TaxTips

Keeping you informed...

Winter 2005/2006

Rules for Flexible Spending Arrangements Have Changed

Don't risk losing your benefits

Does your employer have a flexible spending arrangement (FSA)? An FSA allows you to pay for qualified benefits with pre-tax dollars. Qualified benefits include employer-provided accident and health plans, group-term life insurance, dependent-care assistance, and adoption assistance.

In the past, if you did not use all the money you deferred for these benefits by the end of the year, you lost it. A new rule allows employers to amend their plan to allow you to use pre-tax money for up to 2½ months after the close of the year. This will give you a little extra time to pay for benefits without risking the loss of the money.

Find out if your employer has amended your plan. If not, now is the time to do some planning and estimate the amount of money you should set aside for certain benefits. Don't risk losing your own money.

Are You Collecting Social Security Benefits?

How much can you still earn while keeping all your benefits?

Once you reach age 62, you are eligible to receive social security benefits. However, if you still work, your benefits are reduced when your earnings reach a certain level. For 2005, you will lose $1 in benefits for every $2 you earn over $12,000. In the year you reach full retirement age, you will lose $1 in benefits for every $3 you earn over $31,800 ($2,650/month). This reduction only applies for the months before you actually reach full retirement age.

There is no limit on earnings beginning the month an individual attains full retirement age (65 and 4 months for retirees born in

1939; 65 and 6 months for those born in 1940). Each year, the full retirement age increases by a couple months. If you were born in 1941, full retirement age is 65 and 8 months.

For 2006, these amounts will increase by 2-3 percent. If you are nearing full retirement age and you still work, keep an eye on your earnings. You don't want to lose any of your benefits.

Life Insurance—Who Needs It?

Chances are you do

No one likes to think of their own death and the thought of paying for life insurance doesn't make the thought any more palatable. The truth is, life insurance is protection for those you leave behind—your family.

If you are young and in good health, life insurance premiums are generally less expensive than they will be later in life. For this reason, your insurance agent or financial planner may encourage you to invest in life insurance early.

There are two basic types of life insurance: term life insurance, where you choose the coverage amount and length of the policy; and whole or permanent life insurance (of which there are many variations), which combines an investment product with life insurance.

Term life insurance is good for short-term needs. Two good examples of this are to cover your children's college education and to cover your mortgage. Parents could buy a policy that expires after their children graduate from college to ensure that the full education is paid for in the event that something happens to the parents. Or, the main breadwinner in a house could buy a term policy that matches the length of his or her home's mortgage.

Under a whole life policy, you agree to pay regular premiums in exchange for a guarantee of a specified benefit payable to your spouse or other beneficiaries upon your death. Earnings on a whole life policy are set by the insurance company based on the overall return on its investments. Earnings above and beyond those required to cover the death benefit go to the policy's cash reserve, which you can borrow against, withdraw, use to pay premiums, or allow to accumulate for long-term goals such as retirement. Premiums for whole life or permanent insurance are generally higher than a term policy.

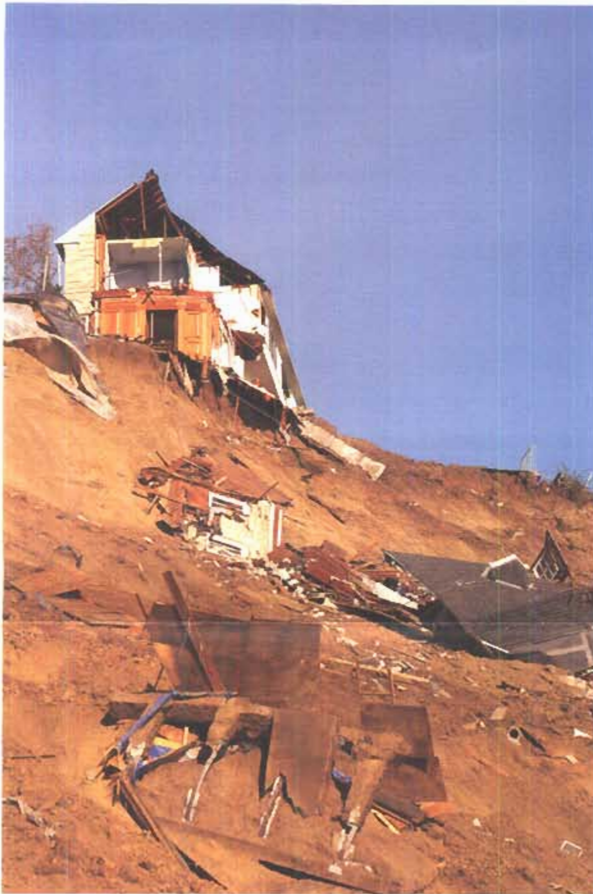
If you do not currently have a life insurance policy, don't wait. Even though life insurance premiums are not tax deductible, the long-term benefits are significant.

Casualty and Disaster Relief

How to make the most of a bad situation

No amount of planning can prepare you for a casualty. If you have suffered a loss of personal property as a result of a casualty, theft, or disaster, there are some tax issues to keep in mind.

