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TAX NEWS & TIPS

MID-YEAR 2003

Thank You

One more tax season is over! If I didn't say it earlier, it's time for a big THANK YOU! Thank you for the kind words, for your patience, and for your referrals. Your trust and confidence mean a lot to me. I'll be working hard to continue to earn your support.

Home Sale Rules Eased by IRS

IRS finally clarifies 5 years of questions

On May 7, 1997, new rules took effect on selling your main home. If certain facts are true, you can ignore the first $250,000 of gain when you sell. Several questions were left unanswered. IRS finally answered them on December 24, 2002.

The basic rule: You may sell and exclude gain up to $250,000 every two years (it's $500,000 on a joint return) if you can pass two tests:

(1) In the 5 years prior to the sale, you must have *owned* the home for at least 2 years, and
(2) In the same 5 years you must have *used* the property as your main home for at least 2 years.

NEW **Partial Exclusion.** What if you are forced to sell within 2 years? The law says you may claim part of the $250,000 exclusion if your sale is caused by a job change, a medical reason, or unforeseen circumstance. But IRS had been saying we could not use these rules until regulations have been developed. Finally, (after 5½ *years!*) we do have the regulations.

Job Change. Compare distance from your old home to old and new jobs. If the distance to the new job would be at least 50 miles farther, you qualify. If this is your first job, it must be at least 50 miles from the home you sell. The job change must occur during the period of ownership and use of the property.

Medical Issues. This one is a little fuzzy. IRS says the primary reasons for the sale must be to deal with medical problems of yourself or a family member living in the home. You won't qualify if your move is because the new location is merely beneficial to health or well-being. You'll need the recommendation of a doctor in order to qualify.

Unforeseen Circumstance. This must be something you could not anticipate before buying and moving into the home. IRS leaves the door open to an "all facts and circumstances" test, but also lists 7 "safe harbor" cases:

(1) Involuntary conversion.
(2) Natural or man-made disaster or act of war resulting in damage to the property.
(3) Death of yourself or a family member residing in the home.
(4) Loss of job that results in qualifying for unemployment benefits.
(5) Change in employment status making you unable to meet reasonable housing and living costs.
(6) Divorce or legal separation.
(7) Multiple births from a single pregnancy.

How Much To Exclude. Rules for full exclusion require 24 months (2 years) of ownership and use. The partial exclusion is a pro-rata share of the $250,000 depending upon the number of months in your own case. Use the lesser of your months of ownership or occupancy. For instance, if you have owned the property for 18 months, but only lived there 12 months, you get 12/24 (50%) of the full exclusion.

NEW **Business-Use Rules.** if you claimed the benefit of home-office deductions in the past, or rented the home part-time, or ran a day care center from home, you had "business use" of the home. Early opinions from IRS said the home must be allocated into its "personal" and "business" parts. The personal part could earn the exclusion. The business part could not. This caused some folks to forego the deductions.

New Rule. The new regulations change this stance for the better. IRS now says you may claim the maximum exclusion as long as the business and personal portions lie within the same dwelling unit. The only caveat — you may not exclude any depreciation claimed for the business portion since May 1997 when the exclusion was enacted.

Call Me For Help. There are several other issues in these new regulations, and not all are clear or easy to apply. I would like to help you before you sell the home. There's a lot of tax money at stake here. Please call me if these rules might apply to you.

This Issue

Your 2002 Return

Your return's been filed. Relax. That's it. It's over. Guess again!

Your refund check does not signal all is done. Your return was simply accepted, not approved. IRS spends a few months processing your return. Then they decide whether or not to audit.

✔ **Refund Late?** IRS policy — they can't check until 10 weeks after you filed the return. You can try earlier, but you may get no help yet. Automated assistance is found at 1-800-829-4477. There's a Refund Hotline at 1-800-829-1954. Or check the "Where's My Refund" link at www.irs.gov. You'll need your Social Security Number and the *exact* amount of your refund.

