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Client Information Bulletin

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Ten Top Tax saving Ideas at Year-end *Popular techniques for individuals and business owners*

With the holidays fast approaching, now is a good time to figure out how to cut your 2004 tax bill. Although everyone's situation is different, here are ten popular year-end strategies for individuals and small-business owners.

1. Charitable donations: As a general rule, the full amount of a cash donation is deductible on the donor's personal tax return. If a donation is made by **credit card** at year-end, the gift is deductible in 2004, even if the charge is not actually paid until next year. **Added tax break:** For donations of property, the full fair-market value is deductible if the property has been held for more than one year.

2. Alternative minimum tax liability: The alternative minimum tax (AMT) can sneak up on unsuspecting taxpayers. It applies if your AMT liability, based on a special tax computation involving tax preference items, exceeds your regular tax liability. Individual taxpayers should have their AMT liability calculated before **year-end**. Depending on the result, it may be advisable to shift tax preferences to next year to avoid or reduce AMT liability. Alternatively, you might accelerate income into 2004 if the AMT rate is lower than your top marginal tax rate.

3. Section 179 allowance: Under Section 179 of the tax code, you can elect to

currently deduct some or all of the cost of business assets placed in service anytime this year. For 2004, the maximum Section 179 allowance, which was quadrupled from \$25,000 to \$100,000 for 2003, has been increased slightly to \$102,000. The maximum allowance reverts to \$25,000 for the 2006 tax year.

4. Bonus depreciation deduction:

There is an extra tax incentive for buying equipment for your business this year. For assets acquired after May 5, 2003 and placed in service before January 1, 2005, you can claim a 50% bonus depreciation deduction in addition to the regular first-year depreciation deduction and the Section 179 allowance. As things stand now, the bonus depreciation deduction is scheduled to go off the books after 2004.

5. Estimated tax penalties: Even if you do not have enough federal income tax withheld during the year, you can avoid an estimated tax penalty by meeting one of two safe harbor exceptions. No penalty is imposed if annual tax payments for 2004 equal 90% of the current year's liability or 100% of the prior year's tax liability. The percentage for the 100% safe harbor is increased to 110% if your adjusted gross income (AGI) for the prior year exceeded \$150,000.

6. Medical and dental expenses: You may deduct unreimbursed medical and dental expenses to the extent the annual total exceeds 7.5% of your AGI. Try to bunch together nonemergency expenses (e.g., new eyeglasses or dental cleanings) in the tax year that provides the best opportunity for a deduction. **Note:** Do not forget to include co-payments required under a company health insurance plan.

7. Dependency exemptions: The parent of a full-time student under age 24 can

still claim a dependency exemption for the child by providing more than 50% of the child's support. Depending on the situation, it may make sense to add to the support total at year-end in order to clear the 50% mark. Each dependency exemption for 2004 is \$3,100.

8. Wash sales: Under the wash sale rule, an investor cannot claim a tax loss if he or she buys back substantially identical securities within 30 days. To avoid this result, you can (a) wait at least 31 days to make the purchase or (b) buy replacement securities first and wait at least 31 days before selling the original shares. **Note:** This must be done more than 30 days before the end of the year to realize the loss in 2004.

9. Hobby losses: If you operate a sideline business, you can claim a tax loss for the year, but be careful. If the activity is characterized as a hobby, not a business, your loss is deductible only up to the amount of your income from the activity. Since the IRS generally presumes the activity is a legitimate business if you have shown a profit in three out of five consecutive years, you might accelerate income into this year and defer deductions to next year.

10. Income-shifting: You can reduce the overall family tax bill by shifting taxable income from your high tax bracket to other family members in lower tax brackets. For instance, you might transfer income-producing property to **custodial accounts** for your minor children. **Caution:** Be aware of the "kiddie tax." To the extent that the unearned income a child under age 14 exceeds an annual limit (\$1,600 for 2004), the excess is taxed at the top marginal tax rate of the child's parents.

In summary: You may be able to use one or more of these techniques to reduce your 2004 tax bill. However, tax planning cannot be done in a vacuum.

With the help of an expert tax-planning professional, you can have a year-end plan tailored to your personal circumstances.

IRS Maps Out Guidelines for Car Donations

New concerns about over-valuations

The IRS has just issued new guidelines for donating used cars to charity.

Background: If you donate property held for more than a year, you can generally deduct an amount equal to the fair-market value of the property. In recent years, a number of programs have been established for the donation of vehicles, either directly to charities or indirectly through private entities. The IRS has become more concerned about aggressive valuations of the vehicles being donated.

As the first step to curbing abuses, the IRS has released new guidelines. According to the IRS, donors of automobiles should:

- ◆ Make certain that the charity is a qualified charitable organization;

- ◆ Assess the fair-market value of the vehicle. A valuation based on a used car guide, such as “blue book value,” may be a good starting point. However, in many cases, the vehicle’s actual fair-market value may be substantially less than the blue book value; and
- ◆ Obtain a contemporaneous written acknowledgement from the charity (assuming the value of the donated vehicle is \$250 or more).

Note: Proposed legislation currently before Congress would impose new requirements for charitable donations of automobiles. We will keep you posted on any significant developments.

Giving Gifts to Family Members

How to maximize annual benefits for lifetime gifts

Although the IRS imposes federal gift tax on donors, you can easily give away thousands of dollars each and every year without paying one red cent in **gift tax**.

