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Client Information Bulletin

INSIDE

**Manufacturing Deductions:
IRS Takes First Step Forward**

**How to Secure
A Comfortable Retirement**

**Involuntary Payouts:
New Rules for Trigger Rollovers**

**When the Software Police
Suspect a Crime**

Facts and Figures

Three Key Rules for Vacation Home Deductions

How to maximize tax benefits on rentals

A vacation home can be more than just a place to get away from the hubbub of daily living. If you own, say, a cottage at the beach or a cabin in the mountains, the home can be a valuable source of income tax deductions. Typically, you can deduct property taxes as well as your mortgage interest (assuming the combined acquisition debt on your main home and your vacation home does not exceed \$1 million).

Hypothetical situation: Suppose you rent out your vacation home when your family is not using it. The rental income you receive can offset some of the costs of ownership. Of course, the income is

taxable, but you may claim offsetting deductions for a portion of your expenses. For instance, if you rent out the home for 75% of the time and use it personally for 25% of the time, you can deduct 75% of your insurance, repair costs, depreciation on the home and so forth.

Now let's say you are running a loss on the rental -- your rental-related expenses (including mortgage interest and property taxes allocable to the rental) exceed the income you receive. Now things get a little more complicated. Under the **passive activity loss rules**, you can only use losses from a rental activity to offset losses from other passive activities.

However, if you are an active participant in the rental (e.g., you make management decisions), the tax consequences depend on your income level and the level of your family's personal use.

There are **three basic rules** to follow:

1. If your income does not exceed \$100,000, you can use the loss to shelter up to \$25,000 of your salary and other income as long as you keep your personal use to a minimum. Your family's personal use cannot exceed the greater of 14 days or 10% of the rental time. **Downside:** When you keep your personal use below these limits, you lose a portion of your mortgage interest deduction (the portion allocable to your personal use).

2. If your income exceeds \$150,000, the tax law says you cannot qualify for the \$25,000 loss write-off. Your total rental deductions basically cannot exceed your rental income, regardless of the amount of your personal use. However, if your personal use is greater than 14 days or 10%, you get an additional deduction: the portion of your mortgage interest you do not claim as a rental expense.

3. If your income is between \$100,000 and \$150,000, things are not so clear-cut. The \$25,000 loss write-off is gradually phased out in this income range. The closer you are to the \$150,000 level, the more likely it is you will get little in the way of a loss write-off. So you will probably want to increase your personal use -- the same strategy for those with incomes above \$150,000. **Result:** You will be able to deduct more of your mortgage interest.

On the other hand, if you are closer to the \$100,000 level, most of your loss write-off will be intact. So you should try to keep your personal use below the 14-day/10% mark.

Note that there is a unique tax opportunity if you rent out the home for two weeks or less during the year. You do not have to report any income or expenses on your personal tax return. **Result:** All of the rental income is effectively tax-free.

The rules in this area can be tricky, so be careful to maximize the annual deductions on your tax return. A tax professional can provide the necessary assistance.

Manufacturing Deductions: IRS Takes First Step Forward

New ruling provides interim guidance on new deductions

The massive 2004 tax act -- the **American Jobs Creation Act of 2004** -- created a new tax deduction for certain manufacturing operations. The manufacturing deduction can be claimed by business entities such as C corporations, S corporations, partnerships and sole proprietors. Now the IRS has issued interim guidance providing several safe harbors for small businesses.

Background: For 2005, a qualified domestic producer can deduct 3% of the lesser of its taxable income from production activities or its taxable income (modified adjusted gross income for individual taxpayers) without regard to the deduction. The deduction percentage increases to 6% in 2007 and tops out at the 9% level in 2010. Therefore, if your company is taxed at the top corporate

rate, the deduction will eventually translate into a tax cut of roughly 3%.

However, the annual deduction is limited to 50% of the W-2 wages paid during the tax year. Your company can use one of three methods for computing the W-2 wages.

Note that income from qualified production activities must be reduced by allocable costs and deductions. The IRS has developed several methods for allocating costs and deductions, other than cost of goods sold, to production activities. The new notice features a simplified formula for certain small businesses (i.e., average annual receipts of \$25 million or less). Under the simplified method, deductions may be ratably apportioned based on relative gross receipts.

What types of companies qualify for the deduction? The list includes, but is not necessarily limited to, the following activities:

- ◆ Software development;
- ◆ Music recordings and film production;
- ◆ Electrical and natural gas;
- ◆ Unbottled drinking water production;
- ◆ Engineering and architectural services; and

◆ Construction.

The IRS has announced it will provide additional guidance for these activities, particularly construction activities, in forthcoming regulations.

To qualify for the deduction, production activities must be performed in whole or in significant part, in the United States. As a general rule, this requirement is met if the activity is substantial in nature. The determination of whether the activity is substantial depends on the particular facts and circumstances. The IRS says it will weigh factors such as the relative value added by the activity, the nature of the property and the nature of the activity performed by the taxpayer in the U.S.

To ease administrative hassles for small businesses, the IRS has established this safe-harbor rule: As long as your labor and overhead costs for the manufacture, production growth and extraction of the property equals at least 20% of the total cost for the property, it will be treated as being manufactured in significant part.

Final note: Remember that the new notice is only intended to provide interim guidance. We will keep you posted on further developments.

How to Secure a Comfortable Retirement

Avoiding potential obstacles in your path

What's your fondest wish for the future? For many couples nearing the end of their working careers, it is a safe and secure retirement. And if you have been diligently setting aside money for your retirement years, it is a reasonable objective that can be achieved.