Got a Letter Instead? Call me now! The letters are confusing. Don't risk making an even bigger mess let me handle it for you.

✔ **Still Owe?** IRs sends bills in June. They show the balance, plus any interest and/or penalty. The bills only allow a 10-day "grace period" before the amount changes again.

Pay Soon. Send what you can. Write your Social Security Number on the check and write "Income Tax — Year 2002." If you can settle the bill within a couple of months, do it.

Installment Plans. If you need more time to pay, call me. I can help you set up an installment plan. IRS will charge $43 to set one up, but the financial charges drop a little. If you can pay within a month or two, don't waste $43 by asking for a plan.

Pay by Credit Card. You can pay with your credit card. The catch — you pay a "convenience fee" as high as 2.5%. You'll find details at 1-800-2PAYTAX. Or you can call 1-888-ALL-TAXX. Major credit cards accepted — Visa, MasterCard, Discover, or American Express.

✔ **Will You Be Audited?** Who can say? Most "audits" are really caused by a computer when items reported by employers, banks, or brokers don't match what's on your return. We'll worry about an audit if and when it happens. For now be sure our records are in a safe place. We might need them.

Roth IRAs Come Of Age

A completely tax-free savings account! That is the Golden Promise of the Roth IRA. A few million Americans can now tap these accounts with no tax issues. 2003 is the year that these accounts have "matured" for many Americans.

To earn the goal you had to promise to leave the account untouched until 2 things had happened:

(1) the account has existed for 5 tax years, and

(2) you have achieved age 59½.

Since Roth Accounts were first allowed for the 1998 tax year, anyone who opened an account in 1998 has met the first test. Tax law presumes a Roth deposit is made on January 1 of the tax year in question, even if the actual deposit is not made until April 15, of the following year. Thus Roth IRAs for 1998 have existed for 5 tax years — 1998, 1999, 2000, 2001, and 2002. If the depositor is now 59½ or older, the account is 100% tax-free.

Contributory Roth. This is an account in which you deposit new money. The old $2,000 yearly maximum is now $3,000. If you are age 50 or older by the end of the year your limit is $3,500. Once you open such an account, you begin counting your 5 tax years with the year of your first contribution. After the 5th tax year, you have passed this part of the test — *even for deposits made in later years!* It makes sense to open your first Roth account as early as possible.

Roth Conversions. You may also take an existing traditional IRA and transfer any part of it to a Roth IRA. The conversion is fully taxable, so this is a serious move. No penalty is charged even if you're under 59½. However, the penalty will apply retroactively unless you leave this account untouched for 5 tax years. This is a *different* 5-year test. It is applied separately to each conversion you make.

Early Withdrawals. Roth IRAs are unique in another way. Suppose you make a withdrawal before meeting the tests. You are deemed to first withdraw any contributory amounts, then your conversion amounts, and last the earnings. Tax and penalty are separate issues. Three possibilities exist:

1. Contributions. Withdrawals *up to the amounts you placed into Contributory accounts* to date are completely free of both tax and penalty.
2. Conversions. Withdrawals taken *from converted amounts* are tax-free, but are subject to penalty if there would have been a penalty at the time of conversion.
3. Earnings. Withdrawals of *earnings* are subject to both tax and penalty unless your have fulfilled the basic promise.

✔ **Your Records.** Put your return and related records somewhere safe. Keep copies of financial records and any worksheets we used to prepare your return. Put your check register with the returns.

Older Records. While you're at it, clean up your older records. It's wise to keep returns indefinitely. Also, keep records of investments or property you still own. What about bills, statements, canceled checks, and worksheets? Definitely keep 3 year's worth of records. Two more years is a good idea, but it is rare that we would need them. Anything beyond 5 years should be destroyed.

Pension Limits Rise

IRS says retirement fund money holds over $2 trillion in deferred taxes. it's the largest tax saver in America. In 2003, the amounts you may defer are at an all-time high.

