

A New Twist on an Old Theme: Roth Offers New Opportunities

Roth IRAs have been popular since their introduction in 1998 because the earnings on funds invested in such accounts build up tax free (as opposed to merely tax deferred as in traditional IRAs). However, a significant portion of the investing public does not have Roth IRAs, either because their income is above the Roth IRA contribution limit (which generally ranges from \$110,000 to \$160,000, depending on filing status) or because they do not have funds available to make Roth IRA contributions after contributing to their 401(k) or other retirement plans. Fortunately, this accessibility issue is scheduled to improve.

As a result of The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), beginning in 2006 employees who participate in a 401(k) plan will be allowed to designate part (or all) of their contributions to the plan as Roth contributions, *provided the plan is amended to accept such contributions*. Note that plans are not required to allow participants to designate their contributions as Roth contributions. Unlike an employee's traditional 401(k) elective contributions, Roth 401(k) elective contributions will be fully subject to tax in the year in which they are made (i.e., contributions are post-tax). However, the earnings on such contributions escape being taxed if they are not withdrawn from the 401(k) plan before the later of (a) when the account owner reaches age 59½, becomes disabled, or dies; or (b) five years after the Roth 401(k) account is first funded.

For 401(k) plans that choose to allow Roth contributions, the plan will need to track these contributions and their related earnings in an account that is separate from (1) the employee's regular 401(k) contributions, (2) any employer matching contributions, (3) any forfeitures allocated to the employee, and (4) earnings on items 1 through 3. Accordingly, an employee's Roth 401(k) account will contain only the employee's own after-tax Roth contributions and the related earnings. Furthermore, note that currently no provision exists for converting existing regular 401(k) accounts into Roth 401(k) accounts.

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How Credible Is Your Credit Report?

Your credit report contains information about where you work and live and how you pay your bills. It also may show whether you have been sued or arrested or have filed for bankruptcy. Consumer reporting agencies (CRAs) or credit bureaus compile and sell your credit report to businesses. Because businesses use this information to evaluate your applications for credit, insurance, employment, and other purposes allowed under federal law, it is important that the information in your report is complete and accurate. Another, perhaps more important, reason is to protect yourself against identity theft.

As we reported in a previous edition of *Tax Accounting Review*, privacy safeguards are constantly under attack. The IRS has routinely issued identity theft scam warnings, including one describing the nationwide use of fictitious bank correspondence and fraudulent IRS forms that affected numerous U.S. and foreign victims.

In the incidents reported, taxpayers received fake documents from their reputed "bank" requesting personal and sensitive banking information such as account numbers, PIN numbers, passwords, passport numbers, mother's maiden name, etc., in order to "update" bank records.

Fictitious Forms W-8888 and W-9095, which are designed to mimic the actual IRS Form W-9, "Request for Taxpayer Identification Number and Certificate," and a modified version of Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding," request more information than the actual forms in an attempt to obtain private information not typically disclosed.

Identity thieves have used the illegally acquired information to exhaust financial accounts, run up charges on charge cards, apply for loans or credit in the taxpayer's name, or file fraudulent tax returns.

With the rising number of privacy and identity theft incidents reported over recent years, especially with the enormous influx of

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Keep in mind that this separate accounting requirement will add another layer of complexity to the qualified plan and will also increase an employer's recordkeeping and compliance costs. Current IRS guidance is limited, but experts have tentatively concluded that a plan that fails to satisfy the Roth 401(k) recordkeeping and compliance requirements may be able to correct any failures through the IRS' Employee Plans Compliance Resolution System program, since the Roth 401(k) is part of a qualified retirement plan.

Subject to a plan allowing it, employees may split their annual 401(k) contribution limit between regular (pre-tax) and Roth (post-tax) contributions, or they may make only regular or only Roth contributions. Regular 401(k) pre-tax contributions, in general, tend to make more sense for employees who expect their marginal tax bracket to fall in the future. Roth 401(k) post-tax contributions are more likely to be the right choice for employees who expect their marginal tax bracket to increase, or at least stay the same, in the future.

