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Client Information Bulletin

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How to Write Off Some "Everyday" Expenses

Basic tax rules for claiming home-office deductions

If you run a business from the cozy confines of your home, you may be able to deduct a portion of your everyday living expenses.

How it works: You can deduct home-office expenses if you use a specific area in your home regularly and exclusively as the principal place of your business, a place to meet or deal with customers, clients or patients in the ordinary course of business, or a place to store inventory or product samples. In addition, you may be able to claim deductions for a separate structure (e.g., a detached garage) that is used in connection with your business.

However, you are not entitled to deductions if you simply take work home from your principal place of business. Also, if you are a corporate employee, the home office must be used for the "convenience" of your employer and as a condition of employment.

How do you figure out the tax deductions for a home office? The home is treated as two separate properties -- one used for personal purposes, the other for business.

For simplicity, let's assume you use 10% of your residence as a home office. As a result, you can deduct 10% of your

mortgage interest or rent, property taxes, utility bills (gas and electric), cleaning services, private trash removal costs and property insurance as office-at-home expenses. If you are a homeowner, you are also in line for a depreciation deduction based on 10% of the home's business use.

Of course, you generally can deduct the full amount of your mortgage interest and property taxes anyway. But you are getting a tax bonus for the other everyday living expenses plus a sizeable depreciation deduction.

The percentage may be based on either the square footage in your home or any other reasonable method.

Example: Ms. Smith uses one of eight rooms in her home as an office. The en-

tire home is 2,500 square feet, while the office is 250 square feet. In this case, the percentage Smith can use for her home-office deductions is 12.5% ($\frac{1}{8}$) based on the number of rooms or 10% ($\frac{250}{2,500}$) under the square footage method.

In any event, you cannot use the deductions to create a tax loss. Specifically, your office-at-home deductions cannot exceed the business income derived from the home office less (1) regular business expenses (e.g., supplies, postage, etc.) less (2) the portion of deductions you could claim in any event (e.g., interest and taxes).

Caution: *If you are not careful, you might "taint" your home office with personal use. Consult with a tax professional concerning your own circumstances.*

Serving Up the Roth 401(k) Plan

New plan offers combined benefits

The 401(k) plan and the Roth IRA (individual retirement accounts) are two of the most popular retirement-savings vehicles. A 401(k) plan enables you to defer part of your salary to a tax-advantaged account. With a Roth IRA, participants may be able to take tax-free distributions after five years. It was only a matter of time before these two retirement-planning concepts were combined.

The IRS is now unveiling the Roth 401(k) plan. This hybrid retirement plan, which was actually authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), will become available to participants in 2006.

The IRS recently issued initial guidance on Roth 401(k) plans in the form of pro-

posed regulations. It is expected that additional guidance will be forthcoming.

Basic ingredients: As with a regular 401(k) plan, an employee can elect to defer salary to the Roth 401(k), but in this case the contributions are made on an after-tax basis. There is no current tax on any accumulations within the Roth 401(k). As with a Roth IRA, qualified distributions may be completely tax-free after five years if they are paid:

- ◆ After the recipient reaches age 59-1/2;
- ◆ For a qualifying first-time home-purchase expense;
- ◆ At or after the death of the contributor; or
- ◆ On account of disability.

Distributions from Roth 401(k) accounts will only be permitted to be rolled over into other Roth accounts, whether it is another 401(k) plan or a Roth IRA.

Now the new proposed regulations have established three requirements for Roth 401(k) plans:

1. The employee must make an irrevocable designation of a Roth contribution at the time of the deferral.
2. The employer must treat contributions as taxable compensation, as if the employee had received cash instead.
3. The Roth contributions must be maintained in a separate account. Separate accounting will apply to the contribu-

tions and earnings until all Roth contributions have been distributed.

Most of the usual requirements and rules for qualified plans also apply to Roth 401(k)s. However, unlike the Roth IRA, this contribution option will be available for all plan participants, regardless of the amount of their income. In addition, lifetime distributions from a Roth 401(k) will be mandatory.

***Ultimate question:** Should you elect to use a Roth 401(k) plan when it becomes available? It depends upon your situation and the other resources you are using for retirement savings. It is recommended that you seek assistance from a knowledgeable professional.*

Spotlight on the New Bankruptcy Reform Law

The new bankruptcy reform law recently signed by the President -- the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 -- takes effect on October 17, 2005. The law is quite expansive, but the most widely discussed provision requires certain debtors to pay off credit card charges, medical expenses and other obligations under a court-ordered bankruptcy plan.

Specifically, the new law establishes an income-based test for measuring a person's ability to repay debt. Individuals who have insufficient assets or income can still file a Chapter 7 bankruptcy that, if approved by a judge, eliminates debts entirely after certain assets are forfeited. However, those individuals who have income above the state's median income and can pay at least \$6,000 over five years (i.e., \$100 a month) will be forced into Chapter 13 bankruptcy where a judge will order a repayment plan.

Note: The new law includes various other measures designed to avoid abuses in the system. It is expected to spur bankruptcy filings as the effective date draws near. Seek legal assistance with respect to your particular situation.

Six Ways to Help Finance a College Education

Common loan options available to most families

Are you sending one or more children off to college this fall? The ever-increasing costs are staggering for many parents. Fortunately, there are a number of available financing options that can help ease your current cash crunch.