The common plans — 401(k), 403(b), and 457 — now let you defer up to the first $12,000 you make. If you will be 50 or older by year-end, you can add another $2,000. Self-employed folks may be able to defer a whopping $40,000 in a SEP, with another $2,000 if 50 or older. Even the lowly IRA is at $3,000 or $3,500 for 50 and up. Save for your future!

New Laws Coming?

President Bush is pushing for big tax law revisions to stimulate the economy. Congress is putting up its customary partisan fight. The "smart money" says we'll definitely see a tax package this summer or fall.

As soon as I know real details, I'll pass along the information to you. In the meantime, only speculation is possible.

Tax cuts are a proven method to stimulate the economy. Expect to see some. You can also expect to see some laws favorable to the military. Congress needs to make a highly visible "Thank You" message after the efforts in the Middle East.

In the meantime, please stay alert for changes in your income or your deductions, and keep me posted. Our information exchange is a two-way street. I'll pass along all the news I can to help you keep your tax bill in hand. I depend upon you to let me know what's happening in your economic life. I can help you avoid pitfalls and save some money.

What's Hot?

Society changes as rapidly as tax laws. Some "new" ideas are really old rules applied to new situations. Here are some of the "new" topics my clients are asking about.

Hot! **Combat-Zone Issues.** With nearly 300,000 military on duty around Iraq, there are questions about tax issues. IRS issued a notice dealing with this. There's even a new web page entitled "Armed Forces Tax Benefits" as www.irs.gov.

Excluding combat pay is a very detailed issue, and I'll leave you to deal with the web page.

Extensions of various deadlines is a common issue. They apply to both military personnel and support personnel in combat zones. The "combat zones" described in the notice and web page cover much of the "Arabian Peninsula" including Iraq. In general, there is an extension for 180 days beyond the period of service in the combat zone for most tax filing issues. This includes filing *and* paying of most tax items.

Hot! **Telecommuters.** More and more Americans are part-time or full-time telecommuters. They do their work from home rather than go to the office each day. Outside of the business considerations, there are a number of tax issues.

Home Office. This is the most common question I get. There are tests to meet for the deduction:

(1) Dedicated Space. The space must be used *regularly* and *only* for business. It need not be a separate room, but must be used solely for business. Moreover the space must be either the principal place of business or used to meet customers and clients. An alternate test only requires that you do administrative tasks of the business here, but it works only if there is no other place where you do such work. Either way, the test is hard to pass if you are a part-time telecommuter.

(2) Employer's Convenience. The only safe way to pass this one is for the employer to *require* that you set up a workspace at home.

(3) Deduction. Costs for the workspace itself are claimed in full. You also deduct a pro-rata share of the home's cost. That's mortgage interest and property tax (or rent), utility bills, insurance and upkeep costs. If you own the home, there is also an allowance for depreciation.

Office Expense. If you add a phone or fax line, deduct it. Same goes for desk, chair, filing cabinets, etc. This is business equipment whether in your home or at employer's site.

Transportation Expense. If your home is your principal place of business, you'll be able to deduct much of your driving. Trips to the boss's office and any driving to sites in connection with the work is fully deductible. If you cannot pass the principal place of business test, the deductions are more limited. You may only deduct driving to work-related sites if those sites are "temporary" rather than "regular" under the law. Generally, a site you must go to 35 times or more during the year is "regular" and the drive is not deductible.

What's Cooking At IRS?

Everything seems to be moving more quickly at IRS. Refunds are faster. Responses come more quickly. Even audits come up more quickly. Maybe IRS reorganization has helped. Maybe it's the increased numbers of electronically-filed returns that turned the tide. The speed-up is real.

Matching Programs. IRS likes to compare your returns with reports from banks and brokers. This program highlights undeclared interest, dividends and stock sales. Past experience told us to expect letters about mismatches on your 2001 returns in August or September of this year. I saw the first one in April — 4 to 5 months earlier than normal.