A significant advantage of Roth 401(k) accounts over Roth IRAs is that the annual contribution limit is higher for Roth 401(k)s (\$15,000 for 2006, increased to \$20,000 for individuals who will be at least 50 by the end of 2006) than for Roth IRAs (\$4,000 for 2006,

increased to \$5,000 for individuals who will be at least 50 by the end of 2006). Also, there is no income limit on making Roth 401(k) contributions (although the annual limits on employee contributions to 401(k) plans, including Roth 401(k) plans, apply, and the standard 401(k) nondiscrimination rules also apply, which can limit certain higher-income taxpayers' ability to make contributions – just as the rules currently do for regular contributions). Since Roth 401(k) contributions are post-tax, adjusted gross income (AGI) is not reduced, which could cause the reduction of deductions or credits. You may want to “crunch the numbers” to determine which type of account is best for you.

Although the Roth 401(k) is a product of 2001 federal legislation, Rep. Benjamin L. Cardin (D-MD) has proposed repealing the Roth 401(k) before it goes into effect. Like most Democratic proposals in a Congress controlled by the Republicans, his proposal would seem to have little chance of being enacted. A pension bill by Rep. Rob Portman (R-OH) would not eliminate Roth 401(k)s, but would rename them “Retirement Savings Accounts.” We will be monitoring these legislative actions.

If you have any questions about the new Roth 401(k) rules or about retirement savings strategies in general, please contact us. |||

How Credible Is Your Credit Report?

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information exchanged via the Internet, federal, state and local governments have become increasingly conscious of taxpayer privacy issues and are enacting legislation to reduce the exchange of personal information to third parties.

We continue to recommend that you periodically review your credit report for inaccuracies or omissions. A credit review is especially important if you are considering making a major purchase. Checking in advance on the accuracy of information in your credit file could speed the credit-granting process.

Under the Fair and Accurate Credit Transactions Act (FACT), consumers can request and obtain a free credit report once every 12 months from each of the three nationwide consumer credit reporting companies. Those companies are Equifax (P.O. Box 740241, Atlanta, GA 30374-0241; (800) 685-1111), Experian ((formerly TRW) P.O. Box 2002, Allen, TX 75013; (888) EXPERIAN (397-3742)) and Trans Union (P.O. Box 1000, Chester, PA 19022; (800) 916-8800). You might want to contact each of these credit bureaus, since more than one agency may have a file on you and the information may differ from agency to agency.

FACT provides the following availability dates for the free credit reports: Western states, December 1, 2004; Midwest states, March

1, 2005; Southern states, June 1, 2005; and Eastern states and all U.S. territories, September 1, 2005. The reports are available online at www.AnnualCreditReport.com, by telephone at 877-322-8228 or by mail at Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.

Go to www.AnnualCreditReport.com for roll-out and additional information.

Under federal law, both the CRA and the organization that provided the information to the CRA, such as a bank or credit card company, have the responsibility to correct inaccurate or incomplete information in your report. To protect all your rights under the law, contact both the CRA and the information provider with any corrections to your credit report.

First, tell the CRA in writing what information you believe is inaccurate. Include copies (NOT originals) of documents that support your position. In addition to providing your complete name and address, your letter should clearly identify each item in your report that you dispute, state the facts and explain why you dispute the information, and request deletion or correction. You may want to enclose a copy of your report with the items in question circled. This is critical if, as indicated above, you are the victim of a tax scam or any other identity theft scheme, and your credit report

reflects activity that you are not responsible for. Just as we recommend with regard to the filing of income tax returns, send your letter by certified mail, return receipt requested, so you can document what the CRA received. Keep copies of your dispute letter and enclosures.

CRA's must reinvestigate the items in question, usually within 30 days. They also must forward all relevant data you provide about the dispute to the information provider. After the information provider receives notice of a dispute from the CRA, it must investigate, review all relevant information provided by the CRA and report the results to the CRA. If the information provider finds the disputed information to be inaccurate, it must notify all nationwide CRA's so they can correct this information in your file. Disputed information that cannot be verified must be deleted from your file.

