



2005 tax year in perspective

This edition focuses on the recent tax law changes and offers planning strategies that may help reduce your 2005 tax liability.

New tax laws, tax reform discussions and increased Internal Revenue Service (IRS) enforcement have had significant impact in the last few years, and 2005 is no exception.

Two important tax laws this year are the *Energy Tax Incentives Act of 2005* (Energy Act) and the *Katrina Emergency Tax Relief Act of 2005* (KETRA). Highlights of the Energy Act are covered on

page 2. For more information on KETRA, visit bkd.com.

Enacted in August, the Energy Act provides new and expanded incentives for efficient energy consumption and production. KETRA provides tax relief for hurricane victims and contains some incentives for those who stepped in to help.

In addition to these new laws, many of the new provisions of the *American Jobs Creation Act of 2004* (Jobs Act) became effective in 2005: The new deduction for qualified domestic production activities and new restrictions on

nonqualified deferred-compensation plans will affect many 2005 business tax returns.

On top of the new rules, the IRS, as promised, stepped up enforcement activities, especially targeting exempt organizations, employee benefits, high-wealth individuals, S corporations and potentially abusive tax shelters.

It also shifted priorities and funds from taxpayer education to increased audit activities and continues to ask Congress for more funds to help narrow the tax gap. Among the IRS's new enforce-

ment measures are increased penalties and restrictions on written tax advice.

With all the action of 2005, how will 2006 measure up? A special panel appointed by the President continues to mull over tax-reform options. So far, it has recommended against imposing a national sales tax but *has* recommended cuts to the alternative minimum tax (AMT).

Add to this the ongoing Congressional debate over estate repeal, and 2006 has the potential for additional tax law changes and debate. ♦♦♦

Alert: Disclose reportable transactions or face penalties

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Certain transactions known as "reportable transactions" are required to be specially disclosed to the IRS on your tax return.

Failure to do so can result in penalties as high as \$100,000 for individuals and \$200,000 for C corporations, per transaction.

Even innocent omissions of seemingly insignificant transactions can result in large penalties. Consider this when compiling your year-end tax information.

Reportable transactions include:

- ◆ Listed transactions; those determined by the IRS as likely abusive tax shelters (for more information, see irs.gov/businesses/corporations)
- ◆ Confidential transactions; a promoter requires you to sign a confidentiality agreement in connection with a tax strategy
- ◆ Transactions with contractual protection; you have a right to a refund of your investment or fees if a tax strategy does not pan out
- ◆ Certain transactions resulting in large losses; \$2 million to start for individuals
- ◆ For publicly traded corporations or corporations with assets of \$250 million or more, transactions in which financial statement treatment differs from tax treatment by more than \$10 million
- ◆ Transactions resulting in tax credits exceeding \$250,000 if the underlying asset giving rise to the credit is owned for 45 days or less

If you think you might have engaged in one of these transactions, call your BKD tax advisor. ♦♦♦

What's inside:

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Highlights of the Energy Tax Act of 2005

Energy tax incentives & credits for businesses & individuals



The *Energy Tax Incentives Act of 2005* (the Act) contains a \$14.5 billion package of tax breaks that include both renewable energy provisions and incentives for the oil, gas, coal and nuclear industries.

Because almost all of the provisions are effective after 2005, you may be wise to delay affected purchases or projects until 2006, where practical.

The Act also includes incentives for energy production:

- ◆ Shorter write-off for natural gas distribution lines and certain assets used in the transmission of electricity for sale
- ◆ Shorter write-off for natural gas-gathering lines
- ◆ Two-year write-off of geological and geophysical expenses
- ◆ Expensing of 50% of the cost of certain capacity-increasing refinery investments
- ◆ For purposes of the small refiner, an exception to the oil-depletion deduction that increases the barrel-per-day limit for independent producers to 75,000 barrels, based on average daily production
- ◆ A new production tax credit for qualifying advanced nuclear power facilities
- ◆ Elective five-year carryback of net operating losses for

certain electric companies of up to 20% of the cost of electric transmission capital and pollution control expenses

- ◆ The placed-in-service date is extended through December

31, 2007, for certain qualified facilities for purposes of the credit for electricity produced from renewable resources; the

Act also adds two new qualifying energy resources—hydropower and Indian coal—and equalizes the period the credit may be taken at 10 years

- ◆ New tax credits for investments in clean coal facilities that produce electricity
- ◆ An 84-month amortization for the cost of power-plant air pollution controls
- ◆ Inclusion in the “general business credit” of the tax credit for fuel produced from unconventional sources, resulting in one-year carry back, 20-year carry forward for unused credits; the tax credit also is extended to coke and coke gas from certain qualified facilities
- ◆ Expansion of the small ethanol producer credit to producers with annual production capacity of 60-million gallons; the Act also adds a small agribiodiesel producer credit to the biodiesel fuels credit
- ◆ Extension of the tax incentives for biodiesel, *e.g.*, income and excise tax credits; producers of “renewable diesel” will be allowed to claim similar income and excise tax credits at the \$1 rate applicable to agribiodiesel ❖❖❖

Energy planning for 2006 & beyond: for homeowners, contractors, manufacturers & other business interests

Here’s a summary of the energy efficiency and conservation measures to consider for 2006.

