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Client Bulletin

BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

Poor Health and Your Home: The Tax Connection

If you own your own home, you're probably familiar with the special tax rule that lets you exclude the gain from the sale of your primary residence. To take advantage of this exclusion, the IRS requires you to have lived in your home for at least two years within the five years prior to the sale date. Married couples that file a joint return may exclude \$500,000, and individual taxpayers get a \$250,000 exclusion.

Another, lesser known, exclusion

There are other, lesser exclusions if you sell your house far "too soon" because of unforeseen circumstances, divorce, or financial hardships.

But a lesser-known exclusion—the health exclusion—may be one of your strongest cases for getting an "early" exclusion. The exclusion amount is computed as a percentage of the regular exclusion rate (either the \$500,000 or \$250,000 rates mentioned above), expressed as the number of months you owned your home as your primary residence divided by 24 months.

Example

Assume that a homeowner purchased his home January 30, 2005 for \$300,000. He sells his home on July 30, 2005. He owned the house and lived in it as his primary residence for six months. If the sale was precipitated by

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Bankruptcy Legislation: Change is in the Air

You cannot watch a TV newscast or read the papers these days without encountering a story on the federal bankruptcy legislation that's made its way through Washington. On April 14, 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S.256), also known as the Bankruptcy Reform Act, which the President signed into law on April 20. While it's a challenge to keep up with all of the twists and turns in the news on bankruptcy, it's even tougher to know how this legislation will affect you; our office is prepared to help.

One thing is for certain: Changes in federal bankruptcy law will have a major impact on both individuals and businesses. Most of its provisions will be effective 180 days from the day it was signed into law.

Bankruptcy, defined, by chapter

Mark Twain filed for bankruptcy protection. So did Walt Disney, as did Milton Hershey, P.T. Barnum, Kim Bassinger, Burt Reynolds, and, yes, even Henry Ford. Approximately 1.6 million Americans did it just last year alone. Bankruptcy is a process that takes place in federal court. It was designed to help individuals and businesses eliminate or repay their debts under bankruptcy court protection. Generally, there are two types of bankruptcies—liquidation and reorganization—which are addressed in various chapters of the U.S.

Did You Know?

It was not until 2004 that the sum total of credit card, debit card, and other forms of e-payments exceeded the number of paper check transactions.

Source: The Federal Reserve

CPASM

America Counts on CPAs

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a bona fide health reason, he will be able to exclude up to \$125,000 in gain on a joint return (one-quarter of the \$500,000 exclusion). Note that an additional adjustment may have to be made if he sells another primary residence (with gain) within two years of this sale.

By IRS definition, your home is sold for "health" reasons if

... Your primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual (such as your child). Health is considered to be the reason you sold your home if ... a doctor recommends a change of residence.

It would be prudent to obtain a doctor's recommendation, in writing, to help substantiate that the sale was brought on by health reasons for you or for a member of your family.

Please consult our office to handle the intricacies involved with obtaining this exclusion, as well as for information on the other lesser-known exclusions on the gain of the sale of your home.

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Bankruptcy Code. For liquidation style bankruptcies, property is sold to pay debts, whereas payment plans are created under reorganization bankruptcies. Chapter 7 covers liquidations for both personal and business bankruptcies, and Chapters 11, 12, and 13 cover reorganization bankruptcies.

While no two bankruptcy situations are exactly the same, individuals and businesses typically file under only certain chapters of the U.S. Bankruptcy Code, the names of which get tossed around a lot without too many people understanding the references. Following is a quick overview of some of the chapters:

Fewer Chapter 7's on the horizon

Filing under Chapter 7 has become more difficult. Currently, almost 70 percent of individuals who file for bankruptcy do so under Chapter 7, according to the American Bankruptcy Institute.

Generally, under the new law, a Chapter 7 case will be converted to Chapter 13 if the debtor can pay the lesser of (a) \$10,000 or (b) the greater of (1) 25 percent of unsecured, non-priority debt or (2) \$6,000. A debtor will be able to rebut the means test by demonstrating "special circumstances," and certain "safe harbor" exemptions may apply.