Here are six common types of loans that may be used to help pay for college expenses.

1. Stafford loans: These government-sponsored loans are available to students, not parents. Currently, first-year students can borrow up to \$2,625 through the Stafford loan program. If a student qualifies for a subsidized loan based on financial need, the government pays the interest while the student is in school. With an unsubsidized loan (i.e., a loan not based on need), the student owes interest on the loan while he or she is in school. However, the student can choose to add the interest to the loan balance, which must be repaid after graduation.

Note that subsidized Stafford loans are considered to be part of the student's overall financial aid package.

2. PLUS loans: This is another type of government-sponsored loan. With a loan under the Parent Loans for Undergraduate Students (PLUS) program, credit-worthy parents may borrow up to the amount of the student's cost of attendance minus any other financial aid. The interest rate for PLUS loans is tied to the three-month Treasury-bill rate (but capped at 9%). Generally, repayments must begin within 60 days of the final loan disbursement.

3. Retirement-plan loans: Certain retirement plans permit you to borrow funds penalty-free if the funds are used to pay for a college education. Although the interest rates may be favorable, you will typically face restrictions on loan amounts and repayments. Most significantly, you will be eroding the nest egg you are trying to build for retirement.

4. Home equity loans: If you have sufficient equity in your home, you may tap into it through a home equity loan or line of credit (where permitted by state law). Remember that the interest paid on the first \$100,000 of home equity debt is deductible as mortgage interest. However, the loan must be secured by your home, so use this technique with discretion.

5. Intra-family loans: In a pinch, you might borrow money from a relative to help pay for college. Be careful to structure the loan properly with a prevailing interest rate and repayment terms. **Reason:** If the IRS thinks the deal is a sham, it might impute interest to the lenders, even if they don't receive any money back.

Fortunately, there are several key exceptions for intra-family loans. First, the imputed interest rules only apply to intra-family loans above \$10,000. Second, for loans of \$100,000 or less, the amount of imputed interest is limited to the borrower's annual net investment income. Finally, if the borrower's net investment income is \$1,000 or less, no taxable interest is imputed on the loan.

6. Life insurance loans: You may be able to obtain favorable terms by borrowing against the cash value of a life insurance policy. However, as with a retirement-plan loan, you are “borrowing from Peter to pay Paul” and potentially jeopardizing another aspect of your financial plan. This option is generally used as a last resort.

Of course, this list is not all-inclusive. It is just meant to provide an overview of some basic options.

Reminder: *Be aware of all of the tax and nontax repercussions when you take out loans to help pay for college expenses. Your financial and tax advisers can point you in the right direction.*

It's Time to Improve Time Management Skills

Increasing productivity through better use of your time

Unlike just about any other resource, time is irreplaceable. Successful business people understand this concept and treat time as one of their most valuable resources. Knowing how to use time wisely increases your productivity and allows you to do “more with less.” As your organization continues to grow, this lesson may enable you to create higher profit through greater efficiency.

Note that different types of time can be used to solve different types of problems.

Uninterrupted time: If you have a complex problem to solve, it's best to take a large uninterrupted block of time to work on it. Sometimes you have to create that block by removing yourself from day-to-day interruptions. Leave the office. Forward your phone calls to voice mail. Then dig into the problem.

Reflective time: This is the time for evaluation. “Am I going in the right direction? Am I using my abilities and resources effectively? How can we improve what we are doing?” Without reflective time, you run the risk of blindly going off in the wrong direction.

Relaxation time: Most people need a change of pace, a time to relax and recharge their batteries. Failure to provide this time can lead to loss of energy and a high level of stress.

Downtime: We spend a large part of our time waiting for things to happen. Think of the time spent traveling to meetings, waiting for appointments, etc. Use this time to do routine tasks such as planning your calendar, revising a report, catching up on required reading, drafting a short memo and so on.

Keeping those differences in mind, here are four ways you might better manage your time:

1. Whenever possible, delegate responsibility, not just tasks.
2. Follow up on results, not details.
3. Collaborate with first-rate people.
4. Use technology to decrease time spent on routine tasks. For instance:

- ◆ Telephone -- it takes less time than writing a letter.
- ◆ Fax -- if you need a written letter, write a short memo and fax it.
- ◆ Word Processing -- save standard letters on the computer.
- ◆ Computers -- use databases, spreadsheets and specialized applications to minimize repetitive tasks.

Last, but not least: Outsourcing is another widely used method of saving time. Your business advisers may be able to provide assistance or make recommendations that make sense for your operation.

Facts and Figures

Timely points of particular interest

- ➔ Improving Performance -- Before you can help other employees develop their skills, you may need to bolster your own. Focus on your ability to diagnose performance -- what factors are critical for your particular operation? In addition, polish up your “mentoring” and “coaching” skills to better provide employees with the benefit of your experience. Tip: The way you have always done things is not always the right way.
- ➔ Flexible Spending Accounts -- If you usually try to empty out your flexible spending account (FSA) before year-end, the government is giving you more breathing room. An employer can now allow the usual deadline for FSAs to be extended by up to 2-1/2 months after the close of the year. Proposed legislation may eliminate this “use-it-or-lose it” feature of FSAs entirely. Updates will be provided to you as soon as possible.