- ◆ New tax credits for the purchase of hybrid, fuel cell, advanced lean burn and other alternative power vehicles placed in service after 2005.
- ◆ New 30% tax credit for the purchase of qualifying residential solar water heating, photovoltaic equipment and fuel cell property placed in service in 2006 and 2007.
- ◆ New 30% business tax credit for the purchase of certain power plants.
- ◆ New 10% personal tax credit for energy-efficient improvements to existing homes; the lifetime maximum credit per taxpayer is \$500 and applies for property placed in service in 2006 and 2007.
- ◆ New business tax credit for contractors that construct energy-efficient new homes; the per-home credit is either \$2,000 or \$1,000 depending on the type of home and the energy reduction standard it meets. The credit applies to homes with construction substantially completed after December 31, 2005, which are purchased after December 31, 2005, and before January 1, 2008.
- ◆ New deduction for energy-efficient commercial buildings placed in service in 2006 and 2007 that meet a 50% energy reduction standard; the deduction, generally \$1.80 per square foot, is 60 cents per square foot in some cases.
- ◆ New manufacturers’ tax credit for energy-efficient dishwashers, clothes washers and refrigerators manufactured in 2006 and 2007. ❖❖❖

Individual year-end tax planning strategies

Take advantage of FSA savings

If your employer offers a flexible spending account, take advantage of the tax savings by making elective contributions to the plan.

Such a plan basically allows tax-free distributions to pay for qualified items like health insurance premiums, qualified child care and medical expenses, such as prescriptions and even over-the-counter drugs like aspirin, cold medicine, antacids, etc.

Long-term care insurance premiums

More taxpayers are purchasing long-term care insurance to cover nursing home and other long-term health care needs that Medicare or health insurance don't cover.

Premiums for this coverage are generally deductible as medical expenses up to specified amounts that vary with the age of the taxpayer.

The 2005 limit for taxpayers:

- ◆ Age 40 or younger—\$270 (\$280 in 2006)
- ◆ Over age 40 but under age 50—\$510 (\$530 in 2006)

- ◆ Over age 50 but under age 60—\$1,020 (\$1,060 in 2006)
- ◆ Over age 60 but under age 70—\$2,720 (\$2,830 in 2006)
- ◆ Over age 70—\$3,400 (\$3,530 in 2006)

Medical expenses are further deductible only to the extent the total for the year exceeds 7.5% of adjusted gross income (AGI) and the taxpayer itemizes.

Taxpayers receiving amounts under a qualified long-term care insurance contract may have taxable income.

Such amounts can only be excluded from taxable income to the extent they do not exceed \$240 per day in 2005 (\$250 in 2006).

Tax break for real estate pros

Losses from real property rental activities are generally not deductible to the extent they exceed net income from other "passive" activities, generally those activities with little taxpayer participation.

However, real estate professionals—those who spend more than half their working hours and at least 750 hours in a real estate activity—are excepted from these passive activity loss limitations.

Those with multiple rental properties must meet the test for each rental separately but can elect to treat all properties as a single activity for this purpose.

If one spouse qualifies as a real estate professional, the exception applies to the other spouse's activities.

A similar break is available for nonreal estate professionals that



actively participate in their real estate rental activities.

They may take up to \$25,000 of losses exceeding other passive activity gains subject to limitations on high-income individuals.

A taxpayer actively participates if he/she makes management decisions, e.g., approves new tenants, decides on rental terms, approves capital or repair expenditures or arranges for others to provide services, such as repairs.

To take advantage of these breaks, make sure you qualify, then maintain documentation of your participation and time spent.

Claim adoption credit

Parents of adopted children may be eligible for a credit equal to the

Tax Strategies

Health insurance purchased in a sole proprietor's individual name, rather than his/her business name, can qualify for the self-employed health insurance deduction. However, a self-employed person cannot aggregate profits/losses from separate businesses to avoid deduction limits.

Consider using a credit card to prepay expenses that can generate deductions for this year.

Convert nondeductible personal interest to deductible interest by paying off the personal debt with a home-equity loan or other qualified residence interest.

If your itemized deductions are limited because of your income, or if they do not exceed the standard deduction, consider "bunching" expenses by either prepaying next year's expenses or delaying payment of current year's.

If you were affected by Katrina, you can use your 2004 income to calculate the child credit and the earned income credit on your 2005 tax returns.

If you were affected by Katrina, you may be eligible to make a penalty-free withdrawal of up to \$100,000 from your IRA or pension; no income tax is due on the distributions if repaid within three years.

Dependency Exemption

	2005	2006
	\$3,200	\$3,300

Basic Standard Deduction

	2005	2006
Married - joint	\$10,000	\$10,300
Head of household	7,300	7,550
Single	5,000	5,150
Married - separate	5,000	5,150

Tax Strategies



If you are 70½ years of age or older, you generally must take required minimum distributions from your traditional IRA. Review your options now to reduce taxes later.



If you have held stock or another appreciated investment for over one year, consider donating it to a qualified charitable organization instead of cash and receive a tax deduction equal to the fair market value of the stock, without paying tax on the appreciation.



To the extent practical, hold investments more than one year before selling to take advantage of lower capital gains rates. Gain on the sale of an investment held less than one year is subject to higher ordinary tax rates.



Are you planning to make charitable contributions in early 2006? If so, consider making the contribution in 2005 instead. Of course, if you are subject to income limitations, don't do this.



Consider making cash donations by December 31, 2005, to avoid deduction limitations.



Take advantage of standard mileage rate that increased to 34 cents for Katrina-related charitable use of a personal vehicle.

amount of qualified adoption expenses.

The total expenses that may be taken as a credit for all tax years with respect to the adoption of a child by the taxpayer is limited to \$10,630 in 2005.

As with most other tax breaks, the credit begins to phase out for taxpayers with higher AGI, \$164,410 in 2005.

Offset capital gains

If you have capital gains from stock sales in 2005 and have stocks with unrealized losses, consider selling the losers to help offset your gains.

