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Big business

Huge tax law offers companies saving opportunities, dangers

The American Jobs Creation Act of 2004 (AJCA) began as a mere phaseout of the foreign sales corporation/extraterritorial income (FSC/ETI) regime, an export subsidy declared illegal by the World Trade Organization. Subsequently, AJCA mushroomed into the largest business tax reform since the 1986 overhaul of the Internal Revenue Code. Here's a look at some of the saving opportunities — and potential dangers — this tax law may offer your company.

New manufacturer's deduction

Lawmakers worried about how the FSC/ETI repeal might adversely affect many U.S. companies. To soften the blow, Congress created the new manufacturer's deduction. But it's not just for exporters: The tax break applies to most domestic production activities, with no export requirement. Thus, it's available to many more taxpayers than the previous export subsidy was.

Better yet, under AJCA, "manufacturer" includes not only traditional manufacturers, but also construction, engineering, architectural, agricultural processing and computer software production activities. Most business entities qualify, including C corporations and pass-through entities, such as sole proprietors, S corporations, partnerships and trusts, for which the deduction is generally applied at the shareholder or partner level.

The deduction is based on the lesser of your qualified production activities income (QPAI — domestic gross receipts less cost of sales and allocable expenses) and taxable income (or adjusted gross income for sole proprietors). The deduction is also limited to 50% of W-2 wages paid during the year.

> *The new manufacturer's deduction is not just for exporters.*

You may start claiming the manufacturer's deduction for tax years beginning after Dec. 31, 2004, but it's actually phased in over several years. For 2005 and 2006, the deduction will be 3% of QPAI or taxable income. It then increases to 6% in 2007 before topping out at 9% in 2010.

Throughout this period, expect the IRS to issue further guidance as to what qualifies as manufacturing activities and how to allocate expenses eligible for the deduction.

Section 179 extension

The Section 179 expense election allows a current deduction for assets that otherwise would be subject to the normal depreciation rules. For several years now, small to midsize businesses have enjoyed the increased Sec. 179 deduction of $100,000 (annually indexed for inflation). It has been available when they placed in service less than $400,000 (also annually indexed) in qualifying property during the year.

Previously, the deduction was scheduled to return to the old level of $25,000 in 2006, but AJCA has extended the $100,000 amount through 2007.

Indexed for inflation, the maximum deduction for 2005 is $105,000 with a $420,000 cap.

Enhanced leasehold improvements

Congress liberalized another depreciation deduction, too. You can now depreciate over 15 years qualified leasehold improvement property placed in service after Oct. 22, 2004, and before Jan. 1, 2006. This is shortened from the old rule, which required companies to depreciate leasehold improvements on nonresidential real property over 39 years.

Qualifying leasehold improvements must be enhancements to the interior of a nonresidential building made by either the lessor or the lessee and completed more than three years after the building was placed in service. Changes to residential real property don't qualify.

Bear in mind, though, that the shortened depreciation period doesn't affect the depreciation *method*. You still must depreciate qualified leasehold improvements under the straight-line method, while you can generally depreciate other 15-year property under the Modified Accelerated Cost Recovery System (MACRS) using the 150% declining balance method.

Nonqualified plan changes

AJCA also brought changes in the area of employee benefits — namely, nonqualified deferred compensation arrangements. The new law affects nearly all nonqualified plans, including traditional ones, phantom stock plans and stock appreciation rights.

The changes address distribution events, elections regarding time and form of payment, and benefit funding. AJCA's revisions also prohibit acceleration of benefit payments.

If a nonqualified plan doesn't satisfy the requirements, the participant will be taxed in the current year on all income deferred under the plan. Plus, he or she may be subject to interest and a penalty tax equal to 20% of the amount that must be included in income for the year. Exceptions are allowed only when the amount in question is threatened by a "substantial risk of forfeiture" or has been previously included in income.

These new rules generally apply to any compensation deferred after 2004 and to any arrangement materially modified after Oct. 3, 2004. If your company has a deferred compensation plan, or is considering one, be sure to get professional advice. The finer points of these revisions are complicated and still undergoing interpretation.

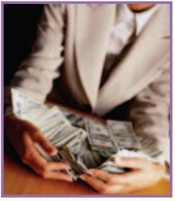
An expansive, varied landscape

AJCA contains many other provisions, including international tax law reforms, corporate tax-avoidance provisions, minor changes to itemized deductions and incentives for specialized industries. It's an expansive, varied landscape of opportunities and dangers if you don't stay on top of how the law's changes affect your business. So don't take any chances — learn all you can about AJCA and take note when the IRS issues guidance on it. ❑

AJCA grants greater flexibility to S corporations

S corporations are already the entity of choice for many businesses. Recognizing this fact, the American Jobs Creation Act of 2004 (AJCA) has granted more flexibility to this business structure. Changes taking effect in 2005 include:

- Increasing the maximum number of S corporation shareholders from 75 to 100,
- Allowing all family members to be treated as one shareholder instead of just a husband and wife being treated as one,
- Permitting an IRA to hold shares in a bank that is an S corporation,
- Granting transfers of suspended losses when stock changes hands in a divorce, and
- Offering relief in the event of inadvertent, invalid Subchapter S subsidiary elections and terminations.



