

CPA CLIENT

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TAXLETTER

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It's January 1: Where's My Roth Designated 401(k)?

We first introduced you to the newest tax-favored savings vehicle—called the Roth designated 401(k) account—last summer, and now its time has come.

Although Congress created the Roth designated 401(k) in 2001, these accounts were not scheduled to become "legal," so to speak, until January 1, 2006.

If you are an employer, you may want to add these plans to your benefits array to retain or attract your higher paid employees. If you are an employee, you should check to see whether your employer has made these plans available to you.

A Roth designated 401(k) allows employees to elect to treat all or part of their 401(k) contributions either as regular tax-exempt contributions or as post-tax "Roth" contributions. The Roth contributions are included in the employee's taxable income when contributed, but the earnings grow tax-free. However, employer matching contributions cannot be designated as Roth contributions and will be treated as being contributed to the non-Roth portion of the employee's 401(k) account.

Who would want a Roth designated 401(k)?

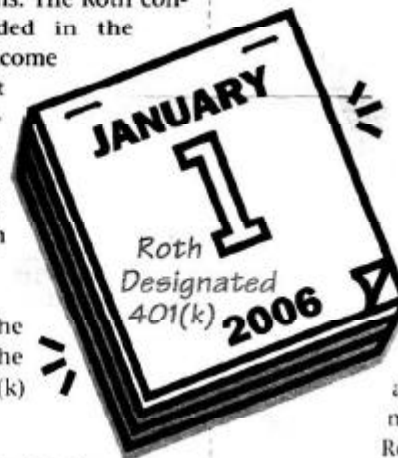
This new savings instrument would be especially attractive to individuals with

income that exceeds the Roth IRA limits on maximum adjusted gross income, allowing them to designate all or any portion of their 401(k) to a Roth portion, up to \$15,000 this year plus \$5,000 for individuals who are 50 or older by December 31, 2006 — which greatly beats the \$4,000 plus \$1,000 (up to \$5,000 total) limits on a Roth IRA. If you are over 50 and qualify to make Roth IRA contributions, you can feed a Roth IRA plus a Roth 401(k) account to a maximum combined contribution of \$25,000.

Tax-free withdrawals

The portion of your 401(k) that you elect to go into your separately administered Roth 401(k) will be includable in your income and taxed as such in the year that it is contributed.

However, like Roth IRA withdrawals, distributions from Roth 401(k) accounts will be tax-free if (1) the withdrawal occurs after the age of 59 1/2, death, or disability; and (2) the contributions have been in the account for at least five years. The major difference from Roth IRAs is that Roth 401(k) accounts are subject to the same required minimum distribution rules after age 70 1/2 as traditional 401(k)s.



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Rollovers

Note to employers: If you offer your employees matching contributions, that portion will be treated as going into the 401(k) plan, not the Roth designated portion. *Note to employees:* Rollovers from the Roth portion of your 401(k) plan can only be rolled into another Roth 401(k) or a Roth IRA.

Divorce Is Bad Enough; Don't Add Tax and Financial Planning Errors to the Mix, Part II

In the last issue, we discussed the importance of paying close attention to tax and financial planning in the face of a pending divorce. We discussed when legal fees are deductible, the importance of carefully deciding dependency deductions, filing status, support payments, and other key concerns.

Too often, individuals going through a divorce are burned by tax and financial planning errors that only exacerbate the pain they feel during an already difficult time.

Your family home

One of the most painful—and costly—issues fought over in divorce proceedings is the family home. Aside from the emotions and memories tied to a home, your primary residence can be a fertile source for tax deductions and future tax-free gains.

There are lots of options for the family home. One spouse could buy out the other's equity in the home and remain there with the children. Other separating couples prefer to sell the house and divide the proceeds. Regardless of your prefer-

ences, it's important to keep in mind some basic rules concerning transfer of your house incident to divorce.

Sale prior to divorce. If you and your spouse decide to sell your family home before the divorce is finalized, you may be eligible to exclude up to \$500,000 of gain from your taxable income so long as the other requirements of the exclusion are met. These requirements are that you have not used the exclusion in the past two years and at least one of you owned and both of you used—or at least one of you owned and one of you used, if under a divorce or separation agreement—the property as a principal residence for at least two of the previous five years ending on the sale or exchange date of the home. You must file jointly to gain this benefit, which often does not happen when people are contemplating divorce.

It is critical to discuss with each other whether and when to sell your home prior to obtaining the final divorce decree. There are reduced exclusion rates for other circumstances (for example, bona fide and well documented health reasons may impact your ability to receive an exclusion rate of gain on the sale of your house—See pp. 5–6).