The same strategy can work if you have losses from 2005 stock sales. Consider selling stocks with unrealized gains to take full tax advantage of your losses.

Gift Exclusions & Exceptions

	2005	2006
Annual Gift Tax Exclusion	\$11,000	\$12,000
Lifetime Gift Tax Exemption	\$1 Million	\$1 Million
Lifetime Estate Exemption	\$1.5 Million	\$2 Million

Of course, don't let the tax tail wag the dog. Do what is best for your overall financial position.

Recipients of such gifts should obtain information about the donor's basis in the gifted property; it will be needed if the property is later sold.

Recipients of gifted property

Year end is the peak time for making gifts of appreciating noncash property, e.g., stocks, partnership interests, real estate interests, etc., to future heirs.

Taxable estate in your future?

If you anticipate a future taxable estate, take advantage of the annual exclusion for gifts.

Individual Tax Rate Schedule

Status	2005 Rates		Estimated 2006 Rates	
	Rate (%)	Bracket	Rate (%)	Bracket*
Single	10%	\$0 - 7,300	10%	\$0 - 7,550
	15	7,301 - 29,700	15	7,551 - 30,650
	25	29,701 - 71,950	25	30,651 - 74,200
	28	71,951 - 150,150	28	74,201 - 154,180
	33	150,151 - 326,450	33	154,181 - 336,550
	35	Over 326,450	35	Over 336,550
Head of Household	10%	\$0 - 10,450	10%	\$0 - 10,750
	15	10,451 - 39,800	15	10,751 - 41,050
	25	39,801 - 102,800	25	41,051 - 106,000
	28	102,801 - 166,450	28	106,001 - 171,650
	33	166,451 - 326,450	33	171,651 - 336,550
	35	Over 326,450	35	Over 336,550
Married Filing Jointly	10%	\$0 - 14,600	10%	\$0 - 15,100
	15	14,601 - 59,400	15	15,101 - 61,300
	25	59,401 - 119,950	25	61,301 - 123,700
	28	119,951 - 182,800	28	123,701 - 188,450
	33	182,801 - 326,450	33	188,451 - 336,550
	35	Over 326,450	35	Over 336,550
Married Filing Separately	10%	\$0 - 7,300	10%	\$0 - 7,550
	15	7,301 - 29,700	15	7,551 - 30,650
	25	29,701 - 59,975	25	30,651 - 61,850
	28	59,976 - 91,400	28	61,851 - 94,225
	33	91,401 - 163,225	33	94,226 - 168,275
	35	Over 163,225	35	Over 168,275

Long-term capital gains and dividends are subject to a maximum tax rate of 15% (5% for taxpayers in the regular 10% and 15% tax brackets).

*These brackets have been adjusted for inflation in 2006; however, the IRS has not yet released the official amounts.

You can reduce your taxable estate by gifting \$11,000 of appreciating assets to each future heir in 2005 without dipping into the lifetime exclusion amount or incurring gift tax. The exclusion can be \$22,000 for married couples. The exemption is expected to increase to \$12,000 in 2006.

Addressing AMT this year

If you expect to pay AMT this year, consider deferring the payment of state taxes and miscellaneous itemized deductions and accelerating other items of income.

Divest yourself of investments in private-activity bonds. Owners of sole proprietorships, rental property or interest in a pass-through entity should evaluate alternatives for depreciating business property.

Before exercising incentive stock options, it's important to consider the consequences.

School expenses must be 'required'

Before taking a distribution from your individual retirement account (IRA) or 529 plan to pay higher-education costs, make sure the costs qualify.

Amounts can be withdrawn from an IRA penalty free to pay qualified higher-education costs. However, amounts paid for computers, housewares, appliances, furniture and bedding do not qualify unless you can prove they were "required" for attendance.

In addition, amounts paid for books do not qualify unless you have receipts or can otherwise substantiate the purchase.

The key term here is "required." Expenses not required by the school for enrollment do not qualify. Unless the school requires students to have a computer or other items as a prerequisite for enrollment, your expenses for

FICA Wage Base			
	Rate	2005 Wage Base	2006 Wage Base
Social Security	6.20%	\$90,000	\$94,200
Medicare	1.45%	Unlimited	Unlimited

them do not qualify for a penalty-free IRA withdrawal.

Withdrawals from 529 plans—which provide for tax-free earnings on higher education savings—also must be used to pay for required expenses.

If you want to buy a computer for higher-education purposes, but it's not *required* for enrollment, consider using a tax-favored Coverdell Education Savings Account.

Under these plans, distributions for student purchases of computer technology or equipment—including expenses for Internet access and any related services they and their families will use during any of the years the beneficiary is in school—are generally tax free.

MBA costs may be deductible

An employee may deduct unreimbursed educational expenses if the education helps maintain or improve skills required for employment.

No deduction is allowed if the education enables an employee to meet the minimum educational requirements for a new position.

Accordingly, expenses related to earning a master of business

administration (MBA) degree aren't deductible if the MBA is a condition precedent to employment or a new position.

When an employee obtains an MBA to help advance his/her career and is soon after promoted, the expenses may be deductible if the degree was not *required* for the new position, even though it helped secure the promotion.

It also helps if the employee has substantial work experience directly related to the MBA coursework.

Certain tuition deductible

In certain situations, tuition payments may be deductible as a medical expense. Tuition for normal education in grades K–12 is generally not deductible.

However, the IRS has ruled that tuition paid to a special school for handicapped children may qualify as a deductible medical expense.

To qualify, a physician must diagnose a medical condition requiring special education to correct it. Further, the school must have professional staff competent to design and supervise a curriculum providing such care.

Finally, the primary purpose for sending the child to the school must be medical care; ordinary education can only be incidental.

