

CPA

OCTOBER 2007

Client Bulletin

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

Smart Handling of Intra-Family Loans

Even though the housing market has cooled off, home prices are still high in many areas of the country. To help your son or daughter buy a starter home, you might want to make a loan. If you do, be careful. You may face surprising and painful tax consequences if you charge no interest or a below-market rate.

Imputed interest

Say your son wants to buy a home. You loan him \$300,000, payable in 9 years, and you don't charge him any interest.

The IRS will impute interest on such loans at an applicable federal rate (AFR). AFRs are published every month at www.irs.gov. Currently, the AFR on loans from 3 to 9 years is about 5% (see table below). In the example above, therefore, the imputed interest would be around \$15,000 (5% of \$300,000).

Tax treatment

In this scenario you would have to recognize \$15,000 in interest income each year. You would owe income tax on that \$15,000 even though you didn't collect it.

Moreover, the IRS would say that you had made your son a \$15,000 gift for each year of the loan. You would have to file a gift tax return. (You wouldn't have to pay gift tax unless you had used up your \$1 million lifetime gift tax exclusion, but your estate tax exemption would be reduced.)

At the same time, your son might be able to take a \$15,000 deduction for the imputed interest on a loan secured by his residence.

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Did You Know?

From December 2005 to February 2007, enrollment in Medicare private fee-for-service plans increased from 208,990 enrollees to 1,338,026, a growth of 535%. Over the same time period, enrollment in Medicare HMOs and PPOs increased by 18%.

Source: Avalere Health LLC

Below-market loans

What if the loan called for a 2% interest rate, which your son paid? This rate would be 3% below the 5% AFR. In that case, the imputed interest on the loan would be 3%, subject to the tax consequences described above. In addition, the 2% of actual interest would be taxable to you and might be deductible for your son.

The \$10,000 exception

There are ways to avoid imputed interest. If the money you loan to a relative doesn't exceed \$10,000, the IRS will not impute any interest. To qualify for this exception, such loans can't be used for income-producing investments. Thus, you might make a small loan to help a child make a down payment.

The \$100,000 exception

Loans up to \$100,000 also won't generate imputed interest if the borrower's net investment income is no more than \$1,000 in a given year.

Suppose you lend your daughter \$100,000 to help her buy a house. If her investment income this year is \$500, the IRS will not impute any income for the interest. If her net investment income next year is \$1,100, some or all of the interest will be imputed income. The amount of imputed income to you the lender would be her net investment income or the amount derived from the AFR rate, whichever is lower. Say the AFR rate is 5%, which would be \$5,000 on a \$100,000

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Safe-Harbor 401(k) Plans

The benefits of 401(k) plans are widely known: these plans allow workers to defer some current income and the tax on that income. Earnings on the untaxed income also escape current tax. The deferred tax is due when money is withdrawn from the plan.

Build a safe harbor

The maximum 401(k) contribution in 2007 is \$15,500, or \$20,500 for workers at least 50 years old. However, if a company's lower-paid workers don't defer enough income, highly compensated employees might not be able to reach those limits. 401(k) plans are subject to two tests: the first applies to pretax contributions and the second applies to aftertax and employer matching contributions. These tests are intended to prevent discrimination in favor of highly compensated employees.

In some cases, higher-income workers might be shut out altogether from a 401(k) contribution. If this issue might be a concern at your company, consider a safe-harbor 401(k) plan. With such a plan, highly compensated employees can maximize their contributions, even if nondiscrimination tests can't

be met. To shelter in a safe harbor, employers must make certain minimum contributions.

There are two ways to proceed:

The 4% solution. One tactic is for a company to match each worker's contribution at 100% for the first 3% contributed and 50% for the next 2%. Assuming a worker contributes at least 5% of his compensation, the company's matching amount equals 4% of the worker's compensation. Say a worker who earns \$40,000 per year contributes \$2,000 to her 401(k) account. The company must match at least \$1,600 (4% of \$40,000).

