TaxTips

Keeping you informed...

Winter 2006/2007

Giving to Charity

New rules require diligent recordkeeping

Keeping the receipts from your charitable contributions just became more of a priority. Starting January 2007, you will not be allowed to deduct charitable contributions of any amount unless you have the proof. What does this mean for you? Starting in 2007, each cash contribution you make must be substantiated with a bank record, receipt, letter, or other written communication from the donee organization that states the name of the donee, the date the contribution was made, and the amount of the contribution.

Without this substantiation, you will not be allowed to deduct the contribution on your tax return.

Cleaning Out Your Closets?

Items you donate may not qualify for a deduction

It used to be that you could take all your unused clothing and household items to the local Goodwill, Salvation Army, or thrift store and reap a nice charitable contribution deduction. All you needed was a receipt stating the fair market value and the deduction was allowed. The rules have changed for any donation of noncash items to charitable organizations after August 17, 2006.

A charitable contribution deduction of clothing or household items will only be allowed if the item is in good used condition, or better, and you have a receipt. The IRS can deny a deduction for any item that has little monetary value. There is an exception for single items that have a value of more than $500 and for which you have a qualified appraisal.

IRAs and Charitable Contributions

New option for charitable giving

If you are age 70½ or older, there is another option for you to consider when making charitable contributions. Beginning after December 31, 2005, you may be allowed to make a charitable contribution of up to $100,000 for 2006 and again in 2007, of distributions from your IRA. Although there is no charitable contribution deduction allowed, you are not required to include the distribution in your income for the year the donation is made. This option is limited and may not be the best option for some taxpayers. First, the charitable contribution

distribution is only allowed in 2006 and 2007, with the maximum contribution limited at $100,000. The taxpayer must be over the age of 70½ and currently taking his or her required minimum distributions. Only the distributions that are otherwise required to be included in income are eligible for the charitable contribution distribution. The distribution must be made to the charity by a trustee directly to the charity. This means that a distribution that is made to the IRA owner and then turned over to the charity, does not qualify.

Using this option to reduce the balance in your IRA can be a valuable estate planning tool. The value of your IRA is required to be included in your estate at death. Until 2009, estates with a value in excess of $2 million are subject to estate tax. Contributing some of your IRA to a charity while you are still living is an effective way to reduce your taxable estate.

Naming a Beneficiary to Your Retirement Plan

Nonspouse beneficiaries have new options

If you are the beneficiary of a decedent's qualified retirement plan, and you are not the spouse of the decedent, you now have additional options for distributions. In the past, only a spouse beneficiary was permitted to roll the account into an IRA. Now, beginning in 2007, if you are the beneficiary, you may roll the distribution into an IRA that has been established to receive the qualified plan.

Under this new option, you will be subject to the rules for distributions that apply to inherited IRAs, as opposed to the more strict rules that apply to distributions from qualified plans. Many qualified plans require beneficiaries to take the entire amount from the plan within five years of the date of death. The rules that apply to inherited IRAs allow the beneficiary to take distributions over his or her life expectancy, thus spreading the tax liability over several more years. If the decedent was over age 70½, the distribution rules are a bit different. Here you have the option of taking the distributions from the inherited IRA over your life expectancy, or the remaining life expectancy of the owner, assuming he or she was still living.

IRA Contributions for Military Personnel

Nontaxable combat pay is considered compensation

Members of the military serving in Iraq, Afghanistan, and other combat zone localities can now put money into an IRA, even if they received tax-free combat pay. Under the *Heroes Earned Retirement Opportunities (HERO) Act*, military personnel can now count tax-free combat pay when determining whether they qualify to contribute to either a Roth or traditional IRA. Before this change, members of the military whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement.

In addition, the *HERO Act* allows military personnel who received tax-free combat pay in either 2004 or 2005 to go back and make IRA contributions for those years. Eligible military members will have extra time, until May 28, 2009, to make these special back-year contributions.

For those under the age of 50, the IRA contribution limit was $3,000 for 2004 and $4,000 for 2005. For those age 50 and over, the limit was $3,500 for 2004 and $4,500 for 2005. The IRA contribution limit for 2006 is $4,000 and $5,000 for those taxpayers age 50 and over.

Direct Deposit of Your Tax Refund

More options are available to you

The IRS is now allowing taxpayers who are due a tax refund the option of having that refund split up and deposited in up to three different bank accounts. This can include a retirement savings account such as an IRA. This option is available to you whether you file a paper return or electronically file your return. However, if you file your tax return electronically and opt for direct deposit, you can receive your refund in two weeks or less.

Are You Putting Investments in Your Child's Name?