If you send your disabled children to special schools that help them deal with their handicaps, consider this deduction.



Tax Strategies



Deduct qualified student loan interest. Such interest may be deducted above the line for single taxpayers with AGI less than \$65,000 and married joint filers with less than \$135,000.



Contribute to a "529" tuition plan, which is a plan established by a state or educational institution that provides account owners and beneficiaries with a tax-free way of paying for higher education costs. Investments in these plans grow tax free and some states provide for a tax deduction for contributions.



If you're facing a penalty for underpayment of estimated tax, you may be able to eliminate or reduce it by increasing your withholding in 2005.



Contemplating marriage or divorce? Watch out for how marriage penalties could affect you. Marriage penalty relief has been extended for the 15% tax bracket and the standard deduction, but other marriage penalties remain.



You may be eligible for full deductibility of personal casualty losses if caused by Katrina.

Tax Alert

Weekly tax updates are available from our web site @ bkd.com. Every Monday you'll find helpful tips and news covering tax issues.

Tax Strategies



Deductible losses from partnerships and S corporations are limited to your basis (generally, the amount your investment, plus taxable income and minus losses and distributions).

If you have such losses, review your basis with your advisor; you may want to discuss ways to increase it.



If your employer offers a qualified retirement plan that matches your elective contributions, take full advantage. It's "free money" and is tax deferred. (See "Defined Benefit Plan Limits," page 7.)



It may be advantageous to arrange with your employer to defer your bonus until 2006.



Renew subscriptions to professional journals, pay union or professional dues, enroll in (and pay tuition for) job-related courses, etc., to bunch into 2005 miscellaneous itemized deductions subject to the 2%-of-AGI floor.



You can deduct in 2005 or 2006 up to \$2,000 if you provided rent-free housing to persons dislocated by Katrina.

Some of the information in this edition of the **BKD Advisor** is specific to 2005 and may not be relevant after December 31, 2005. As always, consult your BKD advisor before taking any action.

Credits help offset higher-ed costs

Take advantage of higher-education tax credits. Two tax credits are available to help offset higher-education costs.

The Hope credit is equal to 100% of up to \$1,000 in qualified tuition and related expenses for the first two years of secondary education, plus 50% of the next \$1,000 of such expenses.

The Lifetime Learning Credit is equal to 20% of up to \$10,000 of qualified tuition and related expenses (limited to \$2,000), and there is no requirement that the expenses be for the first two years of secondary education.

Both credits phase out for higher income individuals. Alternatively, there is an above-the-line deduction available for qualified expenses in 2005.

Be aware of hobby-loss rules

Taxpayers that participate in an activity in their extra time, such as farming, should be aware of the hobby-loss rules that can limit tax deductions.

In particular, taxpayers whose main source of income comes from another business or profession should pay careful attention.

Year end is a good time to document 2005 attempts to make a profit and run the enterprise in a business-like manner, as well as plan for 2006.

Think sales tax deduction

Whether you are buying a hybrid or a regular car, think about the sales tax deduction.

For 2005, you can deduct state and local sales taxes in lieu of state and local income taxes. Unless the law is changed, that choice won't be available for

2006; you'll only be able to deduct income taxes.

So, if you deduct sales taxes this year and plan to buy a car or other major item soon, you may want to pull, *i.e.*, accelerate, the purchase into 2005 to increase your sales tax deduction.

HSAs gaining popularity

Tax-favored health savings accounts (HSAs) are gaining popularity as insurance companies



and financial institutions increase their service offerings.

HSAs allow for above-the-line tax-deductible contributions and tax-free distributions to pay medical costs.

These plans can only be established by eligible individuals covered by a high-deductible health plan (HDHP) and not covered under any other health plan that is not an HDHP, unless the other coverage is permitted insurance or coverage for accidents, disability, dental care, vision care or long-term care.

For 2006, an HDHP is a health plan with an annual deductible of at least \$1,050 for individual coverage (\$2,100 for family coverage) and maximum out-of-pocket expenses of at least \$5,250 for individual coverage (\$10,500 for family coverage).

For 2005, the corresponding figures are \$1,000, \$2,000, \$5,100 and \$10,200.

The maximum annual contribution to an HSA is the sum of

the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month.

Under an HDHP for 2006, the maximum monthly contribution for eligible individuals with self-only coverage is 1/12 of the lesser of (1) the annual deductible under the HDHP or (2) \$2,700 (up from \$2,650).

For eligible individuals with family coverage under an HDHP, the maximum monthly contribution is 1/12 of the lesser of (1) the annual deductible under the HDHP or (2) \$5,450 (up from \$5,250).

Debt cancellation can be taxable

In this age of high leverage, bankruptcies and debt workouts are increasingly common. Those who receive cancellation of debt principal or interest may be in for an unpleasant surprise—the amount cancelled may be taxable.

Tax law generally treats debt forgiveness as taxable income. There are exceptions for those who file bankruptcy or are insolvent, but others should prepare to pay tax.

In cases where there is no bankruptcy, the taxpayer bears the burden of proving insolvency. Lenders are also generally required to report debt forgiveness to the IRS, and IRS computers may issue a notice of deficiency if the borrower does not report a consistent amount of income.

What does this have to do with your year-end planning? If you anticipate a debt cancellation event, consider delaying it until 2006; or you might want to accelerate the event into 2005—it all depends on your particular situation. ❖❖❖

Business year-end tax planning strategies

Captive insurance arrangements

Payments to “captive” insurance subsidiaries or other similar arrangements are generally deductible where risk shifting and risk distribution are both present.

