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Clock Is Ticking for Retirement Plan Contributions

It's never too early to start putting money aside so you can maximize retirement and other special-purpose plan contributions for 2005. Many of those contributions not only build the retirement nest egg, but also deliver tax deductions for the 2005 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 2005 is \$4,000 (\$4,500 if over 49 years old) and can be made up to April 17, 2006. 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 Contributions not eligible to be deducted may be subject to a penalty unless they are withdrawn by April 17, 2006 or designated as nondeductible (on IRS Form 8606).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 2005 tax year is \$4,000 (\$4,500 if the taxpayer is over 49 years old). As with Traditional IRAs, the 2006 contribution can be made up to April 17, 2006.

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 the net earnings from your business. For 2005, contributions are the lesser of 25% of compensation or \$42,000. The 2005 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 2005 may occur up to October 16, 2006, 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 2005, the maximum contribution to a Solo 401(k) is the sum of: a) up to 25% of compensation, and b) salary deferral up to \$14,000. The total of A and B cannot exceed \$42,000 or 100% of compensation. On a last note, a Solo 401(k) account must be established by December 31, 2005 to make 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. It 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 2005 contribution for 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 \$2,650.

The maximum 2005 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 \$5,250. *(continued on next page)*



Clock Is Ticking for Retirement Plan Contributions (Cont'd)

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.

Coverdell Education Savings Account – These plans were originally called Education IRAs, but that moniker created confusion since they were really not retirement accounts. 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 16, 2006 to be considered as 2005 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.

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!

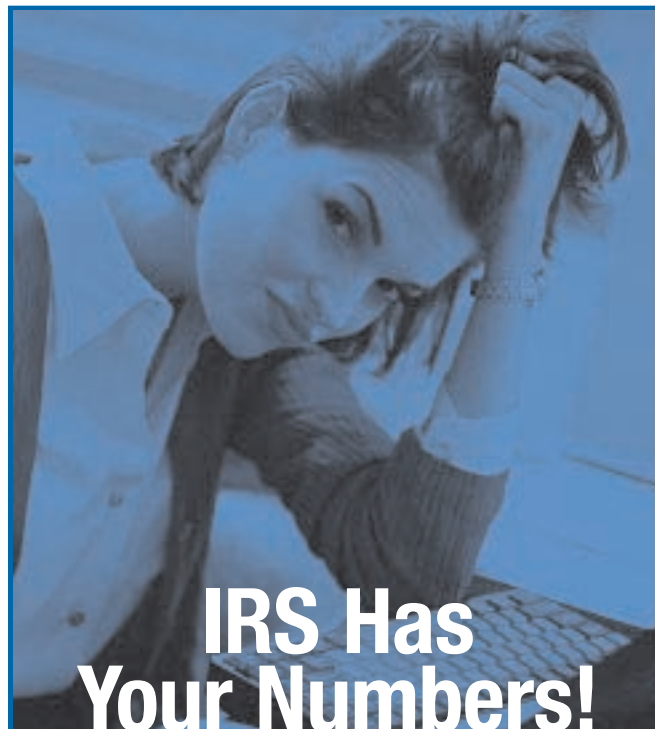
Instead of celebrating your good fortune, find a way to avoid giving the government free use of your money this year. Increasing the number of exemptions claimed on your W-4 or reducing your estimated tax payments should do the trick. You may even consider doing both! Just be careful not to go overboard 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.



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

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IRS Has Your Numbers (Cont'd)

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.

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.

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 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.





Since You Asked...

QUESTION: I am self-employed and have a Keogh pension plan. Do I need to file a return for the plan?

ANSWER: Filing the annual return for pension plans, due on July 31, is a task generally handled by the plan administrator or the employer. Employers who fail to file on time, or obtain an extension to file, face a \$25 per day penalty. Plans that require an annual return to be filed are: (1) those with one or more plans with aggregate assets of \$100,000 or more, (2) those that were previously required to file a return for any year, and (3) those in their final year. Generally, for self-employed plans, the 5500EZ return can be used to file.

Now that the Simplified Employee Pension (SEP) plan limits have been increased to the same contribution levels as the Keogh plans, you may wish to consider rolling your Keogh account into a SEP plan. This will eliminate the filing requirement (except the final year requirement), since one-participant SEP plans are not required to file the annual return. Please call for assistance with the annual return.

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.



taxcalendar JUNE-SEPTEMBER 2005

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.