If the company meets that condition, all of its highly-paid employees can maximize their 401(k) contributions. In addition, the company can match up to \$9,000 per year for each of its highly-paid employees. The \$9,000 maximum match is 4% of \$225,000, which is the most compensation that can be considered in 2007 when figuring a retirement plan contribution.

The 3% solution. The other tactic is for the company to contribute 3% of pay for each eligible worker, regardless of whether he or she makes a 401(k) contribution. Suppose another employee also earns \$40,000 per year but doesn't put anything into his

401(k) account. The company could contribute \$1,200 (3% of compensation) to a 401(k) account for him. The employer's contribution would be the same if the worker earning \$40,000 made a \$1,000 contribution, a \$500 contribution, or no contribution at all.

Again, highly compensated employees could maximize their 401(k) contributions. In addition, the company contribution could be as much as \$6,750 apiece—3% of \$225,000—for those earning that much or more.

Additional requirements

Companies must use one of the two contribution methods described above to qualify their plan as a safe-harbor 401(k). Other requirements may also apply.

All contributions must be 100% vested immediately. That includes employee contributions, employer matches, and any investment earnings. Thus, employees can take all the money in their accounts whenever they leave the company. In addition, eligible employees must receive a written notice each year. These notices, circulated at least 30 days before the start of the plan year, must spell out employee rights and employer obligations.

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loan. Your daughter's \$1,100 in net investment income would be lower than \$5,000, so that year's imputed interest would be \$1,100.

Keep in mind that the \$10,000 and \$100,000 exceptions apply only to income tax. Such interest-free loans or below-market loans still will have gift tax consequences.

Charge at least the AFR

In order to avoid income and gift tax problems, for all types of intra-family loans the best tax strategy is to charge

a rate that's at least as high as the AFR. All parties should sign a written agreement spelling out the terms of the loan, and then follow its terms. If there is no formal loan agreement and the

borrower pays no interest, the IRS may re-cast the transaction as a gift rather than a loan. Then the entire amount could be treated as a gift, triggering a gift tax.

August 2007 AFRs, Interest Compounded Annually

Loan Term	Applicable Federal Rate
Fewer Than 3 Years	5.00%
3 to 9 Years	5.09%
More Than 9 Years	5.31%

Source: www.irs.gov

What You Need to Know About Disability Insurance

According to AMA Insurance Agency (a subsidiary of the American Medical Association), during your working years you're up to four times more likely to suffer a serious disability than to die. About 3 in 10 of today's 20-year-olds will become disabled before they reach age 67.

Moreover, about two-thirds of the disabling injuries suffered by workers occur off the job—generally at home and in motor vehicles. When such incidents occur, the injured individual receives no workers' compensation benefits.

Defining moments

These facts and figures indicate that disability insurance might fill a need for you some day. Such policies may pay benefits when you're unable to earn income.

When you're shopping for a policy you should not go by price alone. A less expensive disability insurance policy may not offer you as much protection as you'd like. A key element in your policy selection is its definition of disability. If the definition is too stringent, you might not collect the insurance benefits you expected.

Own-occupation. Typically, the most expensive disability insurance policies are those that pay benefits whenever an illness or injury prevents you from working at your own specific occupation. Such policies are known as own-occupation, or "own-occ."

Say a surgeon has a hand injury and becomes unable to perform operations. An own-occ policy would pay a benefit no matter how much this surgeon can earn teaching or practicing another medical specialty.

Any-occupation. Other policies will pay benefits when a disability prevents you from working at any occupation considered suitable based on your education and work experience. These are any-occupation policies, known as "any-occ." An injured surgeon who can teach at a medical school would not receive a benefit from an "any-occ" policy.

Some disability insurance policies will pay benefits on an own-occ basis for a few years and then switch to any-occ coverage. So you might think you'll collect lifetime benefits, or at least benefits until retirement age, only to discover, for instance, that your benefits cease after two years if you are able to do any type of suitable work.

Renewal rates

In addition to the policy's definition of disability, you need to check its pricing terms carefully. Some disability coverage is noncancellable ("non-can") while other policies are guaranteed renewable.