Risk *shifting* occurs when a taxpayer transfers the financial consequences of a potential loss to the insurer. Risk *distribution* allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums.

The risk-distribution requirement isn’t satisfied if the insurer has only one policyholder.

Accordingly, arrangements won’t qualify as insurance where an insurer’s only policyholders are limited liability companies or qualified subchapter S subsidiaries wholly owned by the same taxpayer.

Arrangements that involve a second policyholder—but not a

substantial amount of risk-shifting—also don’t qualify.

An arrangement that doesn’t qualify as insurance may be characterized as a deposit, a loan, a contribution to capital or an indemnity arrangement other than an insurance contract.

Captive insurance arrangements can provide significant tax and nontax benefits; however, proper planning and execution is required to maintain these benefits. A good time to do this is during year-end planning.

Consider a Keogh, SEP or SIMPLE

If you are self-employed or a small-business owner, consider implementing a Keogh, a simplified employee pension (SEP) or a Savings Incentive Match Plan for Employees (SIMPLE).

Remember, if you want to contribute to a Keogh, the plan

must be adopted before year end, but the contribution can be deferred to the due date of your tax return.

SEPs and SIMPLEs do not have annual reporting requirements, and each is relatively easy to set up. You can either complete the appropriate IRS form or a plan adoption agreement.

IRS shuts down ‘springing value’ policies

The IRS has shut down perceived “abusive” transactions involving life insurance policies designed to have a low cash-surrender value when transferred from a §412(i) retirement plan.

A §412(i) plan is an exempt insurance contract plan funded exclusively by the purchase of group insurance contracts, *e.g.*, from an employer to an employee.

The goal of such strategies,

Tax Strategies



Accrue and deduct accrued retirement plan matching and profit-sharing contributions paid after year end but before the due date of the tax return.



New Roth 401(k) plans become available January 1, 2006. A mixture of a traditional 401(k) plan and popular Roth IRAs, such plans allow for after-tax contributions, but tax-free retirement distributions. Consider whether these new plans better meet your employees’ needs.



With the increased IRS focus on executive compensation, evaluate current compensation packages, including bonuses and fringe benefits and whether yours comply with tax rules.



Employers offering nonqualified deferred-compensation plans (NQDCs) should note new rules and restrictions. Specifically, elections by employees to defer 2006 compensation must generally be made in 2005. (See “Beware New Requirements for NQDC Plans,” page 12.)



New businesses, consider whether to deduct up to \$5,000 of start-up and organizational costs in the first year of business or recover these costs ratably over 15 years.



If you are in the Katrina disaster area, you can receive a tax credit for hiring or retaining employees in 2005 or 2006.

Defined Benefit Plan Limits

Individuals 50 and over can make elective catch-up contributions to their retirement accounts. The catch-up amounts are in addition to the regular contribution limits, the maximum allowed elective deferral retirement contributions:

	2005	2006
401(k), 403(b), 457 & SAR-SEP Plans - Under 50	\$14,000	\$15,000
401(k), 403(b), 457 & SAR-SEP Plans - 50 & Older	\$18,000	\$20,000
Traditional & Roth IRAs - Under 50	\$4,000	\$4,000
Traditional & Roth IRAs - 50 & Over	\$4,500	\$5,000
SIMPLE Plans - Under 50	\$10,000	\$10,000
SIMPLE Plans - 50 & Over	\$12,000	\$12,500

Elective deferrals are amounts an employee instructs the employer to take out of regular pay and put into a pension account. Employers with profit-sharing plans are required to contribute funds to employee pension accounts. The total sum of an employee’s combined pension contributions can’t exceed \$42,000 for 2005 and \$44,000 for 2006. An employer’s tax deduction for contributions can’t exceed 25% of all employees’ annual compensation, taking into account individual compensation. ❖❖❖

Tax Strategies



If yours is an accrual-basis business, consider deferring sales into 2006 and accelerating purchases into 2005, where practical.



If yours is a cash-basis business, consider paying outstanding payables and deferring collections where practical.



Analyze your tax accounting methods. Tax law provides for alternative methods of accounting for certain items such as depreciation, compensation, inventories, pre-paid expenses and revenues.

In most cases, tax methods do not have to be the same as financial accounting methods and can help with cash flow management.



If yours is a family-owned C corporation with high taxable income, consider paying bonuses to family members before year end to avoid the double tax on dividends; bonuses must be reasonable and paid to only those family members who worked for the corporation during the year.



If you plan to acquire or construct a new building or have already done so, you may want to perform a cost segregation study to help identify building components that qualify for more rapid tax depreciation.



If your business is outside the Katrina disaster area, consider taking a tax credit available for hiring workers in 2005 displaced by Katrina.

known as a "springing value" policy, is to tax the employee on the policy's low cash-surrender value.

However, new regulations prevent this by providing the employee is taxed at the full fair market value of the life insurance contract.

The IRS recently cracked down on several different, aggressive tax-planning strategies involving insurance. If you have this type of arrangement, consider your options in your year-end planning.

Reporting vehicle donations

In response to perceived abuses, a 2004 law limits a donor's charitable deduction for vehicles.

Under this law, if the charity quickly sells the donated vehicle, then the donor's deduction is limited to the charity's sales proceeds; however, exceptions may apply resulting in a deduction equal to the fair market value at the time of donation:

- ◆ The charity uses the vehicle in its charitable endeavors before selling and the use is significant
- ◆ The charity sells the vehicle at a bargain price to a poor person in need of transportation and that is the purpose of the charity
- ◆ The charity makes material improvements to the vehicle before selling
- ◆ Charities also must give the donor a Form 1098-C, which either acknowledges the deduction reflects the sales price or that one of the exceptions applies. Charities also must file a copy of the form with the IRS



Standard mileage rate increases

In response to recent, dramatic gas price increases, the IRS increased the standard mileage rate to 48.5 cents per mile for all business miles driven between September 1 and December 31, 2005, up from 40.5 cents for the first eight months of 2005.

