

Welcome to this month's edition of the *Tax and Business Alert*. Our goal is to provide you with current articles on various tax and business topics. The articles are intended to keep you up to date on trends and issues that may impact your business and personal financial affairs. Please contact us if you have questions about any of the issues discussed.k;

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Federal Workers, Retirees Owe Billions

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In a recent letter to President Bush, Senate Finance Committee members Max Baucus and Charles Grassley cited information from the IRS that 450,000 government workers and retirees receiving paychecks or retirement benefits owe almost \$3 billion in back taxes.

In a follow-up statement, the IRS noted that "federal employees and retirees traditionally have a higher rate of tax compliance than the general population." Furthermore, balance due taxpayers are not tax evaders; most file correct tax returns but can't pay the full amount due. Others may owe additional taxes because of audit adjustments.

See www.senate.gov/~finance/press/Bpress/2007press/prb042507c.pdf for the full text of the letter.

Home Sales for Newlyweds

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One of the most common large-scale financial transactions we encounter is the sale of our home, and newlyweds have unique opportunities to exclude gain. You are allowed to exclude from federal taxation up to \$250,000 (\$500,000 if married filing jointly) of gain realized on the sale or exchange of a principal personal residence. Gain is computed based on the selling price less the adjusted cost basis of the residence and the selling expenses.

Married taxpayers filing a joint return for the year of sale may exclude up to \$500,000 of gain if (a) either spouse owned the home for periods aggregating two years or more during the five-year period ending on the sale date, (b) both spouses used the home as a principal residence for periods aggregating two years or more during the five-year period ending on the sale date, *and* (c) neither spouse is ineligible for the exclusion because he or she had sold another home within the two-year period ending on the sale date to which the exclusion applied.



If only one of the spouses, but not both, meets the qualifications of items b. and c., that spouse may still be entitled to exclude up to \$250,000 of gain on the joint return. When only one individual entering a marriage owns a principal residence, close attention to the calendar and to usage by the nonowning spouse can make the difference between a completely tax-free gain and partially taxed gain.

If both parties entering a marriage intend to move into a new principal residence after marriage, each can sell his or her former residence and claim an exclusion up to \$250,000 if they each meet the three qualifications. The provision limiting the exclusion to only one sale every two years by the taxpayer does not prevent a husband and wife from filing a joint return and each excluding up to \$250,000 of gain from the sale or exchange of each spouse's principal residence owned at the time of their marriage. However, this is only the case when each spouse would be permitted to exclude up to \$250,000 of gain if they filed separate returns.

One-person 401(k) Plans for the Small Business Owner

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One-person 401(k) plans are becoming increasingly popular for businesses that employ only the owner. Given the right circumstances, such plans can allow a large amount to be contributed on behalf of the owner while maintaining flexibility in making contributions in future years. The cost of preparing the annual return (Form 5500 is required) is nominal in comparison to the additional funding a one-person 401(k) plan allows. Also, because the plan has no employees other than the owner, it is not subject to the complicated nondiscrimination tests normally applicable to 401(k) plans.

For 2007, a business owner can make an elective deferral contribution of up to \$15,500 (\$20,500 if he or she is age 50 or older) plus an employer contribution of up to 20% of self-employment (SE) income or 25% of compensation. In calculating the allowable employer contribution, the owner's SE income or compensation is not reduced by the owner's elective deferral contribution.

The total contributions (elective deferral plus the employer contribution) cannot exceed the lesser of 100% of the participant's compensation or \$45,000 (\$50,000 if age 50 or older) for 2007.

Example: Maximizing contributions with a one-person 401(k) plan.

Randy, age 50 (by the end of the current year), is the sole owner and employee of Flight-in-Training, a sole proprietorship. Flight-in-Training is also the sole source of Randy's earned income. Randy earns \$145,000 (net of the SE tax deduction) in the current year and wishes to maximize contributions to a retirement account. Randy believes that the business will probably continue to be profitable, but he would like the flexibility of determining on a year-to-year basis how much to contribute. Randy does not expect to hire employees and will remain a one-person company.

For 2007, the maximum contribution Randy can make to his one-person 401(k) plan is \$49,500. This maximum contribution consists of his elective deferral in the amount of \$15,500, his catch-up contribution of \$5,000 (he is age 50 or over at year-end), and his profit sharing contribution of \$29,000 (20% × his SE income of \$145,000).