However, before you can retire to the lap of luxury, you must overcome several potential obstacles. For example:

- ◆ Retirement is costly. It has been estimated that you will need about 70%-80% of your current income to maintain a similar standard of living

in retirement. Although Social Security benefits may provide some relief, that will not be enough on its own. In fact, there is a great concern that the growing number of baby boomers who will become eligible for Social Security over the next few decades will place an unmanageable strain on the younger workforce. **Note:** At this writing, proposals to revise the Social Security system are being considered.

- ◆ You could outlive your assets. Due to medical advances and increased education about healthy living, life expectancies have been on the rise. Currently, Americans are expected to live around 20 years on average in retirement -- maybe more. If you do not have a retirement plan that can provide a stream of income, you might exhaust all of your funds.
- ◆ Health insurance costs keep escalating. There is no end in sight to spiraling health care expenses. Considering the growing number of aging Americans, it is important to ensure you have adequate coverage to last through your retirement years. Medicare alone probably will not do the trick.

- ◆ Inflation can return in full force. Since inflation has been relatively low the last few years, it is easy to forget its potential impact. Inflation can affect your purchasing power and your standard of living. Just remember the rampant inflation of the 1970s and 1980s. Furthermore, even without a period of double-digit inflation, the cost of goods and services generally increases over time.

Begin by taking advantage of tax-advantaged retirement-planning vehicles such as qualified retirement plans and traditional individual retirement accounts (IRAs) and/or Roth IRAs. Allow for emergencies and other big-ticket expenses like a child's college education. Complement your retirement plans with a sound investment plan that balances your need for income during retirement with your personal tolerance for risk.

Remember that Social Security benefits may be used to complement your other income sources, but they should not be your primary means of support.

Bottom line: *Don't wait until it's too late to address these issues. Retirement planning isn't a luxury; it's a necessity.*

Involuntary Payouts: New Rules Trigger Rollovers

If you switch jobs, you may be required to take an involuntary payout from your old company's qualified retirement plan. **Good news:** Under a new IRS ruling, certain payouts must be automatically rolled over into an individual retirement account (IRA), avoiding any current tax on the distribution.

The new ruling clarifies an obscure provision in the 2001 tax act that finally took effect on March 28, 2005.

Basic premise: When you have "separated from service," your employer can distribute the nonforfeitable benefits without your consent if the present value does not exceed \$5,000. If you do not roll over the funds to an IRA (or other qualified plan), you are taxed on the involuntary payment.

However, if you directly roll over the funds to an IRA, you do not have to pay any current tax. The funds can continue to accumulate tax-deferred until they are withdrawn. Mandatory distributions from the IRA do not have to begin by April 1 of the year following the year in which you turn age 70-1/2.

The new ruling establishes an automatic rollover to an IRA as the default option for involuntary payouts between \$1,000 and \$5,000. Alternatively, you can elect to have the amount rolled over to another qualified plan or receive a direct distribution from the plan.

Note: Employers generally have until the end of 2005 to establish administrative procedures for these rollovers.

When the Software Police Suspect a Crime *How to protect against invasive audits*

Knock, knock: It's the software police. Increasingly, business owners and managers are being accused of unauthorized software use by organizations such as the Business Software Alliance (BSA) or the Software and Information Industry Association (SIIA). These organizations represent many of the major developers and licensors of software products and they are out to protect the interests of their members.

Frequently, calls from the "software police" originate with complaints from a disgruntled employee or former worker to the BSA or SIIA. Once the organization has been notified of an alleged violation, it may pursue litigation and statutory damages reaching up to \$150,000 for a willful infringement of an individual copyright. The accused party generally submits to an audit of its computers and agrees to disclose the results.

The audit process, which tries to make sense out of complex licensing documentation, can be quite lengthy. It may involve accounting for software acquired through a variety of sources, including software bundled on personal computers; resellers; online purchases; off-the-shelf purchases at stores; and software obtained through company mergers and acquisitions. Your company may enlist the aid of both legal and technology experts to avoid paying unnecessary fees and penalties.

Frequently, a business owner subject to an audit chooses to settle the case instead of litigating to avoid imposition of infringement penalties and higher attorney's fees. Any negotiations with respect to a settlement are critical for developing a measure for future licensing activities.

How can you protect your company from these dire results? It is generally recommended that you perform self-

audits periodically -- for instance, at least once a year. In addition, education about software licensing and documentation should be part and parcel of the training requirements for employees, especially for those involved in information technology practices and procedures. Finally, you may find it helpful to

create a written corporate policy concerning software use.

***Be on guard:** Increasing awareness through education and written procedures will provide some security if you are ever summoned by the software police.*

Facts and Figures

Timely points of particular interest

➔ **Whistle Stop** -- Generally, the IRS has discretion for rewards granted to whistleblowers. **New case:** A taxpayer claimed to have exposed the largest bank fraud in United States history, but he was rebuffed when he sought a reward from the IRS. Now the Court of Federal Claims has sided with the IRS. **Reason:** The complaint did not allege that any tax laws were violated or that the information led to the collection of additional taxes. Finally, no agreement with the IRS was ever signed.

➔ **The 90/10 Rule** -- Do your office meetings often deteriorate into finger-pointing or bickering? To focus on more productive issues, you might follow the "90/10 rule." Proponents of this method say that supervisors should meet weekly to review the 90% of the projects and tasks that are proceeding smoothly and then look at the 10% that are problematic. The concept is to stay focused on the positive business aspects.