



## DYER & ASSOCIATES, P.C.

Certified Public Accountants

10415 Armory Avenue

Kensington, MD 20895

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

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# Client Information Bulletin

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## Key Provisions in the Hurricane Katrina Law

*Creates tax breaks for victims and charitable donors*

The tax relief passed by Congress soon after Hurricane Katrina -- the Katrina Emergency Tax Relief Act of 2005 -- creates a wide array of tax breaks for victims of this natural disaster as well as charitable-minded taxpayers. Here is a roundup of the key provisions in the new law.

**Casualty losses:** Generally, individuals can deduct personal casualty losses only to the extent they exceed 10% of adjusted gross income (AGI) after subtracting a \$100-per-casualty floor. The new law removes these limits for losses arising as a result of Hurricane Katrina.

**Retirement plan withdrawals:** If you withdraw funds from a qualified retirement plan or an individual retirement account prior to age 59-1/2, you must pay a 10% penalty tax on top of regular tax, unless a special exception applies. Katrina victims can withdraw up to \$100,000 penalty-free before January 1, 2007. Also, qualified distributions are not subject to the usual 20% withholding requirement. Finally, taxpayers effectively have three years to complete a rollover of these funds to avoid regular income tax liability.

**Retirement plan loans:** The new law authorizes maximum plan loans of up to

\$100,000 -- instead of the usual \$50,000 limit -- for Katrina victims. This provision affects loans made after August 24, 2005, and before January 1, 2007. The due date for repayment for outstanding loans, as well as these new loans, is extended by one year. Other provisions ease the rules for hardship withdrawals.

**Shelter provisions:** For 2005 and 2006, homeowners and renters who take in evacuees free of charge for at least 60 consecutive days can claim a \$500 deduction per evacuee. The total deduction is capped at \$2,000.

**Itemized deductions:** Generally, deductions for charitable donations are limited to 50% of the taxpayer's AGI. The new law eliminates this limit for donations to qualified organizations as well as the reduction of deductions for charitable gifts made by high-income taxpayers. These tax breaks apply to contributions made after August 27, 2005, and before January 1, 2006.

**Charitable travel:** The normal statutory mileage rate of 14 cents per mile for charitable driving is increased for volunteer work related to Hurricane Katrina. It is set at 34 cents per mile for travel from September 1, 2005 through December 31, 2005 (70% of 48.5 cents) plus related tolls and parking fees.

**Corporate donations:** A corporation can generally deduct charitable contributions up to 10% of its taxable income for

the year. The 10% limit is waived for corporate donations made before the end of the year. In addition, C corporations can claim enhanced deductions for qualified donations of food, books and inventory to the needy. The new law extends this tax break to S corporations, partnerships and sole proprietors for donations made before 2006.

**Work credits:** If your company hires workers from a certain disadvantaged group, it may qualify for the **Work Opportunity Tax Credit (WOTC)**. The WOTC is generally 40% of the first \$6,000 of wages paid to a targeted group member in the first year of employment. The new law creates a new target group of "Hurricane Katrina employees" who were domiciled in the core disaster area. It can be claimed for individuals hired to work in the core disaster area before August 28, 2007.

In addition, a brand-new tax credit is available to small employers in the core disaster area who keep employees on the payroll. This employee retention credit is equal to 40% of the first \$6,000 of wages paid to eligible employees after August 28, 2005, and before January 1, 2006. To qualify, the business must have employed no more than 200 employees on average during the tax year.

***Final note:** The IRS is expected to provide additional relief in the wake of this natural disaster. We will keep you posted.*

## New 401(k) Plan Options at Work

*Added features for participants now available*

According to the most recent available figures, almost 50 million workers are participating in 401(k) plans. The total assets in these plans have almost reached the \$2 trillion mark. Now several recent changes in the landscape are enhancing the benefits already available through 401(k) plans.

**Background:** In the typical 401(k) plan setup, an employer allows participating employees to contribute part of their salary to the 401(k). Each employee determines the amount he or she will contribute to the plan, within certain limits. (The maximum dollar amount allowed for 2006 is \$15,000.) Then the funds are invested on behalf of the employees. Since the money is set aside on a regular schedule (e.g., amounts are deducted from your paycheck), this is a relatively painless way to plan for retirement.

Although the employer is not required to provide additional funds, it may choose to do so in a matching plan (e.g., contributing 50 cents for every dollar deferred). Furthermore, “catch-up” contributions are permitted for employees who are age 50 or over. For example, in 2006 you can add up to \$5,000 more to the pot if you qualify.

Note that a 401(k) plan must benefit employees in general. It may be disqualified if highly compensated employees contribute a disproportionately higher amount than lower-paid employees. Withdrawals from the plan can be made when an employee separates from service or due to death or disability. Other-

wise, withdrawals before age 59-1/2 are generally subject to a 10% tax penalty plus regular income tax.

In the last few years, a few new features have increased the viability of 401(k) plans for employers and employees. The following are some examples:

- ❖ **“Solo” 401(k) plans** for small businesses have increased as administrative costs have been reduced.
- ❖ An employer may institute an **“automatic” enrollment program** to ensure that the company meets certain participation requirements under the law.
- ❖ **Safe harbor plans** have been designed to reduce the strict compliance burdens facing employers. These plans allow you to bypass complex testing procedures and permit highly compensated employees to maximize their contributions.
- ❖ A new Roth IRA (individual retirement account) feature may be added to an existing plan that enables 401(k) plan participants to make “qualified distributions” free of any income tax. This new feature -- called the **Roth 401(k) plan** -- first becomes available on January 1, 2006 (although the tax law provision authorizing this plan was enacted in 2001).