Transfer incident to divorce. If you or your spouse sells or transfers the house to one another as part of your overall property settlement in divorce, the transfer occurs free from taxable gain or loss at the time of the transfer. These transactions occur



without recognizable gains or losses, as far as the IRS is concerned. In other words, these are nontaxable events. For such transfers that are "incident to divorce," as language taken from Internal Revenue Code (IRC) section 1041

refers to them, there is no reportable gain or loss.

Several factors must be met for this section of the IRC to apply. The transfer between spouses:

- (1) must take place within one year from "the cessation of the marriage," or
- (2) must be related to the divorce because the transfer is required by the divorce or separation agreement and the transfer occurs within six years of the divorce.

The recipient spouse's basis remains the same as the transferor spouse's basis, regardless of whether the property appreciates or depreciates and regardless of whether the individual spouse originally paid for the property or acquired it in some other way (for example, by gift or inheritance). The rules governing IRC section 1041 apply in both community property and non-community property states.

Note that these rules are not applicable to cases in which (1) the recipient spouse is a nonresident alien and (2) the transfer of property is in trust,

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and the trust itself owes an amount greater than the basis of the property.

Retain house, but sell later. Be advised that when the recipient spouse later sells the house following the divorce, that spouse (or ex-spouse) will only be entitled to an exclusion of \$250,000 if he or she does not file a joint return. Also note that the spouse computes any gain on any subsequent sale of the home based on the transferring spouse's basis in the property, rather than the value of the property when it was received. The cost basis in property is an important factor when computing taxable gain, when taken into account with selling price.

Retirement funds

These days, retirement accounts are one of the most valuable—and litigated—assets that are divided incident to divorce. As IRC section 1041 applies to transfers of real estate, it

also applies to transfers of another type of property—retirement plans.

Broadly speaking, pension plans—whether defined benefit or defined contribution and qualified or nonqualified—will be considered as assets that fall within the marital estate. The marital estate is subject to division by a family court judge and is composed in part of the couple's individual retirement accounts (IRAs), stock options, and other savings vehicles. All items within the marital estate are valued prior to division, and your retirement funds are no exception. Retirement plans are generally valued either based on their current value or the value of the future income stream that they can provide.

Various rules apply to various plans. For example, distributions of IRAs incident to divorce come with their own rules. Ordinarily, IRA distributions are included in gross income. Tax law carves out a caveat for the transfer of an interest in an IRA if that transfer is made to a spouse pursuant to a written divorce or separation agreement. It is critical that the interest in an IRA be transferred prop-

erly to avoid the value of the interest transferred being includable in gross income of one or both spouses.

Your employer or your former spouse's employer might be instructed by a court to distribute retirement assets through a qualified domestic relations order (QDRO). These rules must be followed carefully to avoid immediate taxation and possible penalties.

Gift and estate tax issues

While married, couples enjoy the benefit of combined annual gift tax exclusions, worth \$12,000 times two, or \$24,000 for tax year 2006. While married, the couple can gift \$24,000 to each recipient, for example, to each child, per year. Once divorced and prior to any remarriage, this and other marital tax benefits essentially evaporate, leaving each spouse with only \$12,000 each per donee per year to gift. Heeding rules to minimize gift and estate taxes plays a large part in your long-term financial planning strategy. Call our office to help with your personal financial planning needs following divorce or when entering a new marriage.

Read Here for 2006 Inflation-Adjusted IRS Figures

Each year—and by law—various tax provisions must be reconsidered to keep pace with inflation. As a result, more than three dozen tax benefits are being modified for 2006. The following provides information on some of these figures.

Personal exemptions

Each personal exemption is worth \$3,300 for tax year 2006. Generally, you may claim exemptions for yourself, your spouse, and for any qualified dependent, as long as you provide more than half of his or her support and meet certain other requirements.

Personal exemptions are phased out once your adjusted gross income (AGI) reaches a certain threshold based on your filing status, and eliminated if your AGI exceeds a second threshold.

The standard deduction

The standard deduction is a dollar value used to reduce the amount of income on which you are taxed. You cannot take the standard deduction if you claim itemized deductions.

As a general rule, the amount of the standard deduction varies according to several factors, which include (1)

Status	Begin Phase-Out When AGI =	Fully Phased Out When AGI >
Single (not surviving spouse or head of household)	\$150,500	\$273,000
Head of household	\$188,150	\$310,650
Married, filing jointly/surviving spouse	\$225,750	\$348,250
Married, filing separately	\$112,875	\$174,125

your filing status, (2) whether you are 65 years of age or older, (3) whether you are blind, and (4) whether another taxpayer can claim you as a dependent.

