



DYER & ASSOCIATES, P.C.

Certified Public Accountants

10415 Armory Avenue

Kensington, MD 20895

(301) 654-6200 FAX: (301) 692-1990

April 2006

Client Information Bulletin

INSIDE

**What to Do If Your
Hard Drive Crashes**

**New Tax Blueprint for
Manufacturing Deductions**

**Four Ways to Solve
Business Problems**

**Through the Years:
A Focus on Retirement**

Facts and Figures

There's No Place Like Your Tax Home

Realizing tax-free income for a qualified home sale

Over the last few years, the government has chipped away at some of the biggest tax breaks for individuals, but there is at least one monument still standing: your home. During the period when you own a home, it can be a source of valuable tax deductions for mortgage interest and property taxes. **Even better:** If you sell the home at a huge profit, you may be able to pocket all or most of the gain from the sale tax-free.

By making a special election on your tax return, you can exclude from taxable income up to \$250,000 of gain from the sale of your home. If you are married and file a joint return, the maximum exclusion

amount would be \$500,000. **Background:** To qualify for the \$250,000/\$500,000 home-sale tax break, the home must have been owned by you and used as your "principal residence" at least two of the five years prior to the sale.

This special tax exclusion does not apply, however, if you sold another qualified principal residence within the last two years. (Theoretically, you could qualify for the home-sale exclusion every two years.)

Keeping that in mind, here are some of the finer points of the home-sale exclusion:

- The home may be used as your principal residence for any two of the last five years. The years do not have to be consecutive. Moreover, you can meet the “use” and “ownership” requirements in different tax years.
- If you file a joint return, you can claim the maximum exclusion if (1) either spouse meets the two-year ownership test, (2) each spouse meets the two-year use test and (3) neither spouse has elected the exclusion within the last two years. This is particularly important to remember if you have recently divorced or remarried.
- In order to meet the “use” requirement, you must physically occupy the home, but short absences won’t count against you. On the other hand, a longer absence, such as a one-year sabbatical by a college professor, does not count as time that the home is being used as your principal residence.
- If you own two homes and live in both places during the year, the home where you stay for most of the year is generally treated as your principal residence. For instance, if you spend seven

months at a winter home and five months at a summer home, the winter home is considered to be your principal residence.

- To the extent that the home has been used for business or rental use -- including using a portion of the residence as a home office for your main business or a sideline activity -- you must recapture depreciation deductions attributable to the period after May 6, 1997. The recaptured income is taxed at a maximum rate of 25%.

***Caveat:** This is just a general overview of the rules. It is strongly recommended that you consult with a professional tax adviser concerning the home-sale exclusion and other tax ramifications for your principal residence.*

What to Do If Your Hard Drive Crashes

Improving chances of recovering lost data

This could be your worst nightmare: You are working on an important project and your personal computer crashes. Your initial prognosis is that all the vital information has been lost and you don't have any adequate backup. First things first: Don't panic. It is too late to figure out what you should have done, so you should focus on what to do now.

Starting point: Shut down your system right away if you suspect the hard drive has crashed. Instead of going through the usual shutdown procedures, simply pull the plug out of the socket or power cord. Don't attempt to run off-the-shelf data recovery software or drive utilities. These applications may assume the drive is functioning properly and could increase the risk of permanent data loss.

The next step is usually the most important one. Contact a data recovery professional immediately. Of course, you'll have to pay a fee for these services. Typically, you won't be charged an evaluation fee if you have a standard IDE (integrated drive electronics) hard drive in place. Most companies only charge such fees for complex RAID (redundant array of independent disks) and network server drives. The quality of the service you receive will vary, so do your homework on the available firms.

Once you have settled on a firm, be prepared to answer the following questions relating to your hard drive failure:

- What is the size of the drive?
- What operating system are you using (e.g., Windows XP)?

- What happened just before the drive stopped working?
- Is the drive recognized by the computer's BIOS (basic input/output system) or not?

Generally, the data recovery firm will determine what recovery solution will be necessary. Normally, the drive will be scanned in an attempt to repair the file system corruption. In some situations, a partition can be repaired and the drive restored to its previous status. If this isn't possible, a low-level scan can be performed that essentially searches every sector of the hard drive for files.

Once the files are located, they can then be copied to the media of choice such as a recordable DVD or another hard drive. The recovery can take up an enormous amount of time, especially if the drive is on the verge of physical failure. It's not unusual for this to take one day of scanning and another day for recovering the found files. **Caution:** If you are computer-savvy, you may obtain the necessary software yourself. But remember the old adage, "You get what you pay for." Also, be especially wary of software that can overwrite the damaged disk.

If the drive has suffered a physical failure, the recovery procedure will be even more daunting. A critical element in recovering data from a physical failure is having the necessary parts to have the drive function again. If the electronic circuit board has failed, you must have the exact same circuit board on hand to retrieve the necessary circuit components for replacement. Suffice it to say that this is a job best left to the experts.

Peace of mind: If you have installed a comprehensive back-up system, you may generally avoid a potential catastrophe.

It is best to opt for a system that automatically backs up your critical data.

New Tax Blueprint for Manufacturing Deductions

Proposed regulations clarify previous IRS guidance

The IRS recently issued a comprehensive set of regulations on the new “manufacturing deduction” for certain business concerns. These new regulations expand on the initial guidance provided under a previous IRS notice. Specifically, the new proposed regulations clarify the tax rules in the following areas:

Qualified production activities income: The new proposed regulations clarify the methodology for computing qualified production activities income (QPAI). For instance, if gross receipts and corresponding expenses occur in different tax years, the taxpayer’s accounting method will determine when the receipts and expenses should be taken into account.

