



# Client advisor

CURRENT INFORMATION, NEWS AND TRENDS

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## Avoiding or Mitigating the Effects of the AMT

AMT is the acronym for Alternative Minimum Tax. It is a different (alternative), and generally punitive, method of computing income tax when either certain types of income receive preferential tax treatment or there are excessive deductions in certain categories. The AMT was originally designed to impose a minimum tax on higher income taxpayers who were avoiding taxes. However, years of inflation without corresponding adjustment to the AMT components have caused an increasing number of taxpayers to be subject to the AMT. The following six items routinely affect the average taxpayer:

**Medical Deductions** – These are allowed for the AMT computation, but only to the extent that they exceed 10% of a taxpayer's income. In contrast, the regular tax computation limit is a lesser 7.5%. Sometimes it is possible to defer or accelerate medical expenses from one year to another, such as paying the orthodontist in installments or all at once. If your employer offers one, consider participating in a flexible spending plan. It allows you to pay medical expenses with pre-tax dollars and avoid both the regular tax and AMT deduction limitations.

**Tax Deductions** – When itemizing deductions, a taxpayer is allowed to deduct a variety of taxes, including real property, personal property and state income tax. But for AMT purposes, none of the itemized taxes are deductible. For most taxpayers, this represents one of their largest tax deductions and frequently triggers the AMT. If you are affected by the AMT, conventional wisdom would dictate deferring tax payments to a subsequent year when the AMT may not apply. When deferring, care should be exercised in regards to late payment penalties and interest on underpayments for certain taxes. In addition, taxpayers can annually elect to capitalize taxes on unimproved and

unproductive real estate. This means foregoing the deduction currently and adding the tax paid to the cost basis of the real property.

**Home Mortgage Interest** – For both the regular tax and AMT computations, interest paid on a debt to acquire or substantially improve a home or second home is deductible as long as the debt limit (generally \$1 million) isn't exceeded. This is true of refinanced debt, except that any increase in debt is treated as equity debt. For regular tax purposes, the interest on up to \$100,000 of equity debt on the two homes can also be deducted. However, equity debt is not deductible against the AMT; neither is the acquisition or equity debt interest on a motor home or boat that qualifies as a second home. Therefore, taxpayers should exercise caution when incurring home equity debt. Generally, loan brokers are not aware of these limitations, and there are numerous pitfalls.

**Miscellaneous Itemized Deductions** – The category of miscellaneous deductions that includes employee business expenses and investment expenses is not deductible for AMT purposes. For certain taxpayers with deductible employee business expenses, this can create a significant AMT. Employees with significant employee business expenses should attempt to negotiate an "accountable" reimbursement plan with their employer. Under this type of plan, the reimbursement for qualified expenses is tax-free. Because the employee has been reimbursed, he or she no longer claims a deduction for the expenses, thus eliminating the miscellaneous deduction. Another strategy would be to defer the expenses to a year not affected by the AMT.

**Personal Exemptions** – Personal exemptions for dependents provide no benefit when taxed by the AMT method. Therefore, divorced or separated parents should

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Correspondence from the IRS has a tendency to escalate a taxpayer's pulse rate. However, most of the communication received is not the feared "come on down" letter that requests an appearance for a face-to-face audit, but instead may only require a written explanation.

Generally, all types of income (wages, interest, dividends, etc.) are reported by the payer to the IRS, who in turn, matches the reported income to the recipient's tax return based on Social Security number (SSN). Over the past few years, the IRS has become very proficient in using their computer matching programs to pick up unreported income and other discrepancies on tax returns. Discrepancies will generate an IRS inquiry, so take note of the following items which are frequently monitored by the computer matching programs:

