

TAX & BUSINESS STRATEGIES

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Preparing for an Unexpected Disaster

The recent hurricanes, tsunamis, and terrorist attacks make it clear that even smaller companies are not immune to an unexpected loss. What can you do to prepare and minimize your risk to ensure that such a disaster won't run you out of business?

Unplanned events can have a devastating effect on your business. You need to be protected from any number of natural and unnatural events such as fire, computer failure, and illness of key staff, all of which can make it difficult or even impossible to continue day-to-day operations.

Good planning can help you take steps to minimize the impact of a disaster and protect your business. The following recommendations can help your business cope with an unforeseen calamity.

Why the Need to Plan?

By identifying possible disasters that may affect you and your business, you may be able to minimize the risks and losses that might occur. A well thought-out business continuity plan will identify an action plan, safety concerns, applicable computer back-ups, and alternative operation headquarters. It will also provide a road map back to normal activities by highlighting the points of contact for insurance and emergency relief way ahead of time.

Educate Your Staff.

How will you escape? Where will you meet up? How will you communicate? Map out and practice escape routes from your building. Familiarize yourself with local authorities and emergency radio signals announced at the time of a disaster. What happens if you survive the disaster but your biggest supplier does not? Develop back-up vendors and relationships ahead of time. Don't forget that many employees will have families to care for and may have their homes affected by the disaster. Have you stockpiled water, batteries, first aid kits and food in case emergency services are delayed?

Back Up Key Business Information.

Does your computer system have a nightly back-up tape? If the answer is yes, where are the back-up tapes stored? And more importantly, will the back-ups include all of the

Dear Client:

With the end of the 2005 tax year fast approaching, it's time to get all your planning and preparation in gear. This edition provides year-end tax strategies that can help you minimize your tax liability.

This newsletter also discusses the benefits of the Katrina Emergency Act, which was passed by Congress late in September. Along with a number of tax benefits to residents of the disaster area, it also includes provisions that apply to all taxpayers whether or not they resided within the disaster area.

Another big headliner is the IRS increase of the standard mileage allowance for the last four months of 2005. It will help offset the increased cost of operating a vehicle; however, it adds complexity to those that use the optional mileage allowance by requiring them to keep separate records for the two periods in 2005. Please call our office for more information.

Don't miss the opportunity to reduce your tax burden by not planning ahead. We offer year-round tax planning services and can help you make the most of available tax strategies.

We look forward to assisting you with your tax needs.

(Continued on inside)

Writing Off Your Start-Up Expenses

Preparing for an Unexpected Disaster *(Continued)*

software needed for your computers to function at another location? Many businesses now have outside vendors that host and back up their computer systems for them. Inquire if they have redundant back-up systems and request information on their emergency plans. If the disaster is only temporary and shuts down the electrical grid to your business, a generator may be a sound investment. The generator can power your computer system, equipment, refrigerators, and other items that might be crucial.

Review Your Insurance Coverage.

As many realize after the fact, they are not insured for many natural disasters under their existing business policy. You may need to add or increase coverage if it is available. Check with your carrier for details on your coverage.

Recovering and Government Assistance

The following government agencies may provide assistance:

- **Small Business Administration (SBA)** – Provides low interest loans to businesses, homeowners and renters who are victims of a disaster. They even provide loans for the replacement or repair of damaged or destroyed clothing, appliances, furnishings, and automobiles. For more information, visit their website at: www.sba.gov.
- **Federal Emergency Management Agency (FEMA)** – Disaster assistance is provided in the form of money or direct assistance to individuals, families and businesses in an area whose property has been damaged or destroyed and whose losses are not covered by insurance. It is meant to help with critical expenses that cannot be covered in other ways. For more information, visit their website at: www.fema.gov.

Since a disaster strikes without warning, being prepared can help your business recover more quickly from a catastrophic emergency. Take the necessary steps to ensure that both you and your business investments are well-protected.

Business owners – especially those operating small businesses – may be helped by a recent tax law change allowing them to deduct up to \$5,000 of the start-up expenses in the first year of the business' operation. This is in lieu of amortizing the expenses over 180 months (15 years). Note: Start-up expenses incurred prior to October 23, 2004 generally were deducted by amortizing the costs over no less than 60 months. These expenses continue to be eligible for the 60-month amortization.

Generally, start-up expenses include all expenses incurred to investigate the formation or acquisition of a business or to engage in a for-profit activity in anticipation of that activity becoming an active business. To be eligible for the election, an expense also must be one that would be deductible if it were incurred after the business actually began. An example of a start-up expense is the cost of analyzing the potential market for a new product.

