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TAX IMPACT

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HATCHING A BIGGER NEST EGG

Why it pays to plan IRA distributions

IRAs are an important tool you may use to grow a sizable nest egg for a comfortable retirement because they offer tax-deferred — and even tax-free — growth. Over time, these benefits are more apparent when you see the effect of compound growth on your earnings.

But when it comes to maximizing an IRA's advantages and minimizing taxes, timing is everything. Although you can take IRA distributions at any age, you may face unnecessary taxes or penalties if you take them at the wrong time — or don't take them at the right time. Thus, you need to know the earliest (or latest) possible time you may take distributions so you have enough income to support you and your spouse during your golden years.

THE TRADE-OFF

Although traditional and Roth IRAs both offer tax-saving benefits for retirement, each treats contributions and distributions quite differently. For instance, you may be able to deduct traditional IRA contributions depending on your income level and eligibility. If you contribute to an employer-sponsored retirement plan, the adjusted gross income (AGI) phaseout range is



\$45,000 to \$55,000 if you are single and \$65,000 to \$75,000 if you are married filing jointly. (There are no income limits if you do not participate in an employer-sponsored retirement plan.) The distributions are subject to your ordinary income tax rate at the time you receive them.

Conversely, you cannot deduct Roth IRA contributions, but qualified distributions are tax-free. Also unlike

SHOULD YOU CONVERT YOUR TRADITIONAL IRA TO A ROTH?

If you already have a traditional IRA, you may want to roll it over into a Roth IRA. Why? You can convert tax-deferred future income growth into tax-free growth.

IRA account holders who have more than a decade to save for their golden years or expect to be in the same or a higher tax bracket when they retire may benefit the most from this change. And those planning on working well beyond the usual retirement age may want to consider the rollover because, unlike with traditional IRAs, you can make nondeductible Roth IRA contributions after age 70½. But you must have earned income equal to the contribution amount, and there are certain income requirements and other contribution limits.

If you don't expect to need any of your IRA assets, a Roth IRA can allow you to bequeath more to your heirs because you're never required to take distributions. Plus, the Roth IRA can continue to grow tax-free in your loved ones' hands — though they will be required to take distributions.

To qualify for the rollover, if you are married, you and your spouse must file jointly and your adjusted gross income must be less than \$100,000, not including the conversion amount. Although your income may be too high for you to qualify now for a conversion, you might be eligible after you retire when your income will probably decrease.

There are some disadvantages. For instance, you must pay tax — as if you are taking distributions — on the amount you roll over during the conversion year. Also, the increase in taxable income could limit or eliminate tax breaks such as itemized deductions, education deductions or credits, or other itemized benefits.

traditional IRAs, you can receive Roth IRA distributions without incurring an additional tax against your Social Security benefits and pass funds to your heirs income tax-free. But like a traditional IRA, your income may limit your eligibility to make contributions. For instance, Roth modified AGI limits are \$95,000 to \$110,000 for singles, \$150,000 to \$160,000 for married couples filing jointly and up to \$10,000 for married couples filing separately, regardless of whether you participate in an employer-sponsored retirement plan.

EARLY DISTRIBUTION PENALTIES

Age 59½ typically is the earliest time you may receive unlimited traditional or Roth IRA distributions penalty-free. But, there are instances when you may take early distributions and avoid penalties, such as when you:

- ⊗ Take regular distributions in virtually equal amounts over your life,
- ⊗ Buy or rebuild a first home — up to a \$10,000 lifetime limit,
- ⊗ Pay qualified higher education expenses,
- ⊗ Receive reimbursement of excess medical costs,
- ⊗ Become disabled, or
- ⊗ Are unemployed and pay medical insurance premiums.

Roth IRA holders also may withdraw funds penalty-free in other circumstances as early as five years after their first account contributions. The IRS treats distributions first as nontaxable returns of contributions, so you will

Unlike traditional IRAs, you can receive Roth IRA distributions without incurring an additional tax against your Social Security benefits and pass funds to your heirs income tax-free.



not owe tax on distributions that don't exceed contributions. But you will be subject to regular income tax and a 10% penalty on amounts that exceed accumulated contributions.

MINIMUM DISTRIBUTION REQUIREMENTS

Although Roth IRAs have no mandatory distribution requirement (only upon death), traditional IRAs do: You must begin taking annual distributions from these accounts by April 1 of the year after you turn age 70½ and receive subsequent annual distributions by Dec. 31. If you ignore the deadlines, you will face a 50% penalty on the amounts you should have taken — on top of the required income tax bite. Ouch ... that can put a big crack in your nest egg!

What's worse, that fissure can grow even bigger, costing you more of your savings because the IRS requires delinquent taxpayers to make up such oversights by taking two minimum distributions the next year. Also, you may miss out on certain tax deductions, exemptions and credits because your AGI may exceed phaseout levels, and you also could incur more taxes on your Social Security benefits.