However, there is no relief from the requirement of applying QPAI on an item-by-item basis. If a company’s product does not qualify as an item, the company can still treat any portion of the product that meets the requirements as an item in determining QPAI.

Wage limits: The new deduction is limited to 50% of a taxpayer’s W-2 wages. Under the proposed regulations, payments to independent contractors, self-employment income and guaranteed payments made to partners are not included in the computation of W-2 wages. Furthermore, the same W-2 wages cannot be claimed in different tax years or by different taxpayers.

Domestic production gross receipts: The new regulations also establish standards for calculating domestic production gross receipts (DPGRs). Taxpayers may use any “reasonable” method of allocating gross receipts that accurately identifies those receipts. However, if a taxpayer is able to use a method specifically identifying where an item was manufactured without incurring significant costs, the taxpayer must use that method.

Installation activities: There has been considerable confusion concerning the installation of qualifying production property (QPP). If a taxpayer manufactures, produces, grows or extracts QPP and installs the property while still owning it, the gross receipts from the activity count as DPGRs. However, if ownership is transferred to another party before the property is installed, the gross receipts will not qualify.

Construction activities: Under Notice 2005-14, a taxpayer can qualify for the Section 199 deduction for construction activities if it meets certain standards under the North American Industry Classification System (NAICS). The new regulations allow a taxpayer to qualify even if the construction activity is not its primary business activity. In addition, the regulations ease the safe-harbor rule for tangible personal property sold as part of a construction project. **New rule:** If gross receipts derived from non-construction activities com-

prise less than 5% of the total gross receipts from a construction project, the total gross receipts count as DPGRs from construction.

Engineering and architectural activities: Only engineering and architectural services relating to real property can qualify for the manufacturing deduction. The regulations specifically require taxpayers performing these types of services to be regularly engaged in them, according to the NAICS codes.

Until the new regulations are finalized, taxpayers may rely on either the proposed regulations or the previous IRS Notice. Thus, your business may be able to choose the optimal approach for a given situation.

Four Ways to Solve Business Problems

Business managers have to be problem-solvers in order to be successful in that position. Although every problem must be addressed separately, you can improve the odds in your favor by following these four simple guidelines:

1. Develop multiple solutions. Consider at least one “backup plan” if your optimal approach can’t or won’t work.
2. Weigh the pros and cons for each alternative. Consider all the pertinent factors that might have an impact. Discard the solutions that have numerous downsides.
3. Do a cost analysis for the most promising solutions. Make sure that the ultimate tab -- including time as well as money -- is less than the cost of the problem itself.
4. Search for the “winning” solution. Adopt the plan that produces the best overall results, taking all perspectives into account.

Of course, there’s no absolutely foolproof way to solve problems, but a healthy dose of common sense certainly goes a long way.

Through the Years: A Focus on Retirement

Planning for a comfortable lifestyle

No matter when you plan on actually retiring, you should make the necessary preparations for sustaining a comfortable lifestyle. To help meet this objective, consider these ideas at different stages of your life.

40-25 years to go: During your prime working years, it’s important to maximize contributions to qualified retire-

ment plans. For example, you may be able to defer part of your salary to a 401(k) plan where the employer matches your elective contributions in whole or in part. You may also be able to contribute to a traditional IRA (individual retirement account) or Roth IRA -- or both.

20 years to go: You might want to concentrate on growth investments, which have historically produced relatively high returns. Of course, past performance is no guarantee of future results. Seek diversification within your portfolio.

10 years to go: If you have not been able to save much in your retirement plans, you should step up your contributions at this point. In addition, if you have been focusing on growth investments, you may want to shift more of your portfolio to fixed-income investments. **Caveat:** Assuming you are in reasonably good health, you still need to invest for the long haul.

5 years to go: It's time to start considering where you want to retire. Try to scout out several locations. If you qualify, you may be able to permanently exclude from tax up to \$500,000 of home-sale gain (\$250,000 if you are single). This may affect your decision along with health concerns, location near family, etc. (See page 1.)

4 years to go: The flip side of estimating income is figuring out your expenses. If you are like most people, some expenses (e.g., clothing, taxes and housing costs)

are likely to decrease in retirement. But others may increase, particularly if you hope to travel extensively. Develop a budget that will suit your needs.

3 years to go: Obtain an estimate of your Social Security benefits that you will receive in retirement from the Social Security Administration. If you expect to keep working on a part-time basis, remember that you may forfeit some Social Security benefits.

2 years to go: Your portfolio can probably be fine-tuned. Make the necessary adjustments based on your estimates for income and expenses in retirement.

1 year to go: The biggest decision that remains concerns your retirement plan distributions. Typically, you will be in line to receive either a lump-sum distribution or annuity-type payments. If you opt for a lump sum, you can roll over the proceeds tax-free to an IRA (assuming certain requirements are met). Then you can take out the money as needed (but withdrawals generally are required after reaching age 70-1/2).

At every stage of life, planning is essential. Construct a plan that takes contingencies into account.

Facts and Figures

Timely points of particular interest

- **Religious Training** -- Can you deduct the cost of tuition paid to send a child to parochial school? In a new case, the Tax Court denied a charitable deduction claimed by parents for that purpose. The parents argued that a portion of the cost was deductible because it represented religious instruction. However, the Tax Court disagreed. Reason: The tuition was paid because the parents expected a substantial benefit in return.
- **Minority Interests** -- Buy-sell agreements are not just for major stockholders or partners in a partnership. The same principles can also be applied to minority shareholders who are valued employees such as the company's top salesperson or a fast-rising vice-president. The formula and other terms of the buy-sell agreement should be ironed out by a professional before you give up any shares of your company.