The standard mileage rate can be used to compute tax deductions for business auto usage instead of actual expenses, such as lease payments or depreciation, maintenance, repairs, tires, gas, oil, insurance and license and registration fees.

Separate deductions must be claimed for parking fees and tolls connected to business driving.

The standard mileage rate may not be used for a purchased auto if:

- ◆ It was previously depreciated using a method other than straight line,
- ◆ A Section 179 expensing deduction was claimed for the auto, or
- ◆ The vehicle is used for hire, such as a taxicab

Also, the standard mileage rate can't be used to compute the deductible expenses of five or more autos owned or leased by a taxpayer and used simultaneously in fleet operations, for instance.

Taxpayers can use the mileage-allowance method for a leased auto but only if it's used for the entire lease period.

During the last four months of 2005, employers that require employees to supply their own autos may reimburse them at a rate of 48.5 cents a mile for employment-connected business mileage whether the autos are owned or leased.

The reimbursement is treated as a tax-free accountable plan reimbursement as long as the employee substantiates the time, place, business purpose and mileage of each trip.

In addition, an employee's personal use of lower-priced company autos during the last four months of 2005 may generally be valued at 48.5 cents per mile.

The IRS plans to adjust these rates again for the 2006 calendar year.

Top 10 retirement plan failures

It is crucial that tax-favored retirement plans retain their qualified status. Slip-ups can result in disastrous consequences. Consider this when conducting your year-end planning.

Following are the 10 most common reasons for plan failure:

- ◆ Failure to properly amend the plan within the remedial amendment period for new legislation
- ◆ Failure to follow the plan's definition of compensation for determining contributions
- ◆ Failure to include all eligible employees in the plan

Standard Mileage Rates for 2005

	September - December	January - August
Business	48.5 cents per mile	40.5 cents per mile
Charitable	14 cents per mile	14 cents per mile
Medical & moving	22 cents per mile	15 cents per mile

- ◆ Failure to satisfy the loan provisions of the plan
- ◆ Violation of the in-service distribution requirements
- ◆ Violations of required minimum distributions rules
- ◆ An employer eligibility failure, *i.e.*, improper entity adopting a type of retirement plan
- ◆ Failure to comply with ADP/ACP testing (sometimes due to a failure to follow the proper definition of compensation)
- ◆ Failure to make a top-heavy minimum contribution
- ◆ Violations of contribution and benefit limitation rules

Determine source of U.S. foreign income

Recently, the IRS issued final regulations that explain how an individual taxpayer should determine the source of income from labor or personal services performed partly within and partly outside the U.S.

The new regulations are effective for tax years beginning after July 13, 2005.

Foreign-source income is excluded from a nonresident individual's income. Also, foreign-source income for a U.S. citizen or resident may qualify for a foreign tax credit or for exclusions from gross taxable income.

The final regulations generally use "facts and circumstances" to determine the source of compensation for labor and personal services performed partly within and partly outside the U.S. by a person other than an individual, *e.g.*, corporation, partnership or trust.

The final regulations also provide two new general methods to determine the source of compensation an individual receives as an employee for such labor or personal services.

Nonfringe compensation -

Compensation, other than fringe benefits (described below), is determined on a **time basis** for work performed by an individual partly within and partly outside the U.S.

Fringe-benefit compensation

- Compensation in the form of fringe benefits is sourced on a **geographical basis** (generally, the location of the employee's principal place of work). Regulations describe the following as fringe benefits: housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay and moving-expense reimbursements.

Multiyear compensation -

Compensation that represents a multiyear arrangement is generally determined on a **time basis**.

Multiyear compensation is compensation included in the income of an individual in one taxable year but attributable to a period that includes two or more taxable years.

For stock options, this gener-

ally will be the period between the date the option was granted and the date all employment-related conditions have been satisfied for its exercise, *i.e.*, the option vesting date.

IRS challenges tool reimbursements

Reimbursement arrangements for tools used on the job are tax free to employees and aren't subject to withholding or payroll taxes if:

- ◆ Reimbursed expenses are otherwise deductible and are paid or incurred in connection with performing services as an employee of the employer
- ◆ Each reimbursed expense is adequately substantiated to the employer in a reasonable time
- ◆ Any amount exceeding expenses is returned in a reasonable time

The employees of certain businesses—especially repair and maintenance shops—purchase and maintain various tools needed on the job.

Tax Strategies



Purchase business equipment and place it in service before year end.

Instead of deducting the cost over five or more years, up to \$105,000 of the cost can be expensed in the current year.

Of course, there are limitations for certain automobiles and SUVs. Plus businesses that purchase more than \$420,000 or have a taxable loss face additional limitations.



U.S. corporations with foreign subsidiaries should take advantage of a one-time opportunity to repatriate foreign earnings through dividends.

Qualifying dividends are eligible for an 85% dividends received deduction. Various limitations apply, so contact your BKD advisor.



If your business is entering into transactions with related parties—especially foreign related parties—be prepared to provide contemporaneous support of arms-length pricing methods at the risk of significant IRS penalties. Year end is a good time to consider the adequacy of your documentation.



If your business has a flexible spending account plan, consider amending it to adopt a new rule that allows employees to carry over unused plan amounts 2.5 months after year end. Without such an amendment, the employee forfeits any unused amounts.

