

CPA

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Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

The Roth Designated 401(k) Account . . . What's That?

Over the past few years, you've no doubt read dozens of articles that compare Roth IRAs to traditional IRAs, highlighting the fact that IRAs are funded by pre-tax dollars—and Roths by after-tax, that the funds in a Roth are withdrawn free from tax at retirement, and about the many aspects associated with converting a traditional IRA to a Roth.

But the *au courant* comparison is between Roth IRAs, first legislated for in 1997, and their newly minted relation, the Roth Designated 401(k). Starting January 1, 2006, you will be permitted to designate all or a portion of your contributions to your 401(k) as "Roth contributions" made on an after-tax basis. Employers are authorized under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) to offer this option to their employees, although it is not required.

The differences between traditional and Roth 401(k) contributions are similar to the differences between traditional and Roth IRAs. Traditional IRAs and 401(k) contributions are made with pre-tax dollars and distributions are taxable; Roth IRAs and 401(k) contributions are made with after-tax dollars, but distributions are not taxed.

Note: The new rules also apply to 403(b) plans of nonprofits and education-

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Did You Know?

The cost of day-camp programs counts as an expense toward the child and dependent care credit. The credit ranges from 35% of the cost for taxpayers with income of less than \$15,000 to 20% for those earning in excess of \$43,000.

Source: www.irs.gov

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al institutions. At the time this edition of *CPA Client Bulletin* goes to print, the rules do not apply to 457 plans or to most government plans.

If you are an employer, you should prepare for the fact that your employees will want to take advantage of this new retirement savings option. Both employees and employers are encouraged to call our office to discuss how to implement and take advantage of these accounts.

The basics

Starting in 2006, 401(k) plan sponsors may add a "qualified Roth contribution program," allowing employees to designate all or a portion of their 2006 401(k) contribution as a Roth contribution. Roth contributions will be included in the employee's taxable income when contributed, but the earnings would be permitted to grow tax-free.

Like Roth IRAs withdrawals, distributions from Roth 401(k) accounts are generally tax-free if: (1) the withdrawal occurs after the age of 59½, death, or disability; and (2) the contributions have been in the account for at least five years. Unlike Roth IRAs, Roth 401(k) accounts are subject to the same required minimum distribution rules after age 70½ as traditional 401(k)s and traditional IRA accounts.

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Complex requirements for employers

The proposed rules for Roth 401(k) contributions are intricate, and our office is ready to help both employers and employees navigate them. For example:

- Roth contributions and earnings on those contributions must be maintained in separate accounts that may only be funded by elective employee contributions; therefore, employer-matching and nonelective contributions may not be included in Roth accounts.
- Employee designations of a contribution as a Roth contribution must be "irrevocable" when that election is made, and cannot be altered.
- Roth contributions must be included in the employee's gross income in the year contributed.
- Roth 401(k) accounts can only be rolled over to another plan maintaining designated Roth contribution accounts or to a Roth IRA.

Adding a Roth contribution option to your 401(k) plan will lead to a number of new accounting and recordkeeping requirements, such as creating and maintaining separate accounts for each employee until all amounts in the employee Roth account are distributed. Roth contributions are also subject to the nondiscrimination testing rules.

Contribution limits

The annual contribution rate that an employee may contribute to a 401(k)

plan, inclusive of a Roth 401(k) account, is adjusted for inflation each year. For tax year 2006, the amount is set at \$15,000. This amount is increased by \$5,000 if you are age 50 or older at year end.

Designated Roth contributions would be taken into account under the ADP test in a similar way that pre-tax deferrals are taken into account. A



plan could allow a highly-compensated employee to designate whether a corrective distribution of excess contributions would be made from pre-tax elective contributions or from designated Roth contributions. A distribution of excess contributions would not be includible in gross income to the extent the distribution represents a distribution of designated Roth contributions; however, income allocable to such a corrective distribution would be includible.

If you have any questions regarding the proposed Roth 401(k) plan regulations or are considering the addition of a Roth 401(k) plan feature to your company's existing 401(k) plan, please call.

Employers Also Benefit From Employee Wellness Programs

Summertime . . . beaches, bathing suits, and other reasons to want to "shape up your bottom line," so to speak. How better to do that than doing so with tax-favored benefits?

If you are an employer looking to help your employees get or stay healthy, there are ways you can offer wellness programs that will benefit your business as well as your employees.

Ask business owners of any size company about their costs and—time and time again—you'll hear complaints about constantly rising health insurance expenditures. One way to contain these costs is to reduce the number of claims that

your employees file. Many companies are turning to wellness programs as a way to encourage healthy lifestyles, reduce the likelihood of workplace injuries, boost morale and productivity, and lower their overall health care costs.

Wellness programs include any program that promotes health or disease prevention. Examples include smoking cessation classes, subsidized gym memberships, lunchtime diet and exercise groups, stress management seminars, health screenings, and on-site gyms. As an employer, you have the flexibility to tai-



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for the programs to the needs of your own employees.

Follow the IRS rules to reap the benefits

While offering wellness programs brings you the benefits listed above, you must carefully follow IRS rules (1) to deduct the costs of your program; and (2) to enable your employees to exclude these fringe benefits from their taxable income. And, if your group health plan is "qualified" under the Internal Revenue Code, you can offer premium discounts or rebates to employees who use the wellness program.