Putting it all together

When (and when not) to consolidate your retirement accounts

A generation ago, it was fairly common to work an entire career for a single employer. In turn, that employer would reward such loyalty by funding a pension plan that paid regular benefits for the balance of your retirement. How times have changed.

Today, most workers change jobs several times during their lives, gathering retirement accounts as they go. If you have multiple accounts, consider consolidating them into one or two. But beware the tax pitfalls, which can be deep.

Why should I?

Consolidating accounts gives you a better idea of how your money is invested — something that's tough to figure out when you own multiple accounts. Without this information, it's difficult to respond to life or market changes.

Hanging on to a variety of accounts also increases the likelihood you'll lose track of one. After all, companies change names, sell divisions and go out of business regularly, so an account can easily get lost. What's more, there is no national database of accounts — if you lose one, you're on your own.

In addition, like many investors, you may assume that holding a handful of accounts automatically diversifies your assets. But that's not necessarily so. It's not unusual to find the same stocks making up 30% to 40% of different mutual funds — especially if the funds are from one company.

How can I do it safely?

Consolidating accounts doesn't require large amounts of time or money. When moving funds from a previous employer's 401(k) plan, you essentially have two options: taking it out or rolling it over. If you take out money and don't deposit it in a new 401(k) or a traditional or Roth IRA within 60 days, you will:

- Pay full federal, state and local income taxes on the distribution,
- Face a 10% penalty tax (subject to some limited exceptions) if you're younger than 59½, and
- Deprive yourself of much of the principal balance as well as perhaps decades of tax-deferred growth.

Thus, as long as you don't need the money immediately, you're better off rolling over the balance into your new employer's plan (if it so permits) or into an IRA.

Going the IRA route may be advantageous because your investments won't be limited to what your employer's 401(k) offers. Whether you should choose

a traditional or Roth IRA, however, depends on various factors. Carefully analyze your situation to determine which is best for you.

Also remember that opting for an IRA will leave you with at least two retirement accounts to monitor, which may not necessarily be a bad thing. (See "How many accounts are enough?" below.)

Hanging on to a variety of accounts increases the likelihood you'll lose track of one.

In any case, rollovers can generally occur in one of two ways:

1. A direct rollover. Under this method, sometimes known as a trustee-to-trustee transfer, you never actually receive a check for the funds. The original plan's custodian simply transfers the money to the new one, which can be your new employer, or in the case of an IRA, the bank or brokerage firm you choose.

2. An indirect rollover. The second option entails receiving the funds yourself. But, as mentioned, if you don't complete the rollover within 60 days, you can't make a rollover at all and full taxes and penalties apply.

Another drawback to this option is that your old employer must withhold 20% of your account balance for federal income taxes, which doesn't relieve you of the responsibility to redeposit the full balance within 60 days. If your balance is significant, this can pose a problem.

For example, if you initiate an indirect rollover for $50,000, you'll receive only $40,000 in cash. Although you can claim the remaining $10,000 as federal tax withholding on your next income tax return, you'll still have to deposit the full $50,000 into your new plan within 60 days or face tax (and possibly penalties) on the difference between the $50,000 balance and the amount you actually roll over. Because direct rollovers avoid both of these problems, they're clearly the preferable option.

How many accounts are enough?

When the topic of consolidating retirement accounts comes up, many people assume they should move all of their funds into a single account. Although this may be true in some cases, it's often wise to have two accounts: 1) your employer's plan, and 2) a traditional or Roth IRA.

Why is this so? Because, though consolidating your accounts into your company's plan is simpler, doing so limits your investment options to whatever your employer has selected. By having your own IRA, you

can split your funds among several different investment vehicles — with choices including stocks, bonds, mutual funds and annuities.

But there is one exception to this rule of thumb: when you plan to borrow substantially from your account. In this case, you may be better off rolling over extraneous accounts into your employer's plan. For example, if you need to put down a sizable amount of money on a new home, you may be able to take a loan against your 401(k) plan. This may not be possible with an IRA.

But IRAs allow penalty-free withdrawals before age 59½ under some circumstances. In fact, you can generally deduct up to $10,000 for a down payment on a first-time home purchase. But you will owe income tax on the withdrawal and you may need more than that amount to secure the desired home.