Also, at your request, the CRA must send notices of corrections to anyone who received your report in the past six months. Job applicants can have a corrected copy of their report sent to anyone who received a copy during the past two years for employment purposes. If a reinvestigation does not resolve your dispute, ask the CRA to include your statement of the dispute in your file and in future reports.

Maximize Your Principal Residence Improvements and Minimize Your Taxable Gain

If you recently realized or expect to realize a gain from the sale or exchange of your principal residence, you may be able to exclude from your federal (and possibly your state) income up to \$250,000 of the gain (\$500,000 for certain married taxpayers filing a joint return). But with the sizzling rates of home appreciation since 1999, the exclusion may still be insufficient to shelter your entire gain. Another strategy for reducing the taxable gain from the sale of your main home is to ensure that you properly categorize your home expenditures.

During home ownership, the question as to whether a cash outlay is a repair (nondeductible expense) or a capital improvement (added to tax basis) often arises. The distinction between repairs and improvements is not always clear. Maintaining careful records of qualified home improvements is extremely important.

In general, a repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in operating condition. Improvements, on the other hand, prolong the life of property, increase its value, or make it adaptable to a different use. For example, an assessment for improvements or other items that increase the value of a property are added to the basis of the property. Such improvements may include streets, sidewalks, water mains, sewers and public parking facilities. Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements are also added to the basis of the property.

Second, in addition to writing to the CRA, tell the creditor or other information provider in writing that you dispute an item. Again, include copies (NOT originals) of documents that support your position. Many providers specify an address for disputes. If the provider then reports the item to any CRA, it must include a notice of your dispute. In addition, if you are correct – that is, if the disputed information is not accurate – the information provider may not use it again.

Keep in mind that when negative information in your report is accurate, only the passage of time can assure its removal. Accurate negative information generally remains in your report for seven years, with certain exceptions.

If your personal information has been stolen by identity thieves or you would like to learn more about privacy safeguards in order to reduce the likelihood of identity theft, please feel free to contact us. The investigative accountants of the Tax Accounting Group and the lawyers of our firm would be happy to help. |||

The following chart may assist you in determining whether the outlay qualifies as an improvement, which will reduce your gain on an eventual taxable sale, or a repair and maintenance charge, which will not reduce your capital gain. Keep in mind that there is no official list that distinguishes a repair from an improvement.

Improvement	Repair
Decks	Sealing decks
Windows	Repainting
Fireplace	Pointing bricks
Doors	Fixing locks
Carpeting	Cleaning carpets
Landscaping	Cutting hedges
Installing a new roof	Mending leaks

In addition to the improvements identified above, costs incurred in acquiring your principal residence, such as brokers' commissions, lawyers' fees, architects' fees or costs of defending or perfecting title to property, are also part of your basis in the property. Other acquisition costs reflected on the settlement sheet, such as title searches, recording fees, surveys and transfer taxes, should also be included in your tax basis. However, fees and costs related to obtaining a loan to purchase the property are not generally included. Appliances, window treatments and other removable items must remain with the home upon sale to be considered improvements.

Logbooks or similar records may reduce the recordkeeping burden. Affix all canceled checks and receipts to the appropriate pages for safekeeping.

If you would like a checklist and worksheet on capital home improvements, please contact us. We would be happy to provide

you with a home improvement log that can assist you in determining your basis in your principal residence, or in any other real estate you may own. |||

Social Security Reform – An Overview of the Debate

Many of our clients have contacted us for our take on Social Security reform, including its impact on their benefits and the benefits of their children. With the debate surrounding Social Security reform continuing, we thought this would be a good time to share with you an executive analysis of the study recently prepared by the American Institute of Certified Public Accountants (AICPA).

The goal of AICPA's March 2005 121-page report, titled "Understanding Social Security Reform: The Issues and Alternatives," is to foster an informed discussion by providing unbiased facts and analysis. While we include our observations on Social Security reform herein, we have also reprinted, with AICPA permission, the study's key findings. Our aim is to capture the essence of the study without materially altering or modifying it with our observations.