That means that even if a debtor is \$100,000 in debt and can only afford to

U.S. Bankruptcy Code	Protection offered	Who it protects
Chapter 7	Liquidation—a bankruptcy estate is formed from your personal property, except for certain types that are exempt from the bankruptcy estate, the proceeds of which are used to pay creditors. Most types of debts are then cancelled. Sometimes referred to as "straight bankruptcy" or "fresh start"	Individuals, partnerships, and corporations "Fresh start" is for individuals only
Chapter 9	Debt reorganization	Municipalities (e.g. cities, counties, townships, school districts, and public improvement districts)
Chapter 11	Reorganization of debts to keep a business in business. Debtors may retain income earned after filing for bankruptcy while using only assets held at the time of filing to pay past debts	Corporations, certain individuals (those with debts greater than those that would be covered by Chapter 13 or of over approximately \$1.2 million)
Chapter 12	Debt reorganization	Farms (extended under the new law to include family commercial fishing operations and aquaculture)
Chapter 13	Repayment plan is set up to pay, usually, a portion of the debt and individuals can be forced to allocate disposable income to the plan. The debtor usually keeps his or her personal property.	Individuals only (including sole proprietors, but not partnerships or corporations) with regular income

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pay \$100 a month, as determined by the court, the debtor probably will no longer be able to file Chapter 7. The repayment will be structured under a Chapter 13 plan that spans five years (debtors with income that is less than the state median will pay over a three-year period). A Chapter 13 debtor will be permitted to deduct from plan payments the costs of health insurance, domestic support obligations, expenses to operate a business, and charitable contributions of up to 15 percent of gross income.

Some tax-related information

Non-dischargeable debts now include state and local taxes. Federal taxes were non-dischargeable prior to the enactment of the new law. Along with other documents required under prior law, debtors must now submit copies of tax returns, payroll stubs, and other documents with the petition for bankruptcy.

Saving your home

Under federal bankruptcy law, debtors can shield a portion of the equity in their homes from unsecured creditors. And under the new legislation, debtors who can choose a state homestead exemption over the federal exemption will be bound by a prior state of residence for two years after moving to a more generous state. Under the new legislation, a debtor must have lived in the state for at least 40 months to qualify for the full state homestead exemption. If the debtor has not been in his or her home for the required number of months, the new bill limits the homestead exemption to \$125,000.

Of note to renters, landlords will be able to bypass the automatic stay and initiate or continue eviction proceedings.

Saving your car

Debtors will now be required to pay the full amount owed on a car loan, regardless of the condition of the car. Previously, the debtor would only

have to pay what the car was worth to keep it. For many drivers with unpaid auto loans, this means that its payoff amount may far exceed its current market value, introducing a major change in bankruptcy law.

Saving your business

Before these bankruptcy changes, small businesses with a lot of debt could have filed under Chapter 7, giving them a chance to begin anew in about four months. Because the new law makes filing a Chapter 7 much more difficult, many businesses will have to file under Chapter 13, repaying their debts over five years.

A lot could happen to you in five years—you may close shop, your spouse may become unemployed, or some other unforeseen event could affect your business. However, no matter what contingency occurs or alters your future ability to pay, you must stick to the Chapter 13 repayment plan.

Under the new law, businesses with less than \$2 million in debts can file an expedited form of Chapter 11 reorganization (see chart, p. 2, to appreciate the change from the old law to the new). A Chapter 11 debtor has only 18 months to propose a reorganization plan before creditors are allowed to propose their own plans. Prior to the new law, creditors were barred from making proposals indefinitely due to the debtor's ability to obtain extensions.

Saving your IRAs

Up to \$1 million held in tax exempt retirement accounts (including IRAs) will be exempted. This cap may be increased if "the interests of justice so require." Prior to the Act, only ERISA-qualified pension plans were unreachable by creditors.

Our office staff is closely watching developments concerning bankruptcy law. If you think that a business or personal bankruptcy may be necessary in the near future, call our office to determine what the consequences would be.

AJCA Allows Full Deduction of Some Attorneys' Fees

The American Jobs Creation Act (AJCA) of 2004 has been highly touted for its impact on the manufacturing sector and its effect on the treatment of foreign business income. One less-discussed but important provision of the AJCA known as the Civil Rights Tax Relief Bill may affect you.

