

CPA

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Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

Nearing Retirement? Rethink Your 'Muni' Strategy

The allocation of investments in one's portfolio changes over time. When we are young, for example, we can most afford to "risk big to win big," and we may not need to worry about tomorrow as much as in our later years.

If you are turning the road towards retirement and are earning a handsome income—as many do at this point in their careers—you may want to rethink your strategy concerning your investment in municipal bonds (or "munis"). As you probably know, the interest generated from municipal bonds is tax-free on the federal level. Munis are sometimes also exempt from state taxes, for example, if you purchase them from your state of domicile or from municipalities within your state.

Although their tax-exempt status normally makes munis attractive, they may become less so as you age—the savings from being exempt from federal taxation is most valuable when you are in a high tax bracket (that is, while you are working). However, the interest you earn on munis may be subject to the alternative minimum tax (AMT). You may also owe capital gains tax if you sell your munis at a profit.

Social Security and muni income may not mix well

Workers approaching retirement age must consider another issue: Contrary to popular belief, some portion of many people's Social Security benefits is subject to income tax, and

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Did You Know?

Households in the United States have a negative 0.7% savings rate, which is the lowest in the industrialized world, according to the Organization of Economic Co-Operation and Development.

Source: www.oecd.org

CPASM

America Counts on CPAs

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. Starting January 1, 2006, most individuals and businesses will be able to request a full six-month filing extension, without giving 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 *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

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the attractiveness of holding munis may decline when you consider how deeply your Social Security benefits may be taxed. Although not widely discussed, Social Security benefits have been partially exposed to taxation since 1984.

Whether your Social Security is taxed depends on your "provisional income," which is directly affected by whether you hold municipal bonds. Provisional income is calculated using (1) your adjusted gross income, (2) 50% of your yearly Social Security benefits, and (3) tax-exempt interest income from municipal bonds and/or municipal bond funds. Thus, your tax-exempt income is added to your taxable income when determining whether your Social Security benefits will be taxed.

You can receive up to \$25,000 of tax-free Social Security benefits for a single taxpayer, or up to \$32,000 for joint returns. A certain percentage of your

Social Security benefits are taxed when your provisional income exceeds these limits: Up to 50% of your benefits are taxed until your income calculation exceeds \$34,000 for a single filer or \$44,000 on a joint return, at which point up to 85% of your Social Security benefits can be taxed. As your provisional income increases, the portion of your Social Security benefits that are exposed to taxation also rises.

Because many retirees fall into a lower tax bracket once they are no longer working, full-time or otherwise, holding munis becomes even less valuable to their overall investment strate-

gies. If you find yourself in a lower tax bracket, you may want to alter your strategy to include investments in Treasury or corporate bonds—the latter of which often provides you with higher yields—the former is considered a safe investment.

You should also carefully evaluate how much your munis can offer after you take the potential for additional taxes into account, particularly if you are looking forward to retiring soon and collecting Social Security. If having munis results in your Social Security benefits getting taxed, you definitely need to rethink your overall strategy.

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 in any high-cost locality and \$141 for travel in 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.

2006 Standard Mileage Rates Set

The IRS announced its 2006 optional standard mileage rates. These rates are used by employees, self-employed individuals, and other taxpayers who need to compute the deductible costs of operating an automobile (including vans, pickups, or panel trucks) that they own or lease for business purposes. Different rates are also used to compute the deductible costs of operating automobiles for charitable, medical, or moving expenses.

The new rates apply to automobile costs incurred after January 1, 2006 and are as follows:

- For transportation expenses incurred for business purposes, the standard mileage rate is 44.5 cents per mile, up from 40.5 cents for the first eight months of 2005.
- The standard mileage rate for use of your car for medical reasons is 18 cents per mile, up from 15 cents for the majority of months in 2005.
- For an automobile used to provide free services to a charitable organization, *other than* activities related to Hurricane Katrina relief, the standard mileage rate remains 14 cents per mile, as established by statute.
- The standard mileage rate to use when computing deductible moving expenses is 18 cents per mile, up from 15 cents for the majority of months in 2005.
- For 2006, these Katrina-related charitable rates will be 32 cents per mile for deduction purposes and 44.5 cents per mile for reimbursement purposes.

The standard mileage rate is provided by the IRS as a convenience to taxpayers. You still have the option to calculate your actual costs instead of using the standard mileage rate. However, special rules apply when changing between the two methods. Although the standard mileage rate includes most expenses associated with an automobile, you can still also deduct parking fees, tolls, interest payments on the car, and any property taxes associated with your automobile.

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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 of those 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 could 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, from 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.

How to Avoid the 10% Penalty On Early IRA Distributions

An early distribution from your individual retirement account (IRA)—defined as a distribution before you reach 59½ years of age—must be reported on Part I of Form 5329 and is generally subject to a 10% excise penalty *unless* it qualifies for one of the codified exceptions delineated in the Internal Revenue Code. Fortunately, there are quite a few exceptions.