As with most tax benefits, there is always a catch. Congress put a cap on the amount of the start-up expenses that can be claimed as a deduction under this special election. Here's how: If the expenses are \$50,000 or less, you can elect to deduct up to \$5,000 in the first year, plus you can amortize the balance over 180 months. If the expenses are more than \$50,000, then the \$5,000 first-year write-off is reduced dollar-for-dollar for every dollar start-up expenses exceed \$50,000. For example, if start-up costs were \$54,000, the first-year write-off would be limited to \$1,000 (\$5,000 – (\$54,000 - \$50,000)).

The election to deduct start-up costs is made by claiming the deduction on the return for the year in which the active trade or business begins, and the return must be filed by the extended due date.

On Schedule C, the deduction is taken as part of the "Other Expenses" in Part V. If the entire amount of start-up costs isn't deductible in the business' first year, use Form 4562 to amortize the excess amount over 180 months.

Qualifying Start-Up Costs – A qualifying start-up cost is one that would be deductible if it were paid or incurred to operate an existing active business in the same field as the new business, and the cost is paid or incurred before the day the active trade or business begins. Not includible are taxes, interest or research and experimental costs. Examples of qualified start-up costs include:

- Surveys/analyses of potential markets, labor supply, products, transportation facilities, etc.;
- Wages paid to employees and their instructors while they are being trained;
- Advertisements related to opening the business;
- Fees and salaries paid to consultants or others for professional services; and
- Travel and other related costs to secure prospective customers, distributors, and suppliers.

For the purchase of an active trade or business, only investigative costs incurred while conducting a general search for or preliminary investigation of the business (i.e., costs that help the taxpayer decide whether to purchase a new business and which one to purchase) are qualified start-up costs. Costs incurred attempting to buy a specific business are capital expenses that aren't treated as start-up costs.

How Katrina Tax Incentives Can Benefit You

ate in September, Congress passed the Katrina Emergency Act. This Act provides a vast number of tax benefits to individuals who were residents of the disaster area. In addition, it includes provisions that apply to all taxpayers whether or not they resided within the disaster area. The following is a brief summary of those provisions:

Increased charitable contributions – Generally, most charitable contributions are limited to 50% of a taxpayer's adjusted gross income (AGI). To provide an incentive for larger charitable contributions, that 50% limit has been increased to 100% for cash contributions made between August 28 and December 31, 2005, with a five-year carryover provision subject to the 50% limit for contributions in excess of the 100% of the AGI limitation for 2005. There may be other complications so consult our office if you anticipate making a substantial contribution. In addition, the contributions made during August 28 through December 31 of 2005 are not subject to the overall itemized deductions phase-out that applies to high-income taxpayers.

Additional exemption for housing Katrina-displaced individuals – Taxpayers who provide free housing in 2005 or 2006 for at least 60 days to qualified Katrina-displaced individuals will be entitled to an additional exemption of \$500 for each individual but it is not to exceed \$2,000 for the year. For higher-income taxpayers, these additional exemptions do not phase out like the regular taxpayer, spouse, and dependent exemptions. The deduction can be claimed in either 2005 or 2006, but not both years, by the taxpayer for the same individual.

Recontribution of home purchase withdrawals – Certain retirement plans or IRA withdrawals made after February 28, 2005 and before August 29, 2005 for home purchases in the Katrina disaster area that were cancelled due to Hurricane Katrina, can be returned to a qualified plan or IRA tax-free and without penalty. Under normal tax law provisions, these types of distributions cannot be recontributed and if they are not used towards purchasing a home, they are subject to the 10% early withdrawal penalty. Any amount of the withdrawn funds (not to exceed the total amount withdrawn) can be recontributed at any time during the period beginning on August 25, 2005 and ending on February 28, 2006.

Work Opportunity Credit for Katrina-displaced individuals – Employers may claim the work opportunity tax credit if they hire individuals who:

- On August 28, 2005, had a principal place of abode in the Katrina core disaster area, and who are hired during the two-year period beginning on August 28, 2005 for positions where the principal place of employment is located in the core disaster area, or
- On August 28, 2005 had a principal place of abode in the core disaster area, who are displaced from those abodes because of Hurricane Katrina, and who are hired during the period beginning on August 28, 2005 and ending on December 31, 2005.

IRS Splits Mileage Rates for 2005

Recognizing the increased cost of operating vehicles due to higher fuel prices, the IRS has increased the standard mileage allowance to 48.5 cents per mile for business miles driven between September 1 and December 31 of 2005. The business allowance remains at 40.5 cents per mile for January through August of 2005. This unusual split mileage allowance for the year adds complexity, because it requires taxpayers using the optional mileage allowance to keep separate records for the two periods in 2005.

