

PERSONAL MID-YEAR TAX PLANNING STRATEGIES

TaxSMART

Mid-Year 2005 | Volume XII, Number 1

Mid-Year Tax Tips and Strategies

IRS Has Your Numbers!

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.

Continued on the Inside

Dear Client:

Now that tax season is behind you, it is time to prepare for the 2005 tax year. This newsletter provides many useful tips to help you maximize your deductions and lower your tax liability. It is also designed to help you identify issues that may be relevant to your specific situation.

What sets off a red flag and how can you avoid being audited? The IRS uses computer matching programs to pick up unreported income and discrepancies on tax returns. This edition discusses the items that could set off an IRS inquiry to give you a better understanding of what is being monitored by these programs.

Another growing concern among taxpayers is the Alternative Minimum Tax (AMT), which is also covered in this issue. Many have felt the effects of the AMT and careful planning is needed to minimize its impact. Since this is an extremely complicated topic, we strongly encourage you to contact our office for assistance.

For those taxpayers that owe Uncle Sam a significant amount of money this year, check your withholding amount to make sure that you did not claim too many exemptions. If that does not correct the problem, then estimated tax payments might be necessary. Avoid getting stuck with a tax underpayment next year and call our office to discuss the best course of action.

If you would like a complete tax planning analysis, our services are available throughout the year.

We look forward to hearing from you!

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.

TaxSmart 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.

INSIDE

- IRS Has Your Numbers!
- Avoiding or Mitigating the Effects of the AMT
- Since You Asked...
- Tax Calendar

Avoiding or Mitigating the Effects of the AMT

Q – 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.

Q – 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.

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.



(Continued) IRS Has Your Numbers!

• **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.