Random Audits. The new program has begun with a vengeance! IRS needs to gather information about how the population handles tax issues. For many years IRS had special audits that reviewed even the blank lines on your return. They were interested in learning not only how people might be cheating or misunderstanding the laws, but also where honest mistakes were caused by poor instructions or forms. The official name was "Taxpayer Compliance Monitoring Program" or TCMP for short. Victims of the audits learned to call them "audits form hell." The results were used to build IRS computer programs to help spot returns likely to be worth the expense to audit. Thirty years ago IRS had state-of-the-art computers, and this special software was guarded better than Fort Knox. Today, some of the 30-year-old computers are still in service and IRS feels it's losing the battle with high-tech tax cheats. These audits are their hope to regain the lead.

Still Incorrect Answers. In January 2003, the Treasury Department sent undercover agents to 31 IRS offices to ask questions. About 25% of responses were incorrect — an improvement over last year's 50% score. Treasury is considering hiring independent contracting firms to staff IRS question desks. IRS employees' union is violently opposed to his. Don't expect anything on this soon.

Tips For You

Save on Education. You may be able to save on taxes if you or your family face education expenses. It has always been true you can deduct education to maintain or improve job skills. Employees must be able to itemize deductions to use this rule, but self-employed folks can always deduct this.

New Rules. We have 3 different benefits for eduction costs past high school. They apply whether the classes relate to work or not. If you income is not above $130,000 (couples) or $65,000 (single filers), you can benefit. The only restriction is that we may claim only costs for tuition and course-related fees. Costs for books, supplies, room and board, etc. do not count.

Form 1098-T is issued at year-end by educational institutions. It is used to report tuition and fees, but it often shows nothing at all. This is because your costs must be reduced by any tax-free scholarships, grants, or employer assistance. If any of these are present, the form is usually not completed. Please be alert to the costs and keep your own records; www.1098T is a website which most colleges use. If you know the student's Social Security Number you can get the details here. Your savings can be as high as $2,000, but I need the information to be able to help you. Be sure to keep records.

Family Day Care — New Meal Allowance. In March, IRS gave new rules if you offer day care in your home. Use a meal allowance rather than keep records of actual cost of food. Real costs are hard to track. Which food is for day care, which for family? The allowance is a Department of Agriculture figure for the Child and Adult Care Food Program (CACFP). The 2003 rates are $0.98 for breakfast, $1.80 for lunch or dinner, and $0.53 for snacks (up to three daily).

In two real cases, clients say the allowance figure is nearly twice as large as actual expense. A big win — simpler records *and* more deduction.

IRS also says we can amend older returns if the CACFP figures are used. They can be found at IRS's website — www.irs.gov/businesses/small/industries/index.html.

Deduct Losses on an IRA? Have you lost money in an IRA or Roth IRA account? Want to write off the loss? I get this question frequently. The answer is — maybe.

***"Realized"* Loss.** A loss must be real and final. You must close the account, or it's only a "paper loss."

Only one IRA. Next — tax law treats your IRA accounts as a *single* Individual Retirement *Arrangement*. Same for Roth. You have at most a *single* IRA and a *single* Roth IRA.

Tax Loss? Next — were your deposits pre-tax or post-tax. Pre-tax money placed in an IRA has already been deducted — you promised to pay tax on what you take out. There is no loss. Only post-tax contributions can yield a loss.

How To Deduct. If you have survived the steps up to here, we have the problem of the actual tax return. IRS says the loss is claimed among your itemized deductions as an investment expense. Some think this is an investment loss — a capital loss. The issue has not been tested by the Courts.

The best measure of a man's honesty isn't his income tax return. It's the zero adjust on his bathroom scale.

Arthur C. Clark, English scientist and author. *2001: A Space Odyssey*

Your Tax Calendar

June 16	2nd quarter estimated tax payments due.
July 31	2nd quarter payroll returns due (Aug. 10 if all deposits were paid).
	Forms 5500 due for pension or Keough plans.
Aug.15	Extensions to file form 1040 expire.
Sept. 15	3rd quarter estimated tax payments due.
Today	Be sure to call if there are large changes in income!