Travel Rates

New simplified per-diem travel rates became effective October 1, 2005. Employers can give employees these per-diem allowances instead of reimbursing actual business travel expenses. Use of the per-diem rates greatly simplifies recordkeeping requirements needed to substantiate deductions for business travel.

	Until 10/05	Beginning 10/05
Lodging, meals & incidentals "high-cost localities"	\$204 per day	\$226 per day
Lodging, meals & incidentals other localities	\$129 per day	\$141 per day
Meals & incidentals only "high-cost localities"	\$46 per day	\$58 per day
Meals & incidentals only other localities	\$36 per day	\$45 per day
Transportation industry: meals & incidentals continental U.S.	\$41 per day	\$52 per day
Transportation industry: meals & incidentals outside continental U.S.	\$46 per day	\$58 per day

Tax Strategies



Closely held C corporations whose taxable income consists mainly of investment and rental income should plan to avoid the personal holding company (PHC) tax. The PHC tax can result in a surprise double-tax bill.



Take advantage of the credit for increasing research activities. The credit is generally equal to 20% of qualifying research costs. You may be pleasantly surprised at what types of activities can qualify.



Don't forget the work opportunity tax credit for hiring and retaining qualified high-risk employees. The credit is as much as \$2,400 per employee. A similar credit is available for qualified welfare recipients—up to \$8,500. Pre-registration is required for both credits.



C corporations with average annual gross receipts of \$5 million or more are generally prohibited from using the cash method of accounting. If your business is approaching this milestone, plan to either defer receipts or make the change to the accrual method.



Wholesalers and retailers with average annual gross receipts of \$10 million or more may be required to capitalize additional expenses into the cost of inventories. If your business is getting close to this threshold, plan to defer income where practical.

An employer often pays each employee an hourly wage plus a set amount for each hour worked as a "tool allowance" to cover costs incurred for acquiring and maintaining the required tools.

The IRS says such reimbursements are not tax free to employees:

- ◆ If they are based on estimates
- ◆ If employees are not required to substantiate actual expenses by receipt
- ◆ If excess reimbursements are not required to be repaid within a reasonable time

TPAs & Form 1099 reporting

Third-party payers (TPAs) and authorized agents who report payments on Forms 1099 can use the IRS's Internet program to match payee names and taxpayer identification numbers against IRS records before filing information returns.

This may reduce mismatches and fewer backup withholding and penalty notices.

To take advantage of the taxpayer identification number matching service, generally payers need to have filed information returns in at least one of the two past tax years and register for IRS e-services.

For more information, go to www.irs.gov and navigate to the e-services page or call the IRS e-services line at 866 255-0654.

New deduction for QPAI

Taxpayers in the following businesses should plan to take advantage of a new deduction for qualified domestic production activities (QPAI):

- ◆ Manufacturing
- ◆ Construction, including architecture/engineering

- ◆ Energy production
- ◆ Computer software production
- ◆ Film and video production
- ◆ Agricultural production
- ◆ Equipment leasing

The deduction is basically equal to 3% of net taxable income from such activities, up to 50% of W-2 wages and not to exceed taxable income.

Avoid corporate double tax

Closely held C corporations with projected taxable income should consider making reasonable bonuses to owners before year end to reduce exposure to the corporate double tax.

At the same time, such corporations should remember their first \$50,000 of taxable income is subject to a 15% tax rate and plan accordingly to take advantage of that low-rate bracket where practical.

File for 3% federal excise tax refund

Businesses with significant long distance telephone expenses should consider filing protective claims for refunds of the applicable 3% federal excise tax.

Various courts have ruled this tax doesn't apply in most cases, although the IRS is still appealing to higher courts.

Failure to file protective claims can result in lost refunds if the IRS continues to lose these cases.

Don't neglect state & local taxes

Don't neglect state and local taxes when performing your year-end planning:

- ◆ Businesses that conduct activities in multiple states should

especially gauge their exposure to state and local taxes. Planning issues will vary state by state so consult knowledgeable personnel or counsel.

- ◆ States are increasingly hungry for revenues and are stepping up enforcement activities. Sophisticated techniques are used to root out nonfilers, and penalties can be significant.

One way your business can protect itself is to conduct a nexus study, which helps determine exposure to risk and filing responsibilities.

Where available, delinquent filers should take advantage of state amnesty or voluntary-disclosure programs.

SPE borrowing transactions

A main concern for lenders making loans with commercial real estate as collateral is that the borrower will go bankrupt, causing the collateral to be consolidated with the borrowers' other assets.

To ease such fears, borrowers are increasingly using single purpose entities (SPEs), such as limited liability companies (LLCs), to separate collateral from their other assets.

The idea is to create a bankruptcy-remote entity; however, it's critical to consult a qualified legal advisor to confirm the SPE will not run afoul of bankruptcy or state LLC laws.

In addition, seek tax advice to resolve any resulting tax issues.

Partnership taxation under Jobs Act

Following is a brief summary of how the *American Jobs Creation Act of 2004* (Jobs Act) affects partnership taxation and what it provides:

(continued on page 12)



**Contact BKD Wealth Advisors, LLC
for investment, financial & estate planning**



Market commentary: stock market reaches four-year high during quarter

by Jeff Layman, BKD Wealth Advisors, LLC,
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In early August, the S&P 500 index of large U.S. companies reached a four-year high as investors responded to continued economic growth with low inflation and strong corporate profits.

By the end of the quarter, the market gave back some of these gains as oil prices spiked to new highs. International stocks came roaring back in the quarter, led by Asian markets.

Here are the quarterly and year-to-date returns for the major stock and bond indexes:

Hurricanes ravage gulf coast - During September, major back-to-back hurricanes hit the Louisiana, Mississippi and Texas coasts, an area that's home to a large number of refineries and drilling platforms.