*Which option, if any, is best for you and your company? It depends on your circumstances. With professional assistance, you can make informed decisions concerning your plan.*

# IRS Clarifies Estimated Tax Rules for Couples

*New regulations provide new guidelines to follow*

The IRS recently replaced obsolete regulations relating to estimated tax payments with a set of brand-new regulations. Although the new regulations do not impose any new requirements, they clarify the tax treatment for certain married couples.

**Background:** You are required to pay your annual income tax in quarterly installments or through payroll tax withholding (or a combination of both). The quarterly due dates for the tax payments are April 15, June 15, September 15 and January 15 of the following year (or the following business day if the due date falls on a weekend or holiday).

If you do not meet these requirements, you may be liable for an estimated tax penalty. However, no penalty is imposed if you qualify under a special “safe harbor” rule. For example, you can avoid the penalty if your estimated tax payments equal at least 90% of the current year’s tax liability or 100% of the prior year’s tax liability (110% if your adjusted gross income for the prior year exceeded \$150,000).

Under the new regulations, taxpayers may make joint estimated tax payments, even if they are living apart. However, married taxpayers are not allowed to make joint payments if --

1. They have a decree of separate maintenance or divorce;
2. They use different tax years; or
3. One spouse is a nonresident alien (and they have not filed a proper election).

Once estimated tax has been paid jointly, a husband and wife may still elect to file separate returns. If they file separate returns, they may apply the payment to one of the returns only or they can choose to divide it between the two returns. If the couple cannot agree on the division of the payment, it will be allocated to each of them based on the separate returns filed.

If one spouse dies during the tax year -- after the joint payment of estimated tax -- the estate is not required to make further estimated tax payments. However, the surviving spouse will have to make any later installments as required. The surviving spouse may continue to calculate the payments based on a joint return.

**Facts and circumstances test:** The new regulations also indicate that estimated tax payments should be calculated based on the facts and circumstances known to the taxpayer at that time. In other words, absent any extenuating situations, income from employment and other sources that were reasonably predictable in the past should be assumed to continue on a predictable basis for the remainder of the tax year. Self-employed individuals should estimate credits and deductions based on the best available information from their business.

**Caution:** *This area of the tax law is filled with pitfalls for the unwary. Be sure to seek professional tax assistance.*

### Leasing Equipment to Your Own Company

If you lease personal property to your company, the company can write off the lease payments as business expenses. The rent is taxable to you, but it can be sheltered by deductions such as depreciation, repairs and the like. In a new case, one taxpayer was even allowed to claim a tax loss on the deal.

**Facts of the case:** An attorney began leasing equipment he owned personally -- computers, furniture and audio-visual equipment -- to his law firm. Over a six-year period, he received rental payments from the firm totaling approximately \$1 million. During this time, the attorney claimed depreciation deductions on the leased equipment.

In the following two tax years, the law firm had no income and was unable to pay rent, generating a loss from the leasing activities. Ultimately, the leasing activity did not prove profitable, primarily because of those losses.

The IRS said the losses were "hobby losses" that could not be deducted in excess of income from the leasing activity. However, the Tax Court disagreed.

**Bottom line:** The attorney followed his tax adviser's advice in setting up the arrangement, used the equipment exclusively in the law practice, maintained knowledge about the equipment and collected rent consistently. So the deductions were allowed.

## Protecting Your PC from Identity Theft

*Simple precautions are encouraged by the FTC*

The Federal Trade Commission (FTC) recently launched an initiative to educate personal computer (PC) users about protection from identity (ID) theft. For instance, a hacker can use your information to obtain credit or open new accounts. ID theft also hurts your credit rating if the criminal defaults on a loan or a credit card, fails to pay cell phone bills or writes bad checks. It can take years to fix the damage.

Identity thieves can easily steal the information used for creating common passwords. Or they might also use a Trojan Horse program to invade your PC and take over its Internet connection. You could be contacted as part of a criminal investigation -- even though you have done absolutely nothing wrong. Fortunately, there are several

simple steps you can take to protect your privacy:

- ❖ **Use antivirus software.** It identifies infected e-mail attachments and other virus carriers before they have a chance to do any real damage.
- ❖ **Regularly update the software.** Since new viruses are constantly emerging, make sure that you implement the updates provided by the software provider.
- ❖ **Vary passwords.** Do not rely solely on common passwords such as your mother's maiden name or a pet's name. The hackers have access to programs that can easily crack your passwords. Better passwords avoid personal information; they combine random numbers and letters with at least eight characters.

- ❖ If you have a high-speed connection, **install a personal firewall**. This software blocks hackers who attempt to gain access to your files.
- ❖ **Be suspicious of unsolicited e-mail**. Viruses often are sent as attachments, so hackers may attempt to use e-mail to get personal information by pretending to be an Internet Service Provider (ISP) or some other vendor.
- ❖ Always **confirm the identity of the sender** before opening attachments.

Also, avoid sending personal information through e-mail. If necessary, verify that an e-mail request for sensitive material is legitimate before you share it with others.

*The FTC, as well as some of the major security software vendors, also offer security information for consumers. You can obtain the information by accessing their web sites.*

## Facts and Figures

### *Timely points of particular interest*

- **Social Security Tax** -- The IRS recently announced the annual increase in the Social Security wage base. For 2006, the first \$94,200 of wages will be subject to the 6.2% old age, survivors, disability insurance portion of the tax (up from \$90,000 for 2005). Wages above that amount are still subject to the 1.45% Medicare Hospital Insurance portion of the tax. **Note:** The Social Security tax is paid by both employers and employees.
- **Split in Two** -- Sometimes two heads are better than one, so why not two groups? When you conduct the next “brainstorming” session with managers and key personnel, you might split the attendees into two groups to solve the same problem. Although there will be some duplication, management experts suggest you will receive a greater number of viable ideas.