Any wellness program that ties a reward to the program *must* meet several IRS requirements to avoid discrimination based on a health factor:

1. The total reward given to any individual may not exceed a specified percentage of the cost of employee-only coverage under the plan (ranging from 10 to 20 percent);
2. The program must be reasonably designed to promote good health or prevent disease (and give eligible individuals the opportunity to qualify for the reward at least once per year);
3. The reward must be available to *all* similarly situated employees; and
4. The plan must offer—detailed and in writing—a "reasonable alternative standard" that will allow individuals who cannot satisfy the general standard because it is medically inadvisable or unreasonably difficult due to a medical condition.

Call our office to discuss how to select and establish the best wellness programs for your business.

2005 Per-Diem Travel Rates

Many companies prefer to use the IRS-approved per-diem rates to substantiate deductions rather than keeping track of endless receipts. The IRS has announced the rules and rates applicable for expenses incurred on or after January 1, 2005.

For 2005, the per-diem rate is \$204 for travel to any high-cost locality and \$129 for travel to any other locality within the continental United States (referred to as CONUS). The 2005 meal and incidental expense (M&IE) rates under the optional high-low method are \$46 for high-cost localities and \$36 in all other CONUS localities.

IRS Publication 1542 also describes changes to the list of high-cost localities and revises the description of incidental expenses relating to transportation between places of lodging or business and places where meals are taken. There are also over 20 new destinations added to the listing of locations—contact our office for more information.

These new rules apply to (1) per-diem allowances paid to an employee for lodging, meal, and incidental expenses or with respect to M&IEs paid or incurred for travel away from home; and (2) computing the amount allowable as a deduction for M&IEs or for incidental expenses paid or incurred by an employee or self-employed individual for travel away from home.

Attention Employers: New Notice Requirement

As of March 10, 2005, employers must notify employees who might leave or be called for military service of their rights—including re-employment rights, health insurance protection, and rights to be free from discrimination and retaliation—under the Uniformed Services Employment and Reemployment Rights Act (USERRA). This new requirement is mandated by the Veterans Benefits Improvement Act (VBIA), enacted by Congress in December 2004, and covers all employers, even those with just one employee.

You can meet the new notice requirement by posting a new USERRA poster "in a prominent place where employees customarily check for such information." You may also distribute the notice to your employees in person, or by mail or e-mail.

You can download a copy of the poster from the Department of Labor Web site at www.dol.gov/vets/programs/userra/poster.pdf or call 1-866-4-USA-DOL (1-866-487-2365) to request printed copies. Additional information on USERRA can be found on the DOL Web site at <http://www.dol.gov/vets>. A copy of the statute, fact sheets, and a nontechnical guide to USERRA is available for download at www.dol.gov/vets/programs/userra.

Add a Lexus to the List

The Internal Revenue Service has certified the model year 2006 Lexus RX 400h as being eligible for the clean-burning fuel deduction. Taxpayers who purchase one of these hybrid vehicles new during calendar year 2005 may claim a tax deduction of up to \$2000 on Form 1040.

Under The Working Families Tax Relief Act of 2004, which was signed into law in October of 2004, the clean-burning fuel deduction is limited to up to \$2,000 for certified vehicles first put into service in 2005 and \$500 for vehicles placed in service in

2006. Act quickly: No deduction will be allowed after 2006.

Federal law allows individuals to claim a deduction for the incremental cost of buying a motor vehicle that is propelled by a clean-burning fuel. This one-time deduction must be taken in the year the vehicle is originally used. The taxpayer must be the original owner. Individuals do not have to itemize deductions on their tax return to claim this deduction. This benefit can be taken as an adjustment to income on Form 1040.

Please refer to the IRS Web site at www.irs.gov for more information about this deduction. The following

vehicles also qualify for the clean-fuel vehicle deduction, but be sure to call our office about which model years qualify:

- Ford Escape Hybrid
- Toyota Prius
- Honda Insight
- Honda Civic Hybrid
- Honda Accord Hybrid

Many states also have tax and other incentives available to people purchasing advanced technology vehicles, such as hybrid electric vehicles. In addition, other incentives may be available at the local level—making it more advantageous to purchase these types of vehicles.

Tax Calendar

JULY 2005

July 11

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

July 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

Partnerships. File a 2004 calendar year return (Form 1065). This due date applies only if you were given an automatic three-month extension. Provide each partner with a copy of Schedule K-1 or a substitute K-1. If you need an additional three-month extension, file Form 8800.

Electing large partnerships. File a 2004 calendar year return (Form 1065). This due date applies only if you were given an automatic three-month extension. If you need an additional three-month extension, file Form 8800.

AUGUST 2005

August 1

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2005. Deposit any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through July if more than \$500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500EZ for calendar year 2004.

August 10

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

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2005 only if you deposited the tax for the quarter in full and on time. Otherwise, Form 941 was due on August 1.

August 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

Individuals If you have an automatic 4-month extension to file your income tax return for 2004, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, and penalties due. If you need an additional two-month extension, file Form 2688.