For a decedent's final tax return, the ability to claim the additional deductions for age and blindness depends on whether the decedent was blind or reached age 65 by their date of death:

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Filing Status	Standard Deduction
Single	\$5,150
Married, filing separately	\$5,150
Married, filing jointly	\$10,300
Head of household	\$7,550
Dependent claimed by another taxpayer	May not exceed the greater of (1) \$850, or (2) the sum of \$300 and the individual's earned income
Age 65 and older and/or blind	\$1,000 each for age or blindness \$1,250 if the aged or blind individual is unmarried and not a surviving spouse

Section 179 expenses

The Tax Code allows you to expense up to \$108,000 of qualified fixed assets for 2006, rather than depreciating them over several years. Note that you cannot expense more than the taxable income generated by your active trade or business activities. The expensing deduction is reduced dollar-for-dollar if your total qualifying business property purchases placed in service during the 2006 tax year exceed \$430,000.

Exclusion for gifts

The first \$12,000 of gifts you make to any one person will be excluded

from the total amount of taxable gifts made during 2006. Couples can gift up to \$24,000 in 2006 to any one donee without incurring gift tax.

Kiddie tax and child tax credit

For 2005, the unearned income of a child reported on the parent's return—commonly referred to as the "kiddie tax"—is increased to \$850, up from \$800 in 2005. The Working Families Tax Relief Act of 2004 keeps the per child tax credit at \$1,000. The earned income taken into account in determining whether a portion of the credit is refundable is set for \$11,300 for 2006.

2006 Per-Diem Travel Rates

Attention employers and employees: Because many companies prefer to use the IRS-approved per-diem rates to substantiate travel deductions (rather than keeping track of actual—and endless—receipts), you should pay attention to the new rates announced for 2006.

The per-diem rate is \$226 for travel to any high-cost locality and \$141 for travel to any other locality within the continental United States (referred to as CONUS). The 2006 meal and incidental expense (M&IE) rates under the optional high-low method are \$58 for high-cost localities and \$45 in all other CONUS localities.

Get Tax Breaks for Helping Mom, Dad, or Other Aging Relatives

Do you feel the pressure that comes from financially supporting and caring for your children and your parents at the same time—like you're caught in the middle of two very demanding family roles, while managing a career and your own personal life? If so, you are one of the many thousands of Baby Boomers that comprise the Sandwich Generation.

These simultaneous roles can cause quite a strain on your finances. Before you forgo seeding your retirement account (which is one of the many ways you care for yourself financially), why not try to do all you can for yourself by reaping some of the tax advantages associated with caring for your aging relatives?

Dependency exemption and filing status

Your mother may live at home and your father may live in an assisted living facility, but if you provide their financial support, you are entitled to claim the appropriate number of exemptions and the head of household filing status.

A bit of information that often surprises people: Your parents do not have to live with you for you to claim them as your dependents, nor does where they live impact your filing status. The right to claim the "head of household" status can be beneficial to single filers.

The test is simply whether you supply more than half of the cost for your parents' support in a given year. But there is at least one exception to this rule: If you and your siblings, or other family members, all contribute roughly equally to your aging relative's care, then you cannot claim

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the exemption or filing status. What you can do is bargain each year with all of your relative-caregivers for the exemption. So long as you provide more than 10% of the support, you can receive the entire dependency exemption providing that your relatives agree to that designation. Each of you can take turns claiming it each year, making it fair for everyone.

The dependency exemption is worth \$3,300 for 2006, and it is available for each qualified dependent. Thus, if you are caring for both your mother and your father, you may be entitled to a \$6,600 exemption.

Deductible medical expenses

You may be able to deduct the payments you make for medical expenses for your aging parent. To get this benefit, usually your relative must be your

dependent. But if he or she does not pass the gross income or joint return test for dependency, you may still be able to claim these deductions. Our office can assess your situation to determine whether these are available to you.

Eligible medical expenses include those associated with nursing home or certain other long-term care costs, along with other types of services.

Projections indicate that by 2036, one out of every five Americans will be over the age of 65. Today, that number is somewhere around 36.3 million, or one out of every eight.

Poor Health and Your Home: The Tax Connection

If you own your own home, you're probably familiar with the special tax rule that lets you exclude the gain from the sale of your primary residence. To take advantage of this exclusion, the IRS requires you to have lived in your home for at least two years within the five years prior to sale date. Married couples that file a joint return may exclude \$500,000, and individual taxpayers get a \$250,000 exclusion.

Another, lesser known, exclusion

There are other, lesser exclusions if you sell your house for "too soon" because of unforeseen circumstances, divorce, or financial hardships.