A DIFFICULT CHOICE

Timing IRA distributions may put you in a financial tailspin. But don't let this possibility overwhelm you. Please call us. We can help you properly apply the IRA distribution rules to your situation. ■

MULTISTATE TAXES

How to keep them from multiplying your business's tax bill

With 50 states in the country, you could conceivably have to pay state taxes to all of them. That's pretty unlikely for most companies. But no matter where you operate, determining which ones you are responsible to can be complex. Plus, multistate commerce may create a bigger tax liability in some states and a smaller one in others.

For these and other reasons, it's important to pay close attention to this area. So when determining whether to start offering your products or services online or in another locale, consider each state's different tax types, rates and allocation factors.

CONNECTION WITH A STATE

Before you begin filing tax returns for states you conduct business in, you must determine your "nexus" (or connection) with them. Although nexus is often a fact-specific determination, some activities generally create it. For one, the state of incorporation or charter for your company's operation (your corporate domicile) can subject you to a state's business taxes and fees — even if you have no assets or activities within its borders.

Next, the state where your business is headquartered (your commercial domicile) may tax your company

The Multistate Tax Commission has a National Nexus program to help businesses with state tax challenges.

only on the amount of business attributable to it. Additionally, a state in which you have property, employees or other company representatives (business situs) may trigger liability.

Finally, your economic presence in a state can play a role. But this is an ambiguous area because some tax business revenue for many reasons.

3 STATE TAX TYPES

Although identifying those states you have nexus with can be difficult, assessing the potential taxes



and related compliance expenses is critical because these expenditures will impact your pricing strategies and profits.

One particularly challenging aspect is the varying tax rates and different compliance procedures, which can significantly affect your company's liability. For instance, some states use a single factor (for example, sales) to allocate income to it while others use a three-factor formula consisting of sales, property and payroll. But no matter what state you're looking at, there are three main tax types that you may face:

1. Sales. As you probably already know, your company has to collect and pay sales tax for states where you're located. This may apply if you have a nonphysical presence in an area where you conduct business. For example, if you have traveling sales representatives or independent agents working in the state on your behalf, you may have to collect and file sales taxes. Adding to the complexity, states differ on whether they tax only product sales price or product-related items, such as warranties and repairs.

2. Franchise. Some states tax paid-in capital for franchise taxes while others tax retained earnings — it all depends on the state. To manage franchise taxes, you may need to

establish a separate corporation to adequately support your compliance requirements. But be careful of strategies you use to reduce some state income taxes. For instance, a holding-company structure may exempt your business from state income tax on certain intangible assets, but it may make you liable for franchise tax.

3. Nonbusiness and business income. Companies are liable for taxes on rents, dividends and interest as well as income generated from sales and facilities that they own or maintain. This may include contractors operating on their behalves. Let's say that you have home-office-based sales representatives who do more than solicit orders for approval in your home state. These employees may subject you to business income taxes in the states they cover. In other words, your company may have no facilities in a state and you may still have to pay income tax on local business transactions — regardless of whether you profit.

NATIONAL NEXUS PROGRAM

Like many companies, you may have problems complying with each state's tax code. Fortunately, the Multistate Tax Commission has a National Nexus

Program to help businesses with these challenges. Among other features, the program allows companies to anonymously contact a state regarding sales and use, income, and franchise tax liabilities.

Acting as an intermediary, the program staff will review your case and work with you and the governing body to settle issues, revealing your business's identity only after you and the involved parties reach an agreement and you return the required forms to the program office. Keep in mind that the commission will not act as an intermediary with states that have already formally contacted or advised an audit or review of your company.

MYRIAD RULES

Keeping on top of your federal tax situation can be a daunting task. But when you add to this the challenge of the compliance nuances of each state you have nexus with, you may be overwhelmed to say the least.

Not to worry; we can help you determine whether you have a connection to the states you conduct business in as well as apply strategies to reduce your liability and keep abreast of the differing tax types, methods, rates and procedures. 📖

CHART YOUR WAY TO TAX SAVINGS

3 routes to a larger charitable deduction

With summer approaching, you may hope to go hiking or camping with a map and compass in hand or you might rather read a book on the beach. No matter how you plan to spend your free time, be sure to schedule a few hours to review some tax-saving tips.

Why? Because you can employ a number of strategies to reduce this year's tax bill. For instance, charitable giving is a popular option because it allows you to help others while reaping financial benefits, such as reducing your taxable estate. Let's look at three great ways to demonstrate your generosity — by donating vehicles, homes and collectibles.