Medical travel and moving allowances have also been increased for the last four months of 2005. The allowance for charitable travel is set by statute and generally remains unchanged. The table below summarizes the mileage allowances for 2005.

| Type of Use | Jan - Aug | Sept - Dec |
|-------------------|-----------|------------|
| Business Travel | 40.5 | 48.5 |
| Medical Travel | 15.0 | 22.0 |
| Charitable Travel | 14.0 | 14.0 |
| Moving | 15.0 | 22.0 |

Special Rate for Hurricane Katrina Disaster – A taxpayer who uses a vehicle in providing donated services to a charity for relief related to Hurricane Katrina during the period of August 25, 2005 to December 31, 2006 can compute the charitable mileage deduction using 70% of the standard business mileage rate in effect at the time the vehicle is used. For example, the rate for Katrina relief-related charity miles driven from September 1 to the end of 2005 is 34 cents per mile (70% x 48.5¢). The IRS will not announce the 2006 mileage rates until late 2005 or early 2006.

November-December 2005:

Time for 2005 Year-End and 2006 Tax Planning. This is especially true if you have substantial increases in income or fewer deductions. Tax planning provides an opportunity to make adjustments before year's end that can improve your tax situation and minimize potential penalties. Please call for an appointment.

December 31, 2005:

- Last day to pay deductible expenses for 2005 return (this doesn't apply to IRA, SEP or Keogh contributions, all of which can be made after December 31, 2005).
- Last day to make minimum required withdrawal of funds from a Traditional IRA Account and avoid a penalty if you turned age 70½ before 2005.
- Last day to set up a Keogh Retirement Account if you plan to make a 2005 Contribution.

January 16, 2006:

Fourth-Quarter 2005 Federal Estimated Tax Payment due unless 2005 return is filed by January 31, 2006. **Caution:** Some states may have different filing dates.

January 31, 2006:

Deadline for providing 1099s and W-2s to those people you paid during 2005. If you're a business

owner or rental property owner, and you paid \$600 or more for the services of individuals (other than employees) during the year, you need to provide 1099s for those workers by January 31, 2006. "Services" can mean everything from labor and professional fees to rents on property. In addition, in order to avoid a penalty, copies of 1099s need to be sent to the IRS by February 28, 2006. If you would like this firm to prepare these documents for you, please give us a call.

February 28, 2006:

Deadline for filing (sending) 1099s and W-2s to the government.

April 3, 2006:

Last day to withdraw funds from your Traditional IRA if you turned age 70½ in 2005 and you haven't taken your 2005 Distribution yet. In addition, this is the last day to withdraw funds from your SEP or Keogh plan if you're retired and turned age 70½ in 2005. Failure to take the required distributions can result in substantial penalties.

April 17, 2006:

- Deadline for individuals to file a 2005 Federal Return or request an extension of time to file.
- First Installment of 2006 Federal Estimated Tax Payment due.
- First Installment of 2006 Defined Benefit Pension Plan Contributions due.

The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

TAX & BUSINESS STRATEGIES

SINCE YOU ASKED...

YOU ASKED: I am planning a business trip to a trade show and my family wants to come along. Can I take them and still deduct the expenses? **ANSWER:** If you take others with you on a business trip, you can deduct business expenses for the trip, but no more than if you were traveling alone. If, for example, your family rides along in the car, you can fully deduct the automobile expenses. If your family stays with you in a standard hotel room, your deductible lodging expense is limited to a single rate for that room. In other words, you cannot include the extra charges for multiple guests in a room. Your meals are deductible but meal expenses for your family and their side trips to amusement parks, zoos, museums, etc. are not deductible. If you extend your stay and partake in some of the fun after the business activity is over, the expenses attributed to the non-business days aren't deductible, unless you extended your stay to get discounted airfare (the "Saturday overnight" requirement). In this case, your hotel room and meals would be fully deductible (but those for the family are not). Also, you can fully deduct the cost of your airline ticket even if it features a two-for-one or "companion" discount.

YOU ASKED: I am self-employed and work out of my home. I converted a den in the home to an office that I use only for business. We also have a guesthouse on the property I have been considering remodeling and using as my office. I recall

reading or hearing that it might not be a good idea. Are you aware of any reason that could make that a bad tax move? **ANSWER:** If you own and use the home for two of the prior five years preceding the sale of the home, you are allowed to exclude up to \$250,000 (\$500,000 if you are married and both you and your spouse qualify for the exclusion) of gain from the home. The fact that a portion of the residence is not being used as a home presents no problem if the home office is an integral part of your residence. The exclusion is allowed against the entire gain, except that you are required to recapture as income the depreciation deducted on the home office after May 6, 1997. However, if the portion of your home that you use as an office is located in a separate structure, then the sale would be treated as two sales: one of the home portion and the other the business portion. The exclusion would not be allowed against the business portion. Let's say the guesthouse represents 20% of the entire residential complex. Then 20% of the gain would not qualify for the exclusion of gain. This is probably what you recall. Although complicated, it is possible to combine a home sale subject to the exclusion and a tax-deferred exchange for the business portion where the gain on the office portion is deferred into a replacement office. This is a simplified explanation of a very complex set of rules. Not all of the issues can be covered here, so we recommend you contact this office for additional details before taking action.