the deductibility status of equipment used to support or serve a charity. A deduction cannot be taken for the purchase of equipment if ownership is retained. For example, a tax deduction is not allowed for a computer purchased to help with volunteer service at a qualified religious organization unless it is donated to that organization. If that is the case, the new guidelines for non-cash contributions must be followed.

Tax Tips for the Well-Traveled Businessperson

Did you know that food and lodging expenses may be deducted when away from home for business purposes? This may be particularly beneficial to self-employed individuals who travel extensively. Like everything in the tax law, however, there are certain rules to follow.

The IRS requires that lodging expenses (and other expenses of \$75 or more) be substantiated by records or other evidence. Acceptable records include diaries, logs, receipts, paid bills and expense reports. The records should disclose the amount, date, place and essential character of the expense. Consider the following tips:

- Keep good records of travel expenses.
- Document the business purpose and the expected business benefit.
- Retain your travel itinerary to document the business activity while away.

Travel expenses are deductible only if the individual is away from their "tax home" for more than one business day. "Tax home" usually means their regular place of business.

Meal expenses are deductible only if the trip is overnight or long enough that there is a need to stop for sleep or rest to properly perform one's duties. The amount of the meal expenses must be substantiated, but instead of keeping records of the actual cost of meal expenses, a "standard meal allowance" ranging from \$31 to \$51 can generally be used, depending on where and when the individual travels. Generally, the deduction for unreimbursed business meals is limited to 50% of the cost that would otherwise be deductible.

Actual lodging expenses must be substantiated with actual receipts and are 100% deductible. If meals are included in the lodging expense, they must be kept separate, since meals have the 50% limitation as noted above.

** The standard meal allowance depends on the locality and is set by the U.S. General Services Agency (www.gsa.gov). It is also known as the federal M&IE (meals and incidental expenses) rate.*

Clock Is Ticking for Retirement Plan Contributions

With April 15 looming, the window of opportunity to maximize retirement and other special-purpose plan contributions for 2004 is closing. Many of those contributions not only build the retirement nest egg, but also deliver tax deductions for the 2004 tax return. Let's take a look at some of the ways a taxpayer can benefit.

Traditional IRA – The maximum contribution to an IRA for 2004 is \$3,000 (\$3,500 if over 49 years old). The 2004 contribution can be made up to April 15. If the taxpayer is covered by another retirement plan, a deduction for the contribution may not be allowed, or the permitted deduction may be less than the maximum, depending on the income. Contributions not eligible to be deducted may be subject to a penalty unless they are withdrawn by April 15 or designated as nondeductible (on IRS Form 8606).

Roth IRA – This is a nondeductible retirement account, but the earnings are tax-free upon withdrawal, provided that holding period and age requirements are met. Roth IRAs are a good alternative for many taxpayers who aren't eligible to deduct contributions to a traditional IRA. The maximum deductible contribution for the 2004 tax year is \$3,000 (\$3,500 if the taxpayer is over 49 years old). The 2004 contribution can be made up to April 15.

SEP-IRA (Simplified Employee Pension) – SEP-IRAs are tax-deferred plans for sole proprietorships and small businesses. They are probably the easiest way to build retirement dollars, requiring virtually no paperwork. Maximum contributions depend on your net earnings from your business. For 2004, contributions are the lesser of 25% of compensation or \$41,000. It increases to \$42,000 for 2005. The 2004 contribution can be made up to the due date of the return, including extensions. Thus, unlike a traditional or Roth IRA, funding of a SEP-IRA for 2004 may occur up to October 15, 2005, when an extension has been granted.

Solo 401(k) Plans – A growing number of self-employed individuals with no employees are forsaking the SEP-IRA for a newer type of retirement plan called the Solo 401(k), or Self-Employed 401(k), mostly for its higher contribution levels.

For 2004, the maximum contribution to a Solo 401(k) is the sum of: a) up to 25% of

compensation, and b) salary deferral up to \$13,000. The total of A and B can't exceed \$41,000 or 100% of compensation. The maximum contribution rises to \$42,000 for 2005. On a last note, a Solo 401(k) account must be established by December 31, 2004 to make 2004 contributions. If one was not established, open one now for 2005 contributions.

Health Savings Accounts (HSA) – An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying qualified medical expenses of the account beneficiary. An HSA is designed to assist individuals who have high deductible health plans (HDHP). A taxpayer is only eligible to establish an HSA if he or she has an HDHP.

The maximum 2004 contribution for an eligible individuals with self-only coverage under an HDHP is the lesser of 100% of the annual deductible under the HDHP (minimum \$1,000) or \$2,600.

The maximum 2004 contribution for an eligible individual with family coverage under an HDHP is the lesser of 100% of the annual deductible under the HDHP (minimum \$2,000) or \$5,150.