1. VEHICLES

When you buy a new vehicle, your first instinct may be to sell your old one. But consider donating it instead because you may receive a tax break and the charity



will benefit from your good will. To ensure you receive the deduction, follow these steps:

- ⊙ Confirm the organization's tax-exempt status with the IRS. (Charitable donations to religious groups, such as churches, synagogues and mosques, qualify for the deduction even though they are not required to apply for tax-exempt status.)
- ⊙ Ask the charity how much it will gain from the donation and how it plans to use the item.
- ⊙ Claim only the item's fair market value (FMV) — the price the vehicle would currently sell for.
- ⊙ Obtain an appraisal for donations of \$5,000 or more.
- ⊙ Maintain copies of the title transfer to the charity, the written appraisal and classified ads or guide value estimates of comparable vehicles, and photographs of the item.
- ⊙ Receive written acknowledgment of your donation from the charity.



But be careful if you work with a third-party broker: Only part of the donation may go to the charity and if the nonprofit receives a flat fee from the agent, you may lose the tax deduction.

2. HOMES

You may donate both primary residences and vacation homes to charity as outright gifts. Although this may seem too generous of a gesture, ample benefits abound, such as a charitable deduction equal to the full FMV of the donated property if you've owned it for more than a year. Plus, there will be no capital gains tax on the appreciation.

If you would like to continue living in your home, consider a retained life estate option. You, or another designated individual, can retain lifetime use of the property while leaving a remainder interest to a charity. (Ownership transfers to the organization when you die.) In addition to avoiding estate taxes, you can take a charitable income tax deduction in the year the remainder interest is established.

Usage donations, such as a week's use of a vacation property or a home-cooked meal, don't qualify for deductions. You must spend cash or its equivalent.

3. COLLECTIBLES

Many types of collected works — including books, autographs, stamps, coins, historic items and artwork — qualify for a tax break. Better yet, you may receive a deduction equal to the items' FMV rather than their basis, so long as the donated items are consistent with the charity's purpose.

To help you assess the FMV of collectibles, check out catalogs, pricing lists, specialized hobby publications and reference materials at libraries or museums.

Remember that the IRS typically requires a written appraisal from a qualified professional for deductions of more valuable collections, such as precious art or antiques.

FAIR MARKET VALUE

Determining the FMV of donated property is not a matter of applying one simple formula. Rather, FMV is based on what the property would sell for in an open market. So you must consider a variety of factors, such as the asset's use, demand and availability.

Because market conditions continually change, the cost or selling price that the property is based on must be fairly close to the donation date to be relevant. You can factor in the sale price of similar property if there is a high amount of comparison.

Keep in mind that, in most cases, you must file an appraisal from a qualified professional with your income tax return for property contributions exceeding \$5,000. You may also want to get an appraisal for assets that are difficult to value because a professional can substantiate the quality of reference sources used and recommend appropriate adjustments.

A WELL-PLANNED TRIP

In addition to the strategies we discussed here, you can take advantage of many other charitable giving tools to reduce your tax bite. But just as you would need to diagram the coordinates of a hiking trip, you must also plan carefully to make the most of these financial opportunities. Get a head start and call us for help mapping your strategy. 📄

TAX TIPS

DO YOU HAVE ENOUGH INSURANCE COVERAGE?

There are many benefits, including tax advantages, to life insurance. For example, it can help cover estate taxes and settlement costs as well as provide liquid assets for your heirs. Because your income needs may change over time, periodically review your policies to ensure adequate coverage for:

- ⊙ Life event changes, such as marriage or divorce or the birth of a child,
- ⊙ Inflation,
- ⊙ Business costs,
- ⊙ Personal expenses, and
- ⊙ Loan payments.

Keep in mind that life insurance is just one tool that — with the proper planning — you can use to reduce your taxable estate. Otherwise it can increase an estate and the taxes of the policyholder who died. 📄



MORE TAX TREATS FOR VACATION RETREATS

As with your personal residence, you may generally fully deduct one vacation home's (or second home's) mortgage interest and property taxes. The interest deduction applies to the first \$1 million in mortgage debt used for buying, building or improving one principal residence and one vacation abode, plus \$100,000 home equity indebtedness.

**In 2003, 52% of households
had retirement accounts —
up from 49% in 1998,
according to a UBS/Gallup poll.**

To make the most of the deduction, designate the residence with the largest total mortgage interest and real estate tax deductions as your second home.

There are additional tax advantages if you rent out your vacation home, depending on the number of days you lease it. For instance, you may benefit from additional tax-free rental income or deductions for rental-related expenses, such as utilities and maintenance. 📄

PAYING FOR HEALTH INSURANCE WITH RETIREMENT FUNDS

Will you be taxed on qualified retirement plan distributions used for health insurance premiums? Yes, said the IRS in a recent ruling. In one instance, an employee used qualified retirement plan distributions to pay health insurance premiums. In another case, a worker used them to pay medical care expenses. So, though you can pay such expenses pre-tax from current wages, you cannot enjoy the same tax break when you pay them from retirement plan distributions. 📄

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