How is that possible? The tax law includes several key exceptions to gift-tax liability. If you stay within the generous tax law boundaries, you can pass a considerable amount of wealth to family members during your lifetime with no gift-tax consequences. If you have not

yet started a series of **lifetime gifts**, the end of the year is the optimal time to do it. Let’s take a closer look at the rules.

Annual gift-tax exclusion: The annual gift-tax exclusion enables you to give up to \$11,000 each year to a recipient without paying any federal gift tax. This exclusion applies separately to each recipient. For example, you can give up to \$11,000 to three children -- a total of

\$33,000 in gifts -- without triggering any gift tax.

Furthermore, the annual gift-tax exclusion is doubled to \$22,000 if your spouse joins in the gift. In other words, you might give away \$22,000 to each of three children free of gift tax. That adds up to a total of \$66,000 in **tax-free gifts**. By taking this approach for five years in a row, you can reduce the size of your taxable estate by \$330,000.

Educational and medical gifts: You can pay qualified expenses directly to a medical provider or educational institution on behalf of others without incurring any gift-tax liability. For instance, if your child or grandchild is attending college, pay the youngster's tuition directly to the school. These gifts may be made in addition to the annual gift-tax exclusion.

Cumulative gifts: The amount of any gifts made above the annual gift-tax exclusion may be sheltered by the gift-tax credit. This credit can effectively **shelter** up to \$1 million of gifts. The gift-tax

shelter is reduced by gifts made in prior years that used part of the credit shelter.

Note that your family may also save income tax when you give gifts to other family members. Typically, the income subsequently earned from the gifts is taxed to a family member who is in a lower tax bracket than you are.

For instance, you might decide to transfer income-producing property to a minor child. However, do not overlook the impact of the "kiddie tax." If a child under age 14 receives more than \$1,600 in unearned income in 2004, the excess is taxed at the income tax rate of the child's parents -- regardless of the source of any gifts.

***Year-end planning:** At the end of the year, you can set up a gift-giving program to maximize the tax benefits. For example, you can give \$11,000 to a family member late in December and another \$11,000 to the same person in January. Since the gift-tax exclusion works on an annual basis, both of these gifts are sheltered from gift tax.*

Punch in New Rules for Overtime Pay

As you might have seen in the news, the Labor Department recently revised the rules for overtime pay.

Details: The new rules are designed to make it easier to determine which workers are entitled to overtime pay and which are exempt (i.e., not eligible for overtime pay). For example, employees earning less than \$23,660 a year (or \$455 a week) now automatically qualify for overtime pay regardless of their duties. Under prior law, the threshold was only \$8,060. The new rules also create a new exemption category for highly compensated employees. Essentially, any employee who earns more than \$100,000 a year and regularly performs at least one exempt duty is precluded from earning overtime pay.

The Labor Department also revised the definitions of exempt duties and created new standards for outside salespeople and computer workers. The revised rules went into effect on August 23, 2004.

Supreme Court Restores a Worker's Retirement Benefits

ERISA protection extended after retirement plan amendment

You cannot change the rules of the game after the game has already started. That was essentially the message the United States Supreme Court delivered in a new case affecting a worker's retirement plan benefits (Central Laborers' Pension Fund v. Heinz, Sup. Ct. 02-891, 6/7/04). The worker was protected by the "anti-cutback rule" of the **Employee Retirement Income Security Act (ERISA)** when the company amended its retirement plan.

This new Supreme Court decision, which had been appealed from the Seventh Circuit Court of Appeals, resolves a conflict with the Fifth Circuit Court of Appeals.

Here are the key facts: Thomas Heinz worked in the construction industry in Illinois until 1996. When he retired, he qualified for early retirement benefits through the company's **defined benefit plan**. The arrangement entitled him to the same pension plan payments he would have received if he had retired at the normal retirement age. However, the plan also prohibited employees like Heinz from disqualifying employment after retirement. If they became em-

ployed, benefits would be suspended until they stopped the work.

Subsequently, Heinz was employed as a construction supervisor, which was not included in the plan's original definition of disqualifying employment. However, after the plan was amended in 1998, the definition was expanded to include supervisory jobs. Accordingly, the company suspended Heinz's benefits (the benefits of another worker, who was in the same basic position as Heinz, were also suspended).

Not so fast: In a unanimous decision, the Supreme Court determined that the anti-cutback rule prohibits use of a plan amendment to expand classifications that would trigger suspension of accrued retirement benefits. The Court also ruled that it was reasonable for Heinz to rely on the definition of disqualifying employment at the time he retired. Therefore, the retirement benefits had to be restored.

Lesson to be learned: *The anti-cutback rule of ERISA is essential to protecting the rights of employees. Both employers and employees should take note of this important U.S. Supreme Court decision.*

Facts and Figures

Timely points of particular interest

- ➔ **Broken Dreams** -- While you can avoid tax on a gain under the home-sale exclusion, you cannot deduct a loss. **New case:** A chiropractor tried to build his dream house on a valuable piece of property in Hawaii. But the deal soured and he ended up selling the property to a trust to protect the builder from buying it. The Tax Court ruled that this was a sale of personal property where the chiropractor intended to reside, so the loss is not deductible (Joseph, T.C. Memo 2004-134).
- ➔ **S Corporation Losses** -- S corporations provide numerous tax advantages, including protection from personal liability, but be careful of timing issues. **New case:** The owner of an S corporation filed for bankruptcy before the end of the tax year. Thus, on the last day of the year, the bankruptcy estate owned all the shares. **Result:** The Tax Court ruled that the operating losses must be allocated to the bankruptcy estate (Williams, 123 T.C. No. 8).