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Client Information Bulletin

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How to Qualify for a Casualty Loss Deduction

Find a silver tax lining if a disaster strikes

It can be a catastrophe if your home or other property is damaged by a storm or some other natural disaster. At least there is a silver tax lining in the dark cloud: You may be able to deduct a **casualty loss** on your tax return. Furthermore, if your property is located in an area that is formally declared by the President to be a **federal disaster area**, you could be entitled to a quick tax refund.

Starting point: The tax regulations say that you can qualify for a casualty loss deduction if damage is caused by an event that is sudden, unexpected or un-

usual. This includes not only natural disasters such as tornadoes, hurricanes and earthquakes, but also automobile collisions and frozen pipes bursting. The same basic rules apply to thefts of your property.

However, you are not entitled to any tax relief for damage occurring over a long period of time, such as damage brought on by a drought.

The amount you can deduct depends on whether the property damaged is personal or business property. For personal property, the deduction is limited to the excess above 10% of your **annual ad-**

justed gross income (AGI) after subtracting \$100 per casualty event. For example, if your AGI is \$80,000 and you suffer a loss to your home of \$20,000, your deduction is limited to \$11,900 [(\$20,000 minus \$100) minus (10% of \$80,000)]. In contrast, there are no such limits for business property. The full amount of the eligible loss can be deducted on the company's return.

The amount that is eligible for the deduction is the lesser of (1) the difference in the property's value before and after the casualty or (2) the adjusted basis in the property. Of course, you must reduce the deductible amount by any insurance proceeds you receive.

Going back to the previous example, let's say that you receive \$10,000 in insurance proceeds for the damage to your home. In that case, your deduction is reduced to \$1,900 [(\$20,000 minus \$100) minus (\$10,000 insurance) minus (10% of \$80,000)].

The IRS often challenges casualty loss deductions, so take a lesson from the Boy Scouts: **Be prepared.** The best proof you can offer is a photograph or videotape of your property, as it currently exists. In other words, obtain documentation before a casualty occurs.

The visual proof can be compelling when coupled with snapshots of the

property immediately after a casualty occurs. To further support your position, obtain an independent appraisal of the damage. The appraisal itself is deductible as a miscellaneous itemized deduction (subject to a 2%-of-AGI floor).

Make sure you claim the maximum tax deductions you are entitled to when you file your 2004 return. Consult with a professional tax assistant to obtain the most from your deductions.

How to Obtain Fast Tax Relief:

Normally, you must deduct a casualty loss on the tax return for the year in which the casualty occurred. For example, if your home was damaged by a storm in 2004, the loss is deductible on your 2004 return. However, if you suffer a loss to property located in a federal disaster area, you can elect to obtain fast tax relief.

***Special election:** The tax law allows you to claim a federal disaster area loss on the tax return for the year preceding the year in which the casualty occurred. Say your home is demolished by flooding in the early part of 2005. You can deduct the loss on the 2004 return you are about to file instead of waiting until next year. If you filed your 2004 tax return prior to the casualty, you can file an amended return claiming the loss.*

IRS Boosts Retirement Plan Limits for 2005

Higher limits for qualified plans that take effect

It happens every year. The IRS makes **cost-of-living adjustments** (COLAs) in certain retirement plan limits based on the current rate of inflation. With inflation staying relatively low, most of the limits have remained the same or increased only slightly in the last few years. However, it's a different story for 2005.

Good news: Almost every threshold is going up this year. The increases are essentially due to the cumulative effect of inflation rather than a one-year upswing. Furthermore, the law has mandated other increases in the retirement plan limits. For instance, the dollar limit for 401(k) plan deferrals jumps from \$13,000 to

\$14,000 under a provision in the **Economic Growth and Tax Relief Reconciliation Act of 2001** (EGTRRA).

The table to the right is a summary of the key retirement plan thresholds.

*Finally, you should be aware that the annual limit for contributions to traditional individual retirement accounts (IRAs) and Roth IRAs is increasing from \$3,000 for the 2004 tax year to \$4,000 for 2005. However, the annual limit on "catch-up contributions" to IRAs remains at \$500. **Note:** You still have until April 15, 2005 to make an IRA contribution for the 2004 tax year.*

	2004 Limit	2005 Limit
Maximum annual dollar benefit for a defined benefit plan	\$165,000	\$170,000
Maximum dollar limit on contributions to a defined contribution plan	\$41,000	\$42,000
Maximum amount of compensation taken into account for qualified retirement plans	\$205,000	\$210,000
Dollar limit for definition of "key employee" in top-heavy retirement plan	\$130,000	\$135,000
Dollar limit for definition of highly compensated employee	\$90,000	\$95,000
Dollar limit for elective deferrals to a 401(k) plan	\$13,000	\$14,000
Dollar limit for elective deferrals to a Savings Incentive Match Plan for Employees (SIMPLE) plan	\$9,000	\$10,000
Dollar limit for elective deferrals to deferred compensation plans of state and local governments and tax-exempt organizations	\$13,000	\$14,000
Dollar limit for catch-up contributions to a 401(k) plan*	\$3,000	\$4,000
Dollar limit for catch-up contributions to a SIMPLE plan*	\$1,500	\$2,000

*Catch-up contributions only permitted for individuals age 50 years or over.

Who Needs a Web Site Privacy Policy

Legal issues abound as Internet commerce increases

As the Internet matures as a vehicle of commerce, it is becoming subject to more and more governmental regulation. While just a few years ago one could put up a web site and not have to worry about the content violating federal and state laws, the climate has changed dramatically.