- **Dependent SSN** – The IRS allows only one taxpayer to claim the exemption for a dependent. Frequently, a dependent will claim the exemption themselves, or in other cases, separated or divorced individuals will both attempt to claim the dependent. Expect correspondence when the exemption for any SSN has been claimed twice.
- **Gross Proceeds of Sale** – All brokerage firms are required to report security sales to the IRS as "gross proceeds of sale" on Form 1099-B. The 1099-B copy provided to the account owner is generally combined with interest and dividend reporting requirements and included in a consolidated 1099 statement. These statements can be confusing, and the "gross proceeds of sale" is frequently buried in the multi-page statements. If a taxpayer fails to report these security sales, the IRS will treat the gross proceeds as all profit, recompute the tax owed, and send a bill.
- **Pension and IRA Rollovers** – Unless it is a direct (trustee-to-trustee) rollover, the plan administrator is required to issue a Form 1099-R whenever a taxpayer withdraws funds from an IRA or other type of qualified plan. If the 1099-R income is not properly accounted for on the tax return, the IRS may treat it as unreported pension income and issue a revised tax bill. Even if it is directly rolled over, ALWAYS bring rollovers to our attention.

- **Alimony** – The person paying alimony must include the recipient's name, address and SSN with the deduction claimed for alimony payments. The IRS will match the payments to income reported by the recipient. If the two amounts are not the same, the IRS will initiate correspondence to both parties.
- **Home Sales** – Technically, escrow companies are not required to issue 1099-S forms to taxpayers who sell their primary residence for less than the home sale gain exclusion amount and certify that they meet the exclusion qualifications (\$250,000 for a single taxpayer and \$500,000 for married taxpayers). Despite this, many escrow companies choose to issue them, making it necessary to report the home sale and avoid IRS correspondence.

## IRS Has Your Numbers!



- **Home Mortgage Interest** – Since all lenders who are in the business of lending money are required to report home mortgage interest, the IRS can verify the amount claimed as deductible mortgage interest on the Schedule A of a tax return, and any significant discrepancy can lead to IRS correspondence. If a private party holds the loan (not the course of business), Form 1098 is not required to be filed, but the taxpayer claiming the mortgage interest as a deduction is required to include that party's name, contact information and SSN on Schedule A. The IRS can then match the claimed interest deduction to the amount reported by the private party as interest income.

- **Education Benefits** – Schools are now required to report the tuition payments qualifying for the Hope or Lifetime Learning tax credit or the tuition and fees deduction that were made during the year on Form 1098-T. Educational lenders report the amount of student loan interest paid on Form 1098-E. Both are used to match against claimed deductions and credits on the tax return.

Should you receive a notice, it is generally best to contact this office. Don't just pay the revised tax the IRS proposes. Frequently, the IRS notice is in error and attempting to respond to the notice without professional advice may create additional problems.

## Refund vs. Underpayment: It's All About Your Withholding!

What did Uncle Sam surprise you with this year - a big tax refund or a huge debt to pay? The ideal situation is to owe a small amount at tax time. If you have a large refund coming your way, you just gave the government an interest-free loan. That money could have definitely been put to better use!

Instead of celebrating your good fortune, find a way to avoid giving the government free use of your money this year. Increasing the number of exemptions claimed on your W-4 or reducing your estimated tax payments should do the trick. You may even consider doing both! Just be careful not to go overboard and find yourself stuck with a tax underpayment. Your payments for the 2005 tax year should generally be enough to cover whichever of the following is the lower amount:

- 90% of your 2005 tax liability, or
- 100% of your 2004 tax if your 2005 income (adjusted gross income) is \$150,000 or less (110% if your AGI was over \$150,000).

For those taxpayers that end up owing more than 10% of their total tax bill, an interest-charge penalty could be imposed for not paying enough before filing. This scenario is the exact opposite of those receiving a refund. To avoid falling into this category, examine your paycheck to see how many exemptions you claimed. If too many exemptions were claimed, correct your withholding amount to ensure that it will cover this year's tax bill. File a new W-4 with your employer and claim fewer exemptions to withhold more from each paycheck.