- **Non-can** policies offer fixed pricing. Your coverage will be renewed at the same price every year as long as you keep paying the premiums.
- **Guaranteed renewable** policies may guarantee renewability but not price. That is, your premiums can be increased as long as the increase is imposed on an entire class of policyholders.

Making the choice

As you can see, own-occ, non-can disability policies offer the best coverage and the most predictable pricing. They're also the most expensive. Any-occ and guaranteed renewable policies will cost less. Our office can help you compare prices and benefits of disability insurance policies so you can pick the coverage that's best for you and your loved ones.

When to Start Social Security Benefits

For some people, Social Security is a major source of retirement income; for others, Social Security benefits are merely a supplement to other sources of cash flow. Regardless of your circumstances, deciding when to start receiving benefits can be tremendously important to you and perhaps to your spouse as well.

Setting the baseline

When you're making the decision, a key factor is your "full retirement age," as defined by the Social Security Administration. That's the age at which you'll be entitled to your basic monthly benefit.



For those born from 1943 through 1954, full retirement age is 66. It's a bit younger for those born earlier and a bit older for those born later. For everyone

born in 1960 or later, full retirement will come at 67, under current law.

Starting early. Regardless of when you were born, you can start your retirement benefits at age 62. There are some drawbacks though. Starting early reduces the amount of your monthly checks. Suppose you were born in 1945 and reach age 62 in 2007. Starting benefits on your 62nd birthday would reduce your benefit by 25%.

In addition, from 62 until you reach full retirement age there can be a steep penalty for collecting Social Security benefits while you continue to earn income. For example, in 2007,

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Tax Calendar

OCTOBER 2007

October 10

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

October 15

Individuals. If you have an automatic 6-month extension to file your income tax return for 2006, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalty due.

Employers. For Social Security, Medicare, withheld income tax, and non-payroll withholding, deposit the tax for payments in September if the monthly rule applies.

Partnerships. If you were given an additional 6-month extension, file a 2006 calendar year tax return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute K-1.

Electing large partnerships. If you were given an additional 6-month extension, file a 2006 calendar year tax return (Form 1065).

October 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2007. 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 November 13 to file the return.

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

NOVEMBER 2007

November 13

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

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2007. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15

Employers. For Social Security, Medicare, withheld income tax, and non-payroll withholding, deposit the tax for payments in October if the monthly rule applies.

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at age 62, \$1 in benefits will be withheld for every \$2 in earnings over \$12,960. This means that people who have substantial earned income probably should not take benefits before the year they reach full retirement age. Once you reach full retirement age, you may have unlimited amounts of earned income and still receive your basic Social Security benefit.

Starting later. While there is no penalty for starting benefits at your full retirement age, there is an incentive for waiting a bit longer. By postponing benefits you will get "delayed retirement credits" and increase your monthly check. For everyone born in 1943 or later, these credits increase your payment by 2/3 of 1% per month, so waiting delivers a bonus of 8% per

year. The benefit increase continues until you reach age 70, after which there is no further advantage to delaying benefits.

A bird in the hand

Assuming that no earnings penalty will be involved, starting Social Security becomes a matter of sooner or later.

- **Starting as soon as practical** gives you cash that you can spend or invest. If you need the money now or your health is poor, this choice can be a good one.
- **Starting as late as possible** gives you larger checks for as long as you live. If you don't need the money right away and expect a lengthy retirement, you eventually will appreciate the greater cash flow.

For married couples where the older spouse has been the major breadwinner, delaying Social Security may eventually provide more income for the survivor.

Breaking even

The Social Security Administration generally puts the break-even point in the late 70s to early 80s. That is, if you live well beyond 85, the greater monthly income you'll get by waiting will outweigh all the early cash flow you could have received by starting early.

Our office can help you calculate a break-even point for your specific situation and advise when it makes sense to start benefits.

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

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Federal Laws Require Employers to Have Effective Document Retention Policies

In the aftermath of the legal scandals swirling around Arthur Anderson, Enron and others, a clear and consistently enforced document retention policy is a necessity for every company. A key component of such a policy is having a quick and effective way to halt the process of document destruction if litigation looms.