Case in point: Privacy policies used to be seen only on web sites run by the Microsofts and IBMs of the world. Now, due to governmental regulations, just about every web site should have a posted **privacy policy**.

What is a privacy policy? A privacy policy covers the information the web site collects about users and with whom that information is shared. It describes how users can request changes to the information collected about them. The policy also lists its effective date and describes how the web site will notify users of changes in the policy. Every business that operates a web site that interacts with the public should have a privacy policy that can be accessed with a link from the web site's home page.

What laws affect web site privacy policies? The list of privacy-related laws grows longer every day. Here are some of the major ones:

The Children's Online Privacy Protection Act (COPPA) regulates what information businesses can collect from children under age 13. It generally requires parental consent for collection or use of this information.

The Health Insurance Portability and Accountability Act (HIPAA) regulates what health information can be collected. It applies not only to traditional medical businesses, but also to their "business associates" who have access to medical records such as attorneys, accountants, health plan administrators, consultants and even a physician's transcription service.

Financial institutions and their associates are subject to the regulations of the **Gramm-Leach-Bliley Act**. This law governs the collection and use of financial information. In addition to banks, securities firms and insurance companies, the law applies to credit counselors, real estate settlement services, debt collection agencies and tax return preparers.

The latest addition to these laws is **California's Online Privacy Protection Act**, which went into effect on July 1, 2004. It applies to all web sites that collect personal information from California residents. Since personal information includes a user's name or e-mail address, and any web site on the Internet will attract some California residents, most web sites will be subject to this state law. The California law simply requires web sites to post a privacy policy and to comply with it.

Every business that operates an interactive web site should draft such a policy and post it on their web site with a link to it on the web site's home page. In order to draft a policy, you will need to make a list of all the information that is gathered on the web site, how it is used and who has access to it. Since the

document has legal ramifications, particularly if it is violated, you may want to

have your attorney draft or review it before it is posted.

A New Tax Return Choice for Itemizers

Under the new American Jobs Creation Act of 2004, individual taxpayers have a choice at tax return time -- to deduct their state and local income tax or their state and local sales tax.

For individual itemizers residing in states with relatively high state income tax, taking the deduction for state income tax is generally advisable. Conversely, individuals in states with no income tax or a very low income tax will generally fare better by deducting state sales tax.

How can deductions for state sales tax be substantiated if receipts from early last year have not been retained? The IRS allows taxpayers to deduct (1) the actual sales tax they paid or (2) an amount from an IRS table plus the actual amount for purchases for cars, boats and certain other items. The IRS is providing tables based on state-by-state consumption of residents.

In some cases, it may be beneficial to “bunch” together large purchases in the same year to maximize the deduction for state sales tax. Under the current law, the deduction for sales tax is only available for 2004 and 2005.

Practical advice: Unless there is a clear-cut difference, it makes sense to have the deduction for state income tax compared with the deduction for state sales tax. There is no prohibition against deducting one tax this year and the other tax next year.

Breaking Down Deductions for Buildings Components

How to qualify for faster write-offs under IRS guidance

As a general rule, it takes decades to recoup the full cost of a business building through depreciation deductions. However, in some cases you may be entitled to faster write-offs for parts of a commercial building through a cost segregation process.

Caveat: That is not to say that the IRS will give you free rein to write off components over a short period of time. In fact, it has recently zeroed in on cost segregation studies that may be used by taxpayers to justify faster write-offs. Nevertheless, it is still possible to pass inspection under the latest IRS guidance.

Let's take a closer look. Under the **Modified Accelerated Cost Recovery System** (MACRS), the cost recovery period for a commercial building is 39 years. On the other hand, personal property may be written off over just five years if the property has a useful life of five to nine years. A seven-year period may be used for property with a useful life of 10 to 15 years. As a general rule, personal property is defined in the regulations as tangible depreciable property (other than buildings and their structural components) used in special industries, such as transportation and communica-

tions, and several other specialized types of property.

Several recent court cases have held that parts of a commercial building may be treated like personal property if they relate only to the equipment used in a business located in the building instead of maintenance or operation of the building. This may include components such as electrical systems, plumbing systems in restaurant kitchens and removable carpeting.

Since the write-off periods for components often depend on the use of the building, taxpayers may commission tax professionals and other experts to provide cost segregation studies that break down the write-off periods for various components. Now the IRS has issued a 115-page **Audit Techniques Guide** (ATG) to help its agents determine when a cost segregation study is up to snuff. The new ATG is available to the general public at the IRS web site.

If you think you may qualify for depreciation faster, it is important to obtain professional assistance. Depending on your situation, you may be able to re-classify certain components and file amended returns for certain years.

Facts and Figures

Timely points of particular interest

- ➔ Dealer versus Investor -- A taxpayer who was in the business of commercial real estate purchased a Colorado property through a pass-through entity. The entity was formed solely to hold property for appreciation and resale. To determine if the taxpayer was a dealer or an investor for this particular sale, the Tax Court examined the reasons for the acquisition, the activities in connection with the property (e.g., making improvements and advertising the property for sale) and other factors. Result: Since the taxpayer qualified as an investor, the gain was treated as long-term capital gain.
- ➔ Performance Reviews -- Typically, business managers hold performance reviews with employees at the beginning of the year; it is also a good time to discuss a wide variety of issues. Note that these reviews should not be a one-way street. Suggestion: Ask employees what type of training can help improve their skills and what the company can do to improve their performance. Then listen to the responses and respond accordingly.