For starters, a casualty can only result from something that is sudden or unexpected. Fire, floods, theft, accidents, severe storms, and other acts of nature that destroy your property can result in a casualty loss. You are allowed to deduct losses that result from a casualty on your tax return in the year the loss occurred,



but only if you itemize your deductions. Your losses must exceed $100 and 10 percent of your adjusted gross income before you realize a tax benefit. Your loss is limited to the lower of your adjusted basis (cost) in the property destroyed or the decrease in the property's fair market value. The loss is further reduced by any insurance or other reimbursement.

If your casualty was the result of a disaster that took place in a presidentially declared disaster area, you may elect to deduct the loss on your prior year's tax return. This will enable you to amend your return for the prior year and collect a refund sooner than if you wait to claim the loss in the year it occurred.

Were all your tax records lost? In most cases, copies can be obtained from your bank, employer, or other financial institution that reports taxable income or expenses to you. The IRS will accept reasonable documentation that you reconstruct and use to substantiate your deductions, such as charitable contributions, medical expenses, or employee business expenses.

QUIK TIPS

1 For 2005, the standard mileage rates for the use of a car, including vans, pickups, or panel trucks, are:

- 40.5 cents per mile for all business miles driven;
- 15 cents per mile for all miles driven for medical or moving purposes; and
- 14 cents per mile for all miles driven for charitable purposes.

You may also be able to deduct parking fees, tolls, interest, and state and local taxes (other than gasoline taxes). Even though you are not required to substantiate expense amounts, you must substantiate other elements of time, place, and business purpose of the travel.

News Flash! Due to the high cost of gasoline, the IRS has increased the standard mileage rate for business use of an automobile to 48.5 cents per mile for the period between September 1, 2005, and December 31, 2005. The rate for computing deductible medical or moving expenses between September 1 and December 31, 2005 increases to 22 cents a mile. The rate for charitable deductions has not changed.

2 If you have reached age 70½ this year, don't forget to take your minimum required distribution from your IRA. Failure to do so results in a 50 percent penalty on the amount you do not take.

3 Are you carrying over stock losses from prior years? Sell some of your stock that is doing well and use some of those losses. If you sold stock at a gain this year, sell some losers before year-end to offset some of the gain and save tax dollars.

4 You can deduct up to $4,000 in education expenses if your adjusted gross income is $65,000 or less ($130,000 or less with a joint return). If your adjusted gross income is more than $65,000 but less than $80,001 (more than $130,000 but less than $160,001 with a joint return), your maximum deduction is $2,000. This deduction is allowed whether or not you itemize your deductions.

5 Your cost basis in mutual fund shares includes reinvested dividends.

6 You are entitled to a tax credit of up to $10,390 if you adopt a special needs child. The credit is available in the year that the adoption is finalized, even if you do not have any qualified adoption expenses during that year.

Expenses for Dependent Care

Are you allowed a credit?

If you incur expenses for the care of your dependent child, enabling you to work or look for work, you are entitled to a tax credit based on the amount you pay. If you are married, you must file a joint return and both you and your spouse must work, unless one of you is disabled.

If you cannot claim your child as a dependent, the money you deferred into your dependent care plan through your employer will be included in your income. Often a divorce or separation agreement will require that the noncustodial parent pay for child care. Pre-tax dollars you defer will become taxable if you are the noncustodial parent, even if you are entitled to the dependency deduction. Your child must live in your home for more than half the year before you are entitled to a child- or dependent-care credit.

Using Your IRA to Pay for Higher Education

What are qualified expenses?

One way to pay for college expenses is to use your IRA. Distributions from an IRA that are used to pay for qualified higher education expenses escape the ten percent early distribution penalty. In general, qualified education expenses include the cost of tuition, as well as room and board if the student is enrolled at least half-time. Qualified higher education expenses also include fees and the cost of text books, supplies, and equipment required for enrollment or attendance.

Unfortunately, amounts paid for a computer, housewares, appliances, furniture, and bedding in connection with enrollment at a university do not qualify for the education expense exception to the IRA early withdrawal penalty. Also, the IRA withdrawal must occur in the same tax year the expenses are incurred. For this reason, you cannot escape the penalty by taking a withdrawal from your IRA to pay off a student loan. The exception to the early distribution penalty only applies to an IRA. You cannot take a distribution from your 401(k) plan, for example, and avoid the penalty.

New Credits in 2006 for Energy Efficient Home Improvements

Plan now for future tax savings

Under the *Energy Incentives Act of 2005*, homeowners may claim a lifetime credit of up to $500 for making qualifying energy-saving improvements to his or her existing home in 2006. However, only $200 of this credit amount may be for qualifying window expenditures. Subject to these limits, the credit equals the sum of: (1) A ten percent credit for energy efficient improvements to the home, such as insulation, exterior windows, skylights, exterior doors, and pigmented coated metal roofs; and (2) A credit for residential energy property expenditures in the following amounts:

- $50 for each advanced main air circulating fan;
- $150 for each qualified natural gas, propane, or oil furnace or hot water boiler; and
- $300 for qualified energy-efficient property, such as heat pumps, water heaters, and central air conditioners that meet certain requirements.