Are you also receiving income from self-employment or through investments? This could be another reason for your tax underpayment. To fix this problem, start making estimated tax payments for this year or increase the amount of your payments if you already plan to make them. Keep in mind that estimated payments for the 2005 tax year are due on April 15, June 15, September 15, 2005 and January 16, 2006. Form 1040-ES must be filed with each payment.

By taking the appropriate course of action, you can avoid any unexpected blows next tax season. Please call our office to assist you with your 2005 tax projections, W-4 adjustments and safe harbor estimates.

## Avoiding or Mitigating the Effects of the AMT... cont'd

carefully consider which party should claim the exemption for a dependent child.

**Standard Deduction** – Since the regular tax standard deduction is not allowed as an AMT deduction, taxpayers affected by the AMT should always itemize. Granted that the benefit of some deductions will be lost, there is still a partial advantage. Even the smallest of charitable deductions will benefit at a minimum of 26% (the lowest bracket for the AMT).

The AMT is an extremely complicated area of tax law that requires careful planning to minimize its effects. Please contact our office for further assistance.

**Caution:** Although not frequently encountered, incentive stock options (ISO) can have a profound impact on the AMT, and clients are strongly encouraged to seek our advice prior to exercising incentive stock options.

## Changes for Charitable Donations

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.

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.

## Is a Living Trust the Answer to Probate?

Millions of Americans are turning to the living trust as the most effective way to avoid the trouble and expense of probate. Assets held by a trust pass to the beneficiaries without going through the lengthy and expensive probate process. However, leaving some assets out of the living trust may cause a probate at death. If a taxpayer passes away and has assets in his or her own name (i.e., not in the living trust) worth more than the state will allow, these assets will be subject to the probate process. The fact that there is a living trust containing some or most of the assets will not avoid probate in this case. An exception to this rule is assets held in Joint Tenancy, which revert to the joint tenant and generally also avoids probate.

**Example:** Jackie was a resident of San Diego and passed away in January 2005 from a fatal car accident. She had a living trust in place, but she kept some of her assets under her own name. These assets were worth more than the California threshold of \$100,000 and will be subject to the probate process.

Another thing to consider is that retirement assets, such as 401(k) plans and IRAs, must remain in the individual's own name and cannot be owned by the living trust. These assets pass upon death in accordance with the beneficiary designation. If that is the case, why not make the living trust the beneficiary of the retirement account? The answer is quite simple. Naming the trust as the beneficiary can cause extra administrative hassle after death and can lead to a loss of income tax deferral for the beneficiaries. In certain cases, however, it is prudent to name the living trust as the beneficiary (for example, when minor children are the intended beneficiaries). It is also important to name proper contingent beneficiaries in the event that the primary beneficiary predeceases the retirement plan owner.

If you have a living trust, make sure all of your assets, with the exception of retirement assets such as 401(k) plans and IRAs, are in the name of the trust. This will help eliminate the need for probate.

For more information on the benefits of a living trust, consult an estate planning attorney.

# Tax calendar

June – September

## 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...



**Question:** I recently inherited my father's home after he passed away. He originally purchased it for \$50,000. It is now valued around \$350,000. Will the \$300,000 increase in value be taxed as capital gain if I sell the house? If it is subject to tax, can I apply my father's \$250,000 home gain exclusion to offset the gain? In addition, do I need to keep the home for over a year to receive the benefits of long-term capital gains rates on the taxable gain?

**Answer:** Your father's \$250,000 home sale exclusion is only applicable if he had sold the home. However, this should not be a concern, since you will receive what is known as a "step up" in basis. It is generally the value of the home on the date of your father's death. You would measure your gain or loss from that "stepped up" basis. Therefore, if the home was sold shortly after his death, there is a good probability that you might actually have a tax-deductible loss (due to selling expenses). You also do not have to own the home for over one year. The inherited property will automatically be treated as being held long-term.

**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.