It's my call, right?

If you own several retirement accounts, it's your call what to do with them. But wield your power over this money wisely. Consolidating may make your life easier, keep your money safer and optimize its usefulness. Just make sure you follow the rules. ❑

Moneylines: News briefs for businesses and individuals

The "other" recent tax law offers individuals a variety of benefits. If you don't own a business, you may not have paid much attention to the American Jobs Creation Act of 2004 (AJCA). But don't forget, Congress passed another law just before AJCA: The Working Families Tax Relief Act of 2004 (WFTRA). And many of its provisions pertain, quite beneficially, to individuals — including extending the $1,000 Child Tax credit and the expanded 10% bracket through 2010, as well as prolonging marriage "penalty" and alternative minimum tax relief through 2010 and 2005, respectively.

Got options? Now your business must expense them. A recent ruling by the Financial Accounting Standards Board (FASB) will likely have a profound effect on many companies' reported earnings. Beginning with the first fiscal reporting period after June 15, 2005, businesses must deduct the value of any stock options they offer. (Privately held businesses and those that file as small business issuers have until Dec. 15, 2005, to comply.) FASB did not, however, recommend a specific way of valuing stock options.

Drawing home equity for investment purposes is generally not advisable. A surprisingly large number of people are taking out home equity lines to invest in the stock market, reports the National Association of Securities Dealers (NASD). The move seems to make sense — home equity lines offer cheap, tax-deductible funds and, even in today's uncertain economy, the stock market's charms beckon. But the risks of this move often outweigh the potential gains. Turning saved money into speculative cash is rarely a good move and, at the end of the day, that's your *home* on the line.

Gear up your business to overcome supply shortages. As the world market expands, more and more companies are noticing something else diminishing — raw materials. Elemental items such as lumber, fuel, cement and steel are not as easily accessible as they once were. And they probably won't be again for some time. To strengthen your buying power, consider forming a purchasing collective with other small to midsize companies. Also, take a hard look at your vendors and try to arrange long-term contracts with those you deem the most reliable.

Is now a good time to consider long-term care insurance?

Marcos and Maria have a playfully contentious marriage. They argue about music, politics and, most important, good restaurants. But their discussions took a serious turn when Maria's mother broke her hip. Marcos was convinced that Medicare would cover her extended rehab stay for as long as necessary, whereas Maria wasn't so sure. For resolution, they took the matter to their financial advisor.

The advisor didn't waste any time. Medicare, she explained, helps pay for only the first 100 days of skilled care in a nursing home. Beyond that, the options aren't pretty — generally either costly private pay or the financially obliterating Medicaid.

Marcos isn't alone in his assumption, the advisor noted. Many people mistakenly believe their government-funded health insurance covers extended care indefinitely. And when they learn differently, the more astute ones consider long-term care insurance.

Anticipating the future

A long-term care policy covers medical, skilled-nursing and nonmedical services for people who suffer from chronic illnesses — typically defined as conditions that require care for at least 90 days. Although coverage won't reimburse you for prescription drugs or doctor visits, it will pay for covered expenses whether you live at home, in an assisted-living facility or in a nursing home.

Some statistics about aging show a likely rise in the popularity of long-term care insurance in coming years. The number of Americans who will need the services of nursing homes, alternative residential care facilities or home care organizations will jump from 15 million in 2000 to 27 million in 2050, according to a 2003 report prepared by the Department of Health and Human Services as well as several other government agencies.

Knowing your limits

Still, long-term care insurance is not for everyone. If you have limited income and few assets, you might want to think twice about shelling out precious funds for this type of product.

Determining a cost range for premiums is difficult because there are so many variables. But a policy with a five-year benefit at $150 a day and a 90-day elimination period with inflation protection could cost a 50-year-old couple in good health about $3,000 annually. The same policy for a single person of the same age would be around $2,000 a year.

Premiums are generally guaranteed, but only on a class basis. This means the insurer can't increase the cost of your individual policy, but it can raise premiums for everyone who owns your type of coverage. Thus, you could see your premiums spike if the insurer underestimates the future cost of health care. And such a miscalculation could force you to drop your coverage after having paid for it for a couple of years or more.

Some statistics about aging show a likely rise in the popularity of long-term care insurance in coming years.

Of course, not everyone will qualify for long-term care insurance in the first place. If you have a complex health history or a current health issue, for instance, you may not be able to get it.

Starting early

If you believe you'll qualify for long-term care insurance and can afford it, start early. The younger you are, the less the premiums will be — but the longer you'll pay. In Marcos and Maria's case, it's too late for her mother to procure coverage. But the couple themselves, who are in their 50s, may want to consider buying a policy soon. ❑

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