Amounts contributed to an HSA belong to individuals and are completely portable. Every year, the money not spent on medical expenses stays in the account and gains interest tax-free, just like an IRA. Unused amounts remain available for later years (unlike amounts in Flexible Spending Arrangements that are forfeited if not used by the end of the year).

Coverdell Education Savings Account – These plans were originally called Education IRAs, but that moniker created confusion since they were really not retirement accounts. They are now called Coverdell Education Savings Accounts, named after the late senator from Georgia. Contributions, which can be made for a beneficiary who is under 18 years of age, are not tax-deductible, but the money has the opportunity to grow tax-free if the distributions are used to pay qualified education expenses. The maximum annual contribution is \$2,000 per beneficiary. Contributions do not count toward IRA annual contribution limits; they are also due by April 15, 2005 to be considered as 2004 contributions.

Please note that the information for each plan or account above has been abbreviated. Contact us for specific details on how they may apply to your situation.

Tax Law Tweaks That May Help (Cont'd)

taxability of certain transfers of property under nonqualified deferred compensation plans. This applies to deferrals made after December 31, 2004. Many plans may need to alter their agreements and how they operate.

New rules for vehicle and charitable donations – If a charity sells a donated vehicle (after December 31, 2004), the donor can deduct only the amount of the actual sale proceeds. If the charity keeps and uses the vehicle, the donor can deduct its fair market value, but only if the charity provides an acknowledgement and certifies its intended use, including the time frame in which it plans to use the vehicle. Steep penalties may be imposed for misrepresentation. This provision goes into effect for donations made after December 31, 2004. The deduction for donations of intellectual property (including patents and most copyrights) also will be limited, beginning with contributions made after June 3, 2004.

S corporation reform – The maximum number of shareholders allowed is expanded to 100 from 75, and family members may be considered as one shareholder. S corporations combine the best of corporations and partnerships and are one of the fastest growing business entities.

New Expensing Rule Boosts Small Start-Ups

The American Jobs Creation Act of 2004 gives a boost to small, start-up businesses by allowing up to \$5,000 in immediate deductions for start-up and organizational expenditures. The expenses must be deducted in the tax year in which the business begins. In the past, the deduction for this type of expense was generally spread over a 60-month period.

The deduction for the first \$5,000 of organizational or start-up expenses is generally limited to smaller businesses, because the \$5,000 amount is reduced by the amount that the total start-up or organizational expenditures exceed \$50,000. Start-up and organizational expenditures that are not deductible in the year the business begins must be capitalized and amortized over 15 years on a straight-line basis. These new provisions became effective for expenditures incurred after October 22, 2004.

June 15, 2005:

- U.S. citizens living abroad on April 15, 2005 must file a 2004 Income Tax Return (if not already filed) or file for an extension.
- Second installment of 2005 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

June – July 2005:

- Time to review 2005 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

August 1, 2005:

- Due date for self-employed individuals and employers to file 5500 Series Returns for 2004 calendar year benefit plans (including Keogh/HR-10 plans). This due date is extended to August 1, 2005, since the normal July 31 due date falls on a Sunday.

August 15, 2005:

- Extended 2004 Individual Returns due (if four-month automatic extension was filed).
- Last day to file for an additional extension of time to file the extended 2004 Return. The additional extension, if granted by the IRS, can extend the filing date to October 17, 2005.

September 15, 2005:

- Third installment of 2005 Individual Estimated Taxes due.

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SINCE YOU ASKED...

YOU ASKED: I am a little confused about the itemized deduction for sales tax available in 2005. How does it work when a car is purchased for both business and personal use?

ANSWER: Your question not only applies to sales tax but to consumer loans used to purchase a vehicle as well. Since each scenario is handled a little differently, the answer is divided into two parts.

Part One – When a vehicle is used for both business and personal purposes, the expenses must be allocated between the two uses. For the business portion, the sales tax is added to the cost of the vehicle and is not separately deductible as a tax paid. For example, if the vehicle is used 60% for business, then 60% of the sales tax must be treated as part of the business purchase price and is not deductible as sales tax

either on the business schedule or as an itemized deduction. The remaining 40% can be added to other non-business sales tax paid during the year and deducted as an itemized deduction in lieu of deducting state income tax.

Part Two – Generally, consumer interest is not deductible as an itemized deduction. However, if an individual is self-employed, he or she can deduct interest incurred to purchase a business asset. Therefore, using the same example as in Part One, 60% of the interest paid on a consumer loan to acquire the car can be deducted on the self-employed business schedule. However, since consumer interest generally cannot be used as an itemized deduction, the remaining 40% would not be deductible. If the car is used for business purposes by an employee, rather than a self-employed person, none of the interest is deductible.