The business owner can borrow from his or her 401(k) plan, assuming the plan document so permits. The maximum loan amount is 50% of the account balance or \$50,000, whichever is less.

When the business employs someone other than just the owner, 401(k) contributions may be required for the other employees, in which case the plan would become a "standard" 401(k) plan with all the resulting complications. However, the plan can exclude from coverage any employee who is under age 21 and any employee who has not worked for at least 1,000 hours during any 12-month period. Because this exclusion rule allows the business owner to avoid covering young and part-time employees, the plan may still qualify as a simple and easy one-person 401(k) arrangement.

Additional retirement plan choices for the business owner include Keogh plans, SEP plans, SIMPLE IRAs, and the traditional and Roth IRA. Please call us to discuss which plan will maximize contributions and save the largest amount of tax dollars.

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Review Your Will Periodically

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A will is an integral part of most estate plans. It is the legal instrument through which an individual disposes of his or her property, determines who will manage the administration of his or her estate, and appoints a guardian for any minor children.

We recommend that you review your will periodically, as tax legislation, family relationships, economic situations, personal conditions, planning objectives, and the state of principal residence may all change over time. The importance of the review of your will by all members of the estate planning team cannot be overstated. The ultimate purpose of the review is to ensure that the will and its specific terms meet your ever-changing goals and objectives.

The estate tax is scheduled for repeal effective for decedents who die in 2010 and the tax will reappear in 2011. It will require an act of Congress (literally) to permanently repeal the estate tax. Prior to the scheduled repeal, the 2001 Tax Act provides for a gradual increase in the applicable exclusion amount for estate tax purposes from \$1 million in 2002 to a maximum of \$3.5 million in 2009. Many existing wills provide for a bypass trust to be funded with assets in an amount up to the applicable exclusion amount. Because this amount increases significantly in the next few years, it is important to fully understand the consequences that such a provision will have on your estate.



In addition to your will, other documents should be considered when reviewing an estate plan. Documents that provide for lifetime contingencies or other events, such as incapacity, are an important element of your estate plan. Beneficiary designations for assets that will pass outside the terms of the will must also be reviewed (these are referred to as nonprobate assets). Examples of nonprobate assets are life insurance proceeds, retirement plan benefits, and revocable living trusts which all pass directly to the designated beneficiary.

The probate process applies to decedents who die and leave a will (testate), as well as those who die without a will (intestate). When a will exists, the probate process involves establishing the will's validity. If no will exists, the process centers on establishing who is entitled to receive the property under state law.

Please call us if you have questions on estate taxation or any other personal or business tax planning issues.

Tax Calendar

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July 16—If the monthly deposit rule applies, employers must deposit the tax for payments in June for social security, Medicare, withheld income tax, and nonpayroll withholding.

July 31—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds \$500.

—The second quarter Form 941 (Employer's Quarterly Federal Tax Return) is also due today. (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 August 10 to file the return.

August 15—

If the monthly deposit rule applies, employers must deposit the tax for payments in July for social security, Medicare, withheld income tax, and nonpayroll withholding.

September 17

—Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations.

—If a six-month extension was obtained, calendar-year corporations should also file their 2006 income tax returns by this date.

—If the monthly deposit rule applies, employers must deposit the tax for payments in August for social security, Medicare, withheld income tax, and nonpayroll withholding.

The Adoption Credit

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Taxpayers can claim a tax credit for certain eligible adoption expenses or exclude from income employer-provided adoption assistance if their employer maintains an adoption assistance program. The credit and exclusion are subject to a dollar limitation and phase-out for taxpayers whose income exceeds certain thresholds.

For 2007, taxpayers can claim a credit for *up* to \$11,390 of qualifying adoption expenses. This is not an annual limitation; instead, it applies to the adoption of each child and is cumulative (for that child) over all tax years. When applying the limitation, adoption expenses incurred in an unsuccessful attempt to adopt an eligible child are included with those of the first subsequent successful adoption. The limitation is the same for both married and unmarried taxpayers, but married couples must file a joint return to claim the credit.



The credit for an adoption involving a child with special needs that becomes final is \$11,390 regardless of the actual amount (even if less than \$11,390) of qualifying adoption expenses incurred.