Many were damaged and taken off line, aggravating an already difficult energy situation and causing oil to briefly command \$70 per barrel. Gas prices rose above \$3 per gallon on speculation about the possible damage to supply.

However, oil and gas prices returned to prehurricane levels later in the month as most of the supply disruption was determined to be temporary.

GDP continues growing at above-trend pace - Final second-quarter GDP growth figures were announced, indicating a gain of 3.3% in real terms fueled by homebuilding, consumer spending and business investment.

This represented the ninth consecutive quarter of growth above 3%, which is the longest string of above-average GDP growth since March 1986.

Expectations for economic growth in the third quarter stand at about 3.5%, despite the hurricane-induced loss of momentum at the end of September.

Corporate earnings growth remains healthy - Continuing to benefit from strong gains in productivity, a solid economic environment and an abnormally large increase in energy-sector profits, corporate earnings grew by more than 10% in the second quarter.

These results easily exceeded consensus estimates of 7% growth. Standard and Poor's expects earnings to grow by about 15% in the just-completed third quarter, which would result in a record 14 consecutive quarters of double-digit profit growth.

Fed continues to raise rates at "measured" pace - For the eleventh consecutive time, the Fed raised rates and brought the short-term Fed funds rate up to 3.75% in a late-September meeting.

As a result, investors that speculated the Fed would signal

an end to the tightening process at this meeting now refer to Fed policy as "accommodative" and predict more measured rate hikes in the future.

Citing September's hurricanes, the Fed considered their impact to the economy as temporary and not a "persistent threat."

Despite the string of Fed rate increases, the 10-year Treasury note continues to hover in the area of 4.25%, virtually unchanged over the past two years. The yield curve continues to flatten.

Current economic and corporate profitability news still positive, but investors now considering outlook for 2006

- Judging by almost any measure—including corporate profits, industrial production, employment and household wealth—our economy continues to perform well.

Despite this solid economic and corporate profit performance, stock prices have largely been stagnant in 2005. The result is continued multiple contraction for the S&P 500—in other words—

cheaper stock prices.

The market currently trades at 16 times 2005 expected earnings, and 15 times 2006 estimates. Because the stock market is a discounting mechanism, today's strong corporate earnings results are not creating a commensurate rise in stock prices.

Investors are concerned about growth prospects for 2006, given higher energy prices and higher interest rates.

BKD Wealth Advisors, LLC, believes these factors will slow growth into 2006, but we also believe much of this anticipation is currently built into stock prices.

At current valuation levels, the U.S. stock market is attractive, particularly relative to the other major asset classes, bonds and real estate. ♦♦♦



Market Indexes		
Returns Through September 30, 2005		
	3Q 2005	2005 YTD
S&P 500	3.60%	2.77%
NASDAQ Composite	4.61%	(1.09)%
Russell 2000	4.69%	3.38%
MSCI EAFE	10.38%	9.08%
Lehman Aggregate Bond	(.67)%	1.82%
Lehman Municipal Bond	(.12)%	2.77%

(continued from page 10)

◆ A debtor partnership that transfers a capital or profits interest in the partnership to a creditor to satisfy a debt will recognize cancellation-of-indebtedness income from the transfer. The amount of income is determined by taking the fair market value of the transferred partnership interest into consideration.

◆ Special allocation rules generally apply when—in exchange for a partnership interest—a partner contributes to a partnership property that's worth less than the partner's adjusted basis.

If the property is later sold, the resulting taxable loss may be required to be specially allocated to the contributing partner, or the deprecia-

tion expense may be required to be specially allocated.

◆ When a partnership interest is sold or otherwise transferred, resulting in a loss of more than \$250,000 to the transferring partner, the transferee's adjusted basis in partnership property must be reduced. This can result in reduced depreciation and

amortization to the transferee.

New regulations permit a partnership to revalue its assets to their current fair market values if money or property is contributed to the partnership by a new or existing partner as either a consideration for an interest in the partnership or a distribution of money or property from the partnership to a retiring or continuing partner as consideration for an interest in the partnership. ♦♦♦

Beware new requirements for NQDC plans

by Chip Storey, Springfield,
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The March 2005 and November 2004 **BKD Advisors** alerted you to new requirements for nonqualified deferred-compensation plans (NQDC plans) and the penalty for noncompliance.

Basically, the rules impose limitations on the design of NQDC plans, which must now meet new distribution, election and funding requirements. If a plan fails to comply, all cumulative earned and deferred compensation can be included in a participant's taxable income. A 20% penalty and interest also will be imposed.

Employers must make some choices before year end, the most significant being whether to modify NQDC plans to meet the new requirements or to terminate such plans to

avoid the extra complexity, cost and risk.



Some plans, like those with discounted stock rights, may not meet the new requirements altogether.

Employers that opt to terminate a NQDC plan must do so before year end. Employers that opt to modify existing plans will need to formally amend plan documents to comply or establish a complying written plan document by the end of 2006.

Further, the plans must be

operated in good-faith compliance with the new rules. **If an employer exercises discretion to delay or extend payments under the plan, the plan won't be in good-faith compliance.**

Also, participants' elections to defer compensation must generally be made before January 1, 2006. Failure to terminate a plan or amend to comply can subject participants to additional tax, penalty and interest.

This is only a brief summary of the new rules and additional restrictions and options that exist, depending on the plan and its objectives.

It is imperative that all such plans be reviewed for compliance as soon as possible—regardless of whether the plan's document is formal or informal or if compensation is deferred pursuant to an employment contract. ♦♦♦

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