The provision changes the tax treatment of contingent attorneys' fees and costs related to judgments and settlements arising out of certain employment discrimination and federal whistle-blower laws. So if you have won a judgment or settlement in these sorts of cases, this provision directly affects you.

This relief applies to certain judgments and settlements occurring after October 22, 2004, the date that the AJCA was signed into law. The attorneys' fees must have been paid after that date as well. To benefit from this new provision, you must pay the attorneys' fees in the same year you receive the award. Under the AJCA, attorneys' fees and costs related to an award or settlement that are includible in a taxpayer's income are now 100% deductible from gross income for federal income tax purposes.

Above-the-line versus itemized deductions

Unlike prior treatment, qualified attorneys' fees are deductible "above the line," meaning before adjusted gross income is calculated. Previously, a judgment or settlement from these types of cases was fully included in gross income, but the attorneys' fees could only be deducted (1) if the taxpayer itemized deductions and (2) to the extent the fees exceeded two percent of the taxpayer's adjusted gross income (the miscellaneous itemized deduction "floor").

Taxpayers' ability to benefit from this deduction was also subject to phase-out limitations if their income exceeded certain thresholds. Also, because taxpayers subject to the alternative minimum tax (AMT) are not

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EXAMPLE OF PRE-AJCA AND POST-AJCA TAX TREATMENT OF DAMAGES IN AN EMPLOYMENT DISCRIMINATION CASE

Consider the following example: A successful plaintiff with an employment discrimination claim is awarded \$250,000 in damages and owes her attorney \$75,000 in costs and fees.

Under previous law, she would include the entire \$250,000 in income and would, at best, only be able to deduct a maximum of \$70,000 (\$75,000 minus two percent of \$250,000, or \$5,000, equals \$70,000). She may even have to pay taxes on the full \$250,000, because her deduction is eliminated by the phase-out provisions and AMT, despite the fact that \$75,000 went directly to her attorney. Both she and her attorney pay income tax on the same \$75,000.

Under the new law, she would deduct the entire portion of the award that pays her attorneys' fees, here \$75,000, as an above-the-line deduction. She would pay taxes on \$175,000 (\$250,000 minus \$75,000) regardless of whether AMT and the phase-out provisions apply. Only her attorney would pay tax on the \$75,000.

Overall, the law touches on cases arising out of only certain, not all, employment and whistle-blowing claims, as well as other "catchall" claims. In addition, the new provision limits the amount that can be deducted: it may not be greater than the amount includible in the taxpayer's income.

Contact our office to see if you can benefit from this new provision.

allowed any deductions for miscellaneous itemized deductions, they did not receive any tax relief at all for attorneys' fees.

Taxpayers who received large settlements had to include the entire amount in income in the year in which it was received: this pushed them over the thresholds or made them subject to the AMT. As a result, they could not deduct attorneys' fees, in effect paying taxes on money they never received, which is still the case for all other kinds of lawsuits.

Types of claims eligible

Claims eligible for above-the-line deduction of attorneys' fees include unlawful discrimination claims under several federal

anti-discrimination laws, for example, the Age Discrimination in Employment Act, the Civil Rights Acts of 1964 and 1991, the National Labor Relations Act, the Employee Retirement Income Security Act, and the Family and Medical Leave Act. Also, whistle-blower claims and claims against the government under the False Claims Act are eligible.

The positive impact on civil rights plaintiffs, whistle-blowers, and others could prove to be dramatic. Because the portion of a judgment or settlement used to pay attorneys' fees and costs will no longer be included in adjusted gross income, the effective monetary award will be greater than it was before the enactment of the AJCA. If you are a potential or successful plaintiff in one of these types of cases, you should talk to us immediately.

Tax Calendar

JUNE 2005

June 10

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

June 15

Individuals. If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due. If you want additional time to file your return, file Form 4868 to obtain two additional months to file. Then file Form 1040 by August 15.

If you are not paying your 2005 income tax through withholding (or will not pay in enough tax during the year that way), pay the second installment of your 2005 estimated tax. Use Form 1040-ES.

Corporations. Deposit the second installment of estimated tax for 2005.

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

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.