

# TO the WISE

TIPS, TECHNIQUES AND STRATEGIES FOR A WELL-PLANNED RETIREMENT

## CONTENTS

- ▶ Tax Calendar
- ▶ Seniors Shouldn't Skip IRA Distributions
- ▶ Tax Law Tweaks that May Help
- ▶ Changes for Charitable Donations
- ▶ Clock is Ticking for Retirement Plan Contributions
- ▶ Since You Asked...

## SENIORS SHOULDN'T SKIP IRA DISTRIBUTIONS

As much as we would like to, amounts in an individual retirement account (IRA) cannot be kept indefinitely. A taxpayer, age 70½ or older, who owns a traditional IRA, SEP-IRA or SIMPLE IRA, qualified plan or 403(b) account must withdraw a minimum amount from the balance each year. If the required minimum distribution (RMD) amount is not withdrawn, large excise tax amounts may be owed to the IRS.

Generally, distributions must be received by April 1 of the year following the year in which the taxpayer reaches age 70½. The RMD for any year after the year in which age 70½ is reached must be made by December 31 of that later year. These required minimum distributions are determined by dividing the prior year-end fair market value of the retirement account by the applicable distribution period or life expectancy.

Calculating the current year's RMD amount for a retirement account is relatively easy. All that is needed is the value of the retirement account for the previous year-end (the year-end fair market value) and the distribution period, which can be obtained from the IRS-issued life expectancy tables. The previous year-end fair market value is divided by the distribution period to arrive at the RMD amount for the year.

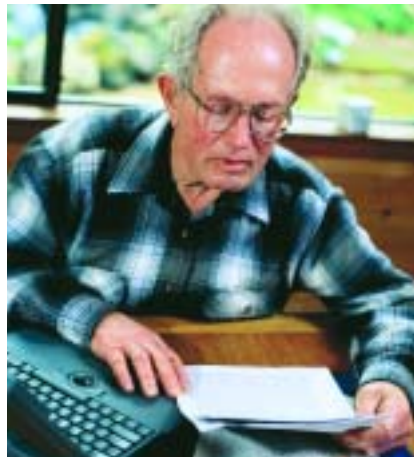
If there are multiple retirement accounts, figure out the minimum withdrawal amount for each. Fortunately, money does not have to be taken

from all the accounts. Instead, a taxpayer may add the separate amounts and withdraw the total from just one. But the distribution cannot be taken from an IRA to satisfy the RMD of a qualified plan or 403(b) plan, or vice versa.

If the RMD amount is not taken by the deadline, a 50% excise tax applies on the amount not withdrawn. This is called an "excess accumulation" or an "insufficient distribution" penalty. If only part of the RMD amount is withdrawn, a penalty is assessed on the remaining amount. For example, if the calculated RMD amount was \$20,000 and only \$13,000 was withdrawn, a 50% excise tax on \$7,000 will be assessed – a hefty \$3,500 penalty. The excise tax is reported on IRS Form 5329, filed along with Form 1040 for the year the distribution was required.

If an error is made and the taxpayer is subject to the penalty, there may be an "out" by requesting a waiver of the excise tax from the IRS. The IRS expects that steps will be taken to correct the error by having the RMD taken out immediately. The procedure is to pay the excise tax up front and send a letter of explanation that asks for a waiver with the income tax return (including the IRS Form 5329). If approved, the IRS will return the excise tax amount.

Should these matters seem complicated, contact our office for assistance. We can help you avoid unnecessary taxes and reap the benefits of your well-deserved retirement dollars.



# 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 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.

## 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 ....(cont'd on page 3)

# 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.

(cont'd from page 2) 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.

**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 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

## CALENDAR



### 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.

To The Wise is published as a service to our clients and friends. The content is general in nature and should not be acted upon without further guidance.

# TO the WISE

## SINCE YOU ASKED...

**Question:** 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.