The exceptions

Substantially Equal Periodic Payments: Distributions that are “part of a series of substantially equal periodic payments” made over the lifetime of the IRA holder or the joint lives of the holder and a designated beneficiary are exempt from the 10% penalty. These payments must occur at least annually, and the exception lasts only so long as the individual does not alter the method of distribution. If, for example, someone takes out payments for five years and then changes the method, the penalty is retroactive to the first year a distribution was taken (assuming the taxpayer is less than age 59½). The goal of this exception is to avoid the potential for lump sum distribution.

Separation from Service: Distributions made after separation from service to an employee who is at least age 55 are exempt.

Limited QDRO Exception: Distributions made subject to a qualified domestic relations order (QDRO) are exempt from the excise penalty *only* if the QDRO specifically lists the IRA (the

IRA itself is subject to the rules relating to the QDRO). If the QDRO does not incorporate the IRA, then distributions from the IRA are not exempt from the penalty.

Distribution to Unemployed Individuals for Health Insurance Premiums: If a medical distribution was made to a qualified unemployed individual and does not exceed certain premium limits, then under the law, that distribution is exempt from the penalty. The individual qualifies if he or she received state or federal unemployment for 12 consecutive weeks. In the case of the self-employed individual, you are deemed unemployed if you would have qualified to receive federal or state unemployment if you were not self-employed. In the event of reemployment, the penalty will apply to any distributions made after you have been working for at least 60 days.

Qualified First-Time Home Buyer: Another exception to the 10% penalty is for the qualified first-time home buyer. In this situation, a first-time home buyer, as defined in the IRC, is one who “had no present ownership interest in a principal residence during the 2-year period ending on the date” the new principal residence is acquired. This exception may be used for up to \$10,000 during a taxpayer’s lifetime and applies to distributions for acquisition costs, closing costs, and

settlement charges for a principal residence for the taxpayer, his or her spouse, child, grandchild, or ancestor.

Higher Education: The 10% penalty is waived if the distribution is used to pay for “qualified higher education expenses” for the taxpayer, his or her spouse, child, or grandchild. Qualified expenses include tuition at a post-secondary educational institution, books, fees, supplies, and equipment. It is not inclusive of living expenses.

Death of the Taxpayer: Although not a “pleasant” exception, distributions made to a beneficiary or to the employee’s estate upon the death of the employee are exempt from the 10% penalty.

Disability: A taxpayer who furnishes medically conclusive proof that he or she is disabled within the meaning of the law may receive IRA distributions before the age of 59½ without incurring the 10% penalty. To qualify as being disabled, an individual must be unable to engage in “any substantial gainful activity” as a result of a physical or mental impairment that is either terminal or of an indefinite long-term duration.

Tax Court

A recent Tax Court opinion illustrates the importance of falling neatly within one of the exceptions listed above.

The taxpayer in this case argued that her declining health (bilateral tendonitis, carpal tunnel syndrome, and depression) forced her to switch from



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full-time to part-time work, and that this change in circumstances constituted a disability that fits within the definition of the disability exception.

The Court did not agree. Its opinion, quoting language straight from

the IRC, focused on the fact that a taxpayer must be "unable to engage in any substantial gainful activity by reason of any medically determinable physical condition or mental impairment which can be expect-

ed to result in death or to be of long-continued and indefinite duration." The taxpayer in this case was not found to be disabled within this definition, thus she failed to benefit from the disability exception to the 10% penalty for her early IRA withdrawal.

Tax Calendar

FEBRUARY 2006

February 10

Employees who work for tips. If you received \$20 or more in tips during January, report them to your employer. You can use Form 4070.

February 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2005, but did not give you a new Form W-4 to continue the exemption for 2006.

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

February 28

All businesses. File information returns (Form 1099) for certain payments you made during 2005. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is March 31.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2005. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration (SSA) will be extended to March 31.

MARCH 2006

March 10

Employees who work for tips. If you received \$20 or more in tips during February, report them to your employer. You can use Form 4070.

March 15

Corporations. File a 2005 calendar year income tax return (Form 1120 or 1120-A) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2005 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2006. If Form 2553 is filed late, S treatment will begin with calendar year 2007.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date is effective for the first March 15 following the close of the partnership's tax year. The due date of March 15 applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

March 31

Electronic filing of Forms 1098, 1099, and W-2G. File Forms 1098, 1099, or W-2G with the IRS. This due date applies only if you file electronically (not by magnetic media). Otherwise, see February 28. The due date for giving the recipient these forms was January 31. For information about filing Forms 1098, 1099, or W-2G electronically, see Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically.

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose.

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