The primary objective of President Bush's domestic economic agenda is the reform of the Social Security system. Enacted in 1935, Social Security is by far the largest federal program, paying benefits to approximately 47 million retirees, disabled workers and their families. In 2003, the federal government spent a total of \$479 billion, or roughly one-quarter of the entire federal budget, on Social Security payments.

The Situation

According to the Social Security Administration's "best guess" (intermediate) assumptions, the Social Security Trust Fund surplus will peak in 2028. Thereafter it will decline steadily until 2042, at which time the Trust Fund will be exhausted. However, inadequate funds do not mean zero benefits. If no changes are made to Social Security, beneficiaries could receive full scheduled benefits through 2042. After 2042, however, scheduled benefits would have to be reduced by 27 percent. By 2078, benefits would have to be reduced by 32 percent.

Although the intermediate assumptions seem reasonable, there is still considerable uncertainty about actual results. Under Social Security's high-cost projections, the Trust Fund peaks in 2021 and is entirely depleted by 2031. Under low-cost projections, the Trust Fund would not be depleted and there is no long-term financing problem.

Restoring Fiscal Balance

The Social Security "deficit" contemplated under the "best guess" and high-cost projections could be funded by an immediate infusion

of \$3.54 trillion; by increasing the payroll tax rate from its current level of 12.4 percent to 14.3 percent; or by reducing current scheduled benefits 12.6 percent.

There are four general methods of improving the financial condition of the Social Security Trust Fund: (1) reducing benefits; (2) increasing revenues; (3) improving the rate of return on Trust Fund assets; and (4) other revenue sources, such as appropriating Treasury general funds.

Benefit reductions can be accomplished through a variety of measures, including across-the-board cuts, means-testing, raising the retirement age, or changing the inflation-adjustments used to determine benefits. Revenues can be increased by raising the payroll tax rate, raising the cap on taxable income, extending the payroll tax to all government workers, raising income taxes on Social Security benefits, or diverting general tax revenues to the Trust Fund.

Investing in Private Securities

If Social Security remains a pay-as-you-go system, the average rates of return on Social Security contributions will eventually decline below rates of return historically available in financial markets. Even if Social Security became a fully funded system, its rate of return could not significantly improve unless the restriction to invest solely in U.S. government securities were lifted.

Investing trust fund assets, as a whole, in the stock market could improve Social Security's financial condition, because – over long periods of time – the stock market generally outperforms the return on U.S. government securities. However, investing in private securities adds risk and increased administrative costs to the financing equation. Further, the potential for large-scale government investment in private equities could result in undue political influence on markets.

Personal/Private Accounts

Under a system of personal accounts, a portion of payroll taxes paid by each worker under age 55 would be redirected from the Trust Fund to that worker's own personal account. Some restrictions would be imposed on investment and payout options, but the personal account holder could, theoretically, generally expect to earn a higher return on his/her contributions.

Although personal accounts would not entirely eliminate traditional Social Security retirement benefits, under most proposals reviewed

in this report, traditional benefits would be reduced regardless of whether an individual chooses to participate in the voluntary account program.

Benefit Offsets: Workers choosing to contribute to personal accounts would receive benefits from their personal account along with traditional benefits that have been reduced according to the amount redirected to the investment in the worker's personal account. Obviously, the greater this "benefit offset," the less attractive the personal account option will be; however, large benefit offsets make personal account proposals less costly for the Trust Fund and would, therefore, enhance its financial stability.

Risk Shifting: Personal accounts expose account holders to uncertainty about their future benefit levels because of market performance risks. Although some of this risk can be eliminated through diversification, the balance of the risk could be assumed by the federal government in the form of minimum benefit guarantees.

Administrative Costs: The costs to administer private accounts have a large impact on the benefits ultimately available to retirees. For example, for an individual with average annual earnings of \$30,000 who is contributing 2 percent of earnings to an individual account, incurring administrative costs of 0.1 percent of assets could allow an accumulated balance of \$125,430 by retirement. However, if administrative costs were higher, say 1.0 percent, the accumulated balance would be approximately \$98,000 – a 22 percent reduction.