But a lesser-known exclusion—the health exclusion—may be one of your strongest cases for getting an "early" exclusion. The exclusion amount is computed as a percentage of the regular exclusion rate (either the \$500,000 or \$250,000 rates men-

tioned above), expressed as the number of months you owned your home as your primary residence divided by 24 months.

Example

Assume that a homeowner purchased his home January 10, 2005 for \$300,000. He sells his home on June 30, 2005. He owned the house and lived in it as his primary residence for six months. If the sale was precipitated by a bona fide health reason, he will be able to exclude up to \$125,000 in gain on a joint return (one-quarter of the \$500,000 exclusion). Note that an additional adjustment may have to be made if he sells another primary residence (with gain) within two years of this sale.

By IRS definition, your home is sold for "health" reasons if:

...Your primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified indi-

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Did you know that the dependent care savings plans available at your workplace are not just for child care? They are also available to help you fund care for your aging relatives—you can direct these tax-favored funds to cover up to a certain amount of pre-tax income for their care.

Social Security Changes for 2006

The Social Security Administration has announced increases in benefit amounts, cost-of-living adjustments, and maximum taxable earnings for 2006. Social Security and Supplemental Security Income (SSI) benefits increase automatically each year based on the increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers.

Social Security payments

Monthly Social Security and SSI benefits have increased 4.1% for 2006 — representing the largest increase in a decade. This means the average monthly Social Security benefit amount for all retired workers will rise from \$963 to \$1,002. The average retired couple, assuming both are receiving Social Security, will increase from \$1,583 in 2005 to \$1,648 in 2006. The maximum monthly benefit for a person retiring at "Full Retirement Age" (age 65 and 6 months for those born in 1940, age 65 and 8 months for those born in 1941) rises from \$1,939 to \$2,053 in 2006. The maximum federal SSI monthly payment to an individual has risen from \$579 to \$603 and from \$869 in 2005 to \$904 for couples.

Social Security taxes

Based on the increase in average wages, the maximum amount of earnings subject to Social Security tax increases from \$90,000 to \$94,200 for 2006.

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vidual (such as your child). Health is considered to be the reason you sold your home if...a doctor recommends a change of residence. It would be prudent to obtain a doctor's recommendation, in writing, to help substantiate that the sale was brought on by health reasons for you or for a member of your family.

**New for Tax Year 2006:
Automatic Extensions**

The IRS recently announced something new and—for some—exciting: Taxpayers can now request an automatic six-month tax-filing extension for most common individual and business returns.

New regulations provide streamlined and simplified procedures aimed at saving taxpayers between \$73 million and \$94 million annually by eliminating or consolidating several existing IRS forms. Most individuals and businesses will be able to request a full six-month tax-filing extension, without a reason or even a signature.

Two-step process reduced to one

The new procedures will replace the existing two-step process under which noncorporate taxpayers could only get a six-month extension by first requesting an automatic extension for part of

the period, then applying for a discretionary extension for the remainder. As always, a tax-filing extension does not extend the tax-payment deadline.

Beginning with tax year 2005 returns, individuals will be able to use a single IRS Form 4868 to get an automatic six-month extension of time to file. This will replace the existing two-step process under which an automatic extension was only allowed for four months, generally until August 15. If more time was needed, a taxpayer had to explain why, using a second extension request form (Form 2688). About 6% of individual taxpayers request the initial four-month extension, and about one-third go on to request an additional two-month extension, until October 15. Form 2688 is scheduled to be eliminated.

Business taxpayers

Extension procedures will also be streamlined for business taxpayers, thus eliminating three existing forms. Under existing procedures, only corporations can request an automatic six-month tax-filing extension. The new regulations will also make this option available to most noncorporate business taxpayers, including partnerships and trusts.

Accordingly, starting January 1, all eligible business taxpayers will use Form 7004 to request an automatic six-month extension of time to file. In the past, eligible noncorporate business taxpayers had to request an

initial three-month extension and then, if more time was needed, request another three months.

**Alert for Small and Large
Business Owners**

FYI: IRS Commissioner Mark W. Everson recently announced:

- Audits of small businesses organized as corporations increased after many years of decline. 17,867 were completed in 2005 against 7,294 a year earlier.
- Audits of larger corporations—those with assets over \$10 million—also increased, up 14% from a year ago to 10,878. The coverage rate of 20% has rebounded significantly from that of 12% just two years ago.
- Enforcement revenues—the monies the IRS gets from collection, examination, and document matching activities—increased by 10% to a record \$47.3 billion.



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