New rules tighten your options

Beginning with the 2006 tax year, children, under the age of 18 who have unearned income in excess of $1,700, are taxed at their parent's higher rate. Previously, this rule only applied to children who were under the age of 14. This new rule does not apply to married children who file a joint return, or to distributions from certain qualified disability trusts. Generally, unearned income includes interest and dividend income, capital gains, taxable social security benefits, and pension distributions.

Saving for Your Retirement

Certain taxpayers are eligible for a tax credit

If your adjusted gross income is less than $50,000, you may be eligible for a nonrefundable credit against your income tax for elective contributions you make to §401(k) plans, §403(b) annuities, §457 plans, SIMPLE or simplified employee pension (SEP) plans, traditional or Roth IRAs, and voluntary after-tax employee contributions to a qualified retirement plan or a 403(b) annuity.

The amount of your credit can be as much as 50%, 20%, or 10% of your contribution depending upon your filing status and modified adjusted gross income, giving you a maximum annual credit of $1,000 ($2,000 if married filing jointly).

This credit was due to expire at the end of 2006; however, recently enacted legislation made this credit permanent. After 2006, the adjusted gross income limits will be indexed for inflation, making more taxpayers eligible for the credit.

Tax Break for Reservists Called to Active Duty

Penalty-free withdrawals from retirement plans

If you are a reservist or national guardsman who was ordered or called to active duty for a period in excess of 179 days, you may withdraw money from your qualified retirement plan or IRA without incurring the 10% premature distribution penalty. You must have taken the distribution during your active duty status. This new rule applies to any distribution made to you after September 11, 2001 and before December 31, 2007.

If you received a distribution from your retirement plan or IRA during the period you were on active duty, you have the option to repay that distribution within two years from the date your active duty ended or August 17, 2008, whichever is later.

QUIK TIPS

1 If you own mutual funds, it is important to keep track of your reinvested dividends. These dividends increase your cost basis resulting in a lower capital gain when you sell the fund.

2 Contributions to your IRA must be made by the due date of your tax return. Generally this is April 15. Extending the due date of your tax return does not extend the due date of your IRA contribution.

3 You can actively participate in your employer's qualified plan and still contribute to a Roth IRA. A deduction for contributions to a traditional IRA may be limited or nondeductible if you are a participant in a qualified retirement plan.

4 Contributions to a health savings account (HSA) must be made by the due date of your tax return, excluding extensions.

5 Go to your tax appointment well organized. Have all your income statements such as W-2s and 1099s, separate from your expenses. Make sure you have all the proper social security numbers for dependents, as well as their names as they appear on their social security card. Careful organization will save you time come tax season.

Public Safety Officers Get a Tax Break

Tax savings for health care costs

Beginning in 2007, retired public safety officers, or those who have separated from service due to disability, get a tax beak for health care costs. If you are a retired public safety officer, such as a policeman, fireman, member of a rescue squad or ambulance crew, a member of a volunteer fire department, or a chaplain of a volunteer fire department, you may be eligible to exclude from income distributions from your governmental retirement plan that are used to pay health insurance premiums.

The exclusion is limited to the lesser of your actual health insurance premiums, or $3,000. The payment of the health insurance premiums must be made directly to the provider of the health insurance plan. The exclusion will not apply if the premiums are paid by you then reimbursed by the pension plan. This exclusion applies to distributions from governmental defined benefit plans or defined contribution plans, governmental 403(b) tax-sheltered annuity plans, and governmental 457(b) eligible deferred compensation plans.

Overlooked Employee Business Expenses

Don't miss out on deductions you are allowed to take

Unreimbursed employee business expenses are allowed as a miscellaneous itemized deduction provided they exceed two percent of your adjusted gross income when combined with all your other miscellaneous expenses. This fact causes most taxpayers to miss out on the deduction. However, if you keep careful records of all your expenses, you may well meet the two-percent floor. In addition to these requirements, the expenses must be ordinary and necessary business expenses. An expense is *ordinary* if it is common and accepted in your type of business. An expense is *necessary* if it is appropriate and helpful to your business.

The most common types of deductible employee business expenses are professional dues, safety equipment required by your employer, and business travel. You may also take deductions for the cost of uniforms and other special work clothes that are not suitable for everyday wear, including the cost of cleaning the clothing. Some other commonly overlooked employee business expenses include:

- Depreciation on a computer or cellular phone required by your employer.
- Job search expenses for a new job in your present occupation.
- Licenses and regulatory fees.
- Passport for a business trip.
- Subscriptions to professional journals and trade magazines related to your work.
- Tools and supplies used in your work.
- Damages paid to a former employer for breach of an employment contract.
- Business liability insurance premiums.
- Home office required by your employer and used regularly and exclusively.
- Dues to a chamber of commerce if membership helps you do your job.
- Education that maintains or improves your job skills or required by your employer.
- Transportation costs for going between job locations in the same work day.