Under federal law, a company is required to preserve evidence when it is, or should be, aware that evidence in its possession or control is relevant to litigation, whether pending or probable.

also address where and how records will be stored.

Business vs. Personal Records

Distinguish between business records and personal records. In addition, the policy should also cover company materials employees may have on their home computers, personal digital assistants and other electronic devices.

Under federal law, a company is required to preserve evidence when it is, or should be, aware that evidence in its possession or control is relevant to litigation, whether pending or probable. State law requires preservation of evidence once litigation is foreseeable. Under either standard, the failure to halt the routine destruction of documents can result in sanctions for the destruction of evidence, whether intentional or negligent. All document destruction should cease once litigation is threatened or begun. This includes paper and electronic documents, as well as back-up records of documents.

Companies should enact a system for alerting the IT department to stop any automatic purges. The freeze should continue until at least such time when documents can be reviewed and cataloged by appropriate personnel, and any modifications to the retention policy can be made. Even a reasonable document retention policy will not withstand scrutiny if a company destroys documents it should have known would be material.

In drafting a document retention policy, don't forget to check if government regulations require holding onto documents for a specific period of time. For example, banks must maintain a copy of any Suspicious Activity Reports, along with any supporting documentation, for five years. Even those in less regulated lines of work may find regulations govern some aspects of document retention. Failure to preserve such records could hurt a business if litigation were to occur.

Businesses should be proactive and establish a comprehensive document retention policy. Features of the policy should include:

Guidelines

Create clear guidelines appropriate for different types of records, both paper and electronic. The policy should

Permanent Storage System

Designate certain records for permanent storage, and set up systems for such storage. Careful attention must be given to cataloging information in such a way that it is easily retrievable.

Established Processes

Establish guidelines for how documents will be destroyed. Confidential materials such as employee records should be destroyed in such a way as to maintain their confidentiality. Companies should also establish how different types of records should be destroyed. This includes how the policy will be enforced; such as through software programs which automatically delete e-mails after a certain period of time.

Time Periods

Establish how long different types of records must be kept. This should be done by a careful review of industry standards and government regulations.

Responsible Personnel

Designate an employee or group of employees whose duties will solely, or in addition to their current role, make them responsible for managing and enforcing the policy.

At its most basic, a document retention policy describes what records – both paper and electronic – should be saved, in what format, and for how long. Tailoring an effective document retention policy to an individual business requires companies to take into account both their business and legal needs for information, with special consideration given to any regulatory concerns. ○

These materials have been prepared for educational and informational purposes only. It is not intended to be legal advice or a legal opinion on any specific matters. Always consult an attorney before taking action. (c) 2006 Bond, Schoeneck & King PLLC. If you would like to contact Mr. Frankel, e-mail him at pfrankel@bsk.com.

E-filing Benefits

The IRS points to the following benefits practitioners and their clients can enjoy when choosing to e-file:

- Ninety-nine percent of individual forms and schedules are available for e-file and the revenue service continues to add more.
- Filers receive proof of receipt within 48 hours.
- Once accepted, e-filed returns have a 99 percent accuracy rate, compared to 90 percent of those paper filed by a tax professional.
- Clients receive their refunds in half the time as paper filers, faster if they choose direct deposit.
- If clients owe money, they can e-file any time during the tax season and delay payment through automated withdrawal until tax day.
- Mistakes are caught immediately instead of weeks, months or even years later.
- In 37 states and the District of Columbia, taxpayers can use the Federal/State e-file program, through which both federal and state income tax returns can be filed together.
- Returns remain in the IRS systems precisely as the preparer created them instead of IRS staff re-inputting data.
- Self-select PINs allow clients to electronically sign their e-filed return by selecting a five-digit code and eliminates the requirement for Form 8453, U.S. Individual Income Tax Declaration for an IRS e-file Return.
- Transmission methods meet or exceed all government security standards.
- There is no greater chance of being audited.
- Research shows that 80 percent of taxpayers who have tried e-file are "very satisfied," and 83 percent remained loyal and tried it the following year.



DOVE Goppender---

"It's this \$2,342.55 for a trip down Memory Lane that I have some questions about."