Tax Guide

Tricia Suit / The Sunday Challenger

CHANGE IS GOOD?: Andrew Modrall and Martin Horwitz discuss changes to Kentucky tax laws, and how those affect business owners.

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long list in my office of expenses that qualify. Things like glasses, dentist visits, contact lenses, chiropractor, health club membership if recommended by a doctor…

HORWITZ: Medical adjustments to your home may also qualify…

MCNEILL: …And mileage to the doctors.

CHALLENGER: Speaking of mileage. Car manufacturers are touting the tax breaks the new hybrid cars get. How does that work? Is it worthwhile?

HORWITZ: I see two conflicting things on these credits that could be confusing to car buyers.

MODRALL: Yes, in 2005 there was a deduction for buying a hybrid car. In 2006 there is a tax credit instead of a deduction.

MALOF: A problem that exists currently is that the IRS hasn't published the amount of credit that a car will receive. Vehicles will receive different credits based on their fuel efficiency. Also, once each manufacturer sells 60,000 units, the credit will no longer be available.

HORWITZ: Exactly, so under the new rules you buy a car in 2006 and you'll get a credit of some unknown amount between $650 and $3,400.

MALOF: The credit also doesn't reduce your taxes if you owe the AMT.

MODRALL: I would not advise anyone to buy a hybrid car just to get a tax credit. I would do it for the gas mileage. If you are leaning towards buying a hybrid this is just an extra incentive.

CHALLENGER: Banks and mortgage companies are advertising low payments in the form of interest-only mortgages. What do you think of those?

MALOF: I like them in the right situation, but you've got to have someone who is disciplined in their savings. It only makes sense if you have someone who can save what they would have paid in principal payments. It's the "other-people's-money" concept in that you take what you are not paying to the bank and save or invest it – preferably tax deferred – and at the end of 20 years when the principal comes due they've made enough to pay off the loan and have a profit. But you have to have the discipline to save.

MODRALL: I rarely see people with enough discipline to save each month. What I fear is that people decide what they can afford each month, then buying a larger house using an interest-only loan and count on the appreciation of the house for any equity build-up. That scares me.

HORWITZ: As our (region) catches up with the rest of the nation in housing values, I think there will be a tendency toward interest-only loans because they won't be able to afford the larger payment to live the lifestyle they want to live. In California and Florida the equity is growing rapidly, but I don't think that will last.

MALOF: The one problem you run into with the interest-only loans idea is a lot of people have been raised under the auspices of the depression era. They hate being in debt for that length of time, even though they wind up wealthier using it.

MCNEILL: I think a lot of people in society have a monthly payment mentality. They don't think about whether it's a good deal, but if it's a good payment.

MALOF: They manage the payments, not their finances.

HORWITZ: It's not the price, it's the terms.

> "Kentucky now has its own version of the alternative minimum tax. So now Kentucky is going to make sure that business pays at least $175 and you may pay the regular corporate income tax rate or a percentage of sales or a percentage of gross profit. The owner does get that amount credited on their personal income tax return."
>
> – **Andrew Modrall,** Harrell & Modrall

Looking at Savings

CHALLENGER: The individual retirement account (IRA) contribution limits have changed also, haven't they?

MODRALL: The 2006 IRA limits are the lower of $4,000 of earned income per year or 100 percent of compensation and those over 50 are allowed to contribute an extra $1,000 to catch-up. Those limits increase in 2008.

CHALLENGER: Why is it important to use an IRA?

MALOF: Two reasons – tax savings and to build up money for retirement – that pretty much covers it.

HORWITZ: A $150 per month IRA contribution at 8 percent growth per year, will grow to $225,044 in 30 years. At a 25 percent tax rate, $73,616 of that will be due to the tax deferred status of the IRA.

MALOF: It may be apocryphal, but supposedly Einstein said that the greatest discovery of man was the power of compounding interest. Back to IRAs, the phase-outs for deducting your IRA contributions do kick in at fairly low levels – especially for those that have a retirement plan at work.

CHALLENGER: That's for traditional IRAs. Roth IRAs, where you don't get a current year tax deduction but can withdraw the money during retirement tax-free, have also become popular. Do you suggest to clients to convert a traditional IRA to a Roth by paying the taxes today?

MALOF: We looked at that when the option first came out and in most cases it doesn't make sense at all. I think I've had one client in 20 years do it.

MODRALL: We've done it two or three times – but not many.

HORWITZ: You have to have youth on your side.

MALOF: You have to run the numbers to see if it makes sense. But you'll be using numbers that project 20 years out and we don't know what the tax rates are going to be in three years, much less 20 years.

CHALLENGER: Some employers may start offering a Roth 401(k) or a Roth 403(b) this year. What is it?

MALOF: It allows an employee to take a portion of their allowed retirement savings and put it into a Roth 401k. There's no tax deduction, but it does allow for tax deferral. Then at distribution there is no tax on the growth of the account.

HORWITZ: A lot of our closely held companies are starting to do it and offer it to their employees. It seems that it's more advantageous for younger participants – there's more time for growth.

> "You really need to have three advisors – a financial advisor, your tax advisor, and an attorney to plan collectively. The consequences both short and long-term can be tremendous to your after-tax wealth accumulation."
>
> – **Martin J. Horwitz,** The Horwitz Law firm

MALOF: There isn't an incentive to the companies who sponsor these plans to pay to have their retirement plans revised to incorporate the Roth 401(k) provision.

MODRALL: Also, there's no match in a Roth 401(k). Just larger contribution limits and tax-free withdrawals.

Saving for College

CHALLENGER: We've touched on the house and retirement. That only leaves the kids. Any tax breaks for sending them to college?

MODRALL: There is still a $2,500 student loan interest deduction above the line subject to certain adjusted gross income phase-outs. There is also a college tuition payment deduction of up to $4,000.

MALOF: That was a nice give-back by Congress. There used to be a 60-month limit rule, but now as long as you have student loans you can deduct the interest.

MALOF: In the case of a high-income parent and the college-aged child-student who has a job, we try to decide whether to take the hope or lifetime learning credit and who should take it. The phase-outs for the parent start at very low income levels. Really high income folks lose most of their benefits.

CHALLENGER: It's always nice to tell these people all the tax benefits they lose once they start making money.

HORWITZ: If you have enough family income to pay for education, sometimes you lose the benefit of the credit.

For Small Business Owners

CHALLENGER: What kinds of changes are small businesses facing?

MODRALL: We could talk about this subject at length.

MALOF: One change is the bonus depreciation that President Bush initiated two years ago to jump-start the economy – that's gone! What's left is the expensing election for up to $105,000 in cost of tangible personal property.

MCNEILL: Businesses also have to figure out how to use the Roth 401k.

HORWITZ: Two issues – especially with S-(corporations) – the IRS has initiated a pretty good-sized project to explore whether S-corp owner operators are taking an unreasonable distribution over a salary. They are auditing 5,000 companies. If there's not reasonable compensation where FICA is not paid, they are auditing them. It should be pretty easy to pick them off.

MALOF: It depends on the life cycle of the business. For a start-up, no salary makes sense, but as time goes on we always recommend that a client take a reasonable salary.

HORWITZ: You just have to be reasonable.

MALOF: Yes, I read that 5,000 audit figure as well, but keep in mind that the number of S-corp returns filed annually are somewhere around 2 million to 3 million.

MCNEILL: The best advice to give a small business owner is to have someone look at their return because you can see the stupid stuff right on the front.

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