Funding Transition Costs

Over the 75-year horizon used to measure the financial impact of Social Security reforms, the creation of personal accounts by themselves worsens the financial condition of the Social Security Trust Funds, since the amounts invested are not part of the trust funds. During the long transition to a personal account system,

fewer funds would be available to pay traditional benefits to current retirees and near-retirees because contributions diverted to the personal accounts of younger workers would result in lower contribution levels into the Trust Fund. Therefore, extra funds from outside the program or cost savings from inside the program would be needed to fund the transition.

Questions for Evaluating Personal Account Proposals

Many important issues need to be considered under any personal account proposal, including (1) the degree to which, and over what period, benefits under the existing system would remain in place; (2) the availability of a safety net for low-income beneficiaries; (3) the degree of control that individuals will have regarding participation, investments and distributions; (4) the extent to which benefit payments will be subject to tax, and, if so, the tax rate; and (5) the amount that the plan will "cost" beneficiaries in lost traditional benefits as a trade-off for a personal account.

With regard to Social Security reform, we can aid individuals, employers and businesses in understanding the consequences of: (1) a payroll tax increase on businesses' total expenses and work force decisions; (2) a benefit reduction on individuals' financial planning and retirement decisions, and (3) the assets that can be built in private savings accounts and the offsetting reduction in scheduled benefits.

Conclusion

Social Security reform, as well as changes in federal tax policy, will be among the dominant issues in the 109th Congress. Decisions by this Congress in these areas will have profound and long-lasting economic implications on future generations. We will be monitoring developments in both areas. |||

Tax Accounting Group News

Rodney Anello joins the Tax Accounting Group as a Tax Accountant. He will practice in the areas of federal, state and local tax compliance and planning, including financial statement analysis for individuals and businesses. Mr. Anello graduated from Drexel University with a bachelor of science degree in business administration, concentrating in accounting and international business.

William J. Friel joins the Tax Accounting Group as a Tax Accountant. He will practice in the areas of federal, state and local tax compliance and planning, including financial statement analysis for individuals and businesses. Mr. Friel graduated from

Drexel University with a bachelor of science degree in business administration, concentrating in accounting.

Mike Gillen, Director of the Tax Accounting Group, was recently elected to an unprecedented second consecutive term as President of the Greater Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants (PICPA), a 9,000-member chapter of the second-oldest and fifth-largest state CPA society in the country.

Bruce J. Rogers, CPA, JD was published in the *Pennsylvania CPA Journal*, Summer 2005 Edition. Mr. Rogers authored "A Brush-Up on Basic Rules for Retirement Plans."

About Duane Morris

Duane Morris LLP, among the 100 largest law firms in the United States, is a full-service firm of over 550 lawyers. In addition, Duane Morris affiliates have approximately 50 professionals engaged in ancillary service businesses, such as the Tax Accounting Group. The

firm represents clients across the nation and around the world through a combination of 18 offices and a relationship with an international network of independent law firms. |||

About the Tax Accounting Group

The Tax Accounting Group, one of the largest groups of its kind in any law firm, has an active and varied practice with more than 60 service lines in more than 45 industries, serving clients in 43 states and eight foreign countries. The Group's certified public accountants, certified fraud examiners, financial consultants and advisors provide a broad range of cost-effective tax preparation, planning and consulting services as well as accounting, financial and management advisory services to individuals, corporations, partnerships, estates and trusts and nonprofit organizations. The

Group also provides an array of litigation consulting services to numerous lawyers and law firms representing clients in regulatory and transactional matters and throughout various stages of litigation. Consulting services include, but are not limited to, case assessment and strategy development; asset recovery investigation and locator services; damage assessment; marital disputes; forensic and investigative accounting; fraud and embezzlement detection; and civil and criminal tax controversies. |||

Tax Accounting Group

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