

Charting your secure financial future Money Matters



Financial news, information and advice for the savvy Mariner
from Transport Workers Tax Service, LLC and CFS/Retirement & Tax Solutions

Fall 2005

IRS AUDIT TRIGGERS

Colleen H. Emery, CPA

● FOREIGN TAX CREDIT

Did your return seem too good to be true this year?
Is there a dollar amount on your 1040 line 46, "Foreign Tax Credit?" A word of caution, per the I.R.S.:

The foreign tax credit is intended to reduce the double tax burden that would otherwise arise when foreign source income is taxed by both the United States and the foreign country from which the income is derived.

IRS Publ. 514

The foreign tax credit only applies if you DID in fact pay taxes to a foreign country. If you have **not** filed a tax return with another country and did not pay taxes to the foreign local, **DO NOT** take this credit! If audited, you will be subject to the tax due and may also be subject to a 25% penalty!

● MEALS ON BOARD

In the past few months, action has been taken against tax preparers for preparing returns that claim deductions for non-existent or improper business expenses. In all cases, the government's complaint alleged the returns claimed deductions for meals that were provided by employers for free. The daily per diem amount (\$38-\$42/day) was simply multiplied by the number of days the mariner was on board the vessel. A fact common to all cases was that the so-called "mariner's tax deduction" was improper and not supported by the Internal Revenue Code or other law.

We have stressed in our newsletters, website, seminars, etc. that as a mariner you are not eligible for the 'M' portion of the **M&I** rate (Meals and Incidentals).

This does not disallow you from deducting meal expenses while in port, during the period of time you are job searching, or while attending school for continuing education; however, it does further emphasize that ***you are not eligible to deduct meals while on board the vessel.*** See below for further clarification of deductibility of meals.



100% deduction of meal expenses

Perhaps the confusion comes from the following IRS Code section. We have seen it cited to validate deducting 100% of your meal expense. As you can see, the Code strictly covers the "companies" that provide the meals:

IRS Code Sec. 274(n)(2)(E)(i) allows companies that are required by federal law to provide crew members food or beverages the ability to deduct 100% of their costs.

Clarification - deductibility of meal expenses:

- 1) **On the job** (signed-on vessel articles) - such as in port. This is considered Department of Transportation (DOT) hours of service. While you are under DOT hours of service, you are allowed to deduct 70% of the cost of meals while ashore.
- 2) **Work related** (not signed-on vessel articles) - such as job search, education, trips to the union hall. This is considered Non-DOT hours of service. While you are under Non-DOT hours of service, you are allowed to deduct 50% of the cost of meals.
- 3) **Meals on board** - see above. There is no (0%) deduction allowed.

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CFS CFS/RETIREMENT SOLUTIONS

Early Retirement?

How to Avoid IRS Early Withdrawal Penalties

Mark E. Engberg (Investment Advisor Rep.)
Bruce W. Robson, CFP

Previously, the only way to use funds from an IRA prior to age 59 ½ without the 10% premature distribution penalty was death or total disability - choices that are not on the top of anyone's list. The Tax Reform Act of 1986 added another exemption - Internal Revenue Code Section 72(t)(2)(A)(iv), referred to as 72(t). This exception permits individuals to take "substantially equal periodic payments" (SEPP) and avoid the 10% penalty; of course State and Federal taxes are still due. (There are other exemptions related to health care costs, first time home purchases, and higher education expenses - not covered in this article.)

Originally, this exemption was not very useful because there were many gray areas regarding how to establish your payments. The IRS has since provided guidance (Rev. Rule 2002-62, 2002-42 I.R.B. 710) and various private letter rulings that help retirees assure they are properly utilizing this very effective "legal loophole." These rules are effective for all payments commencing on or after January 1, 2003.

Quotable Quotes:

"The question for each man to settle is not what he would do if he had means, time, influence and educational advantages, but what he will do with the things he has."

- *Hamilton Wright Mabie*

"Money is of no value; it cannot spend itself. All depends on the skill of the spender."

- *Ralph Waldo Emerson*

"Whatever you have, spend less."

- *Samuel Johnson*

"Enough is greater than more."

- *Mark Engberg*



Three methods are provided by the IRS to calculate the allowable SEPP:

1) **Life Expectancy Method or Required Minimum Distribution (RMD)**

- Generally provides the smallest annual amount
- Amount you receive will fluctuate each year - normally increases gradually each year
- Must recalculate the payment each year
- Calculation - based on the account value at Jan 1 and the following year's life expectancy

2) **Amortization Method**

- Generally produces a larger annual amount than the Life Expectancy Method
- Amount you receive is fixed - perform the calculation only once
- Calculation - IRA balance is amortized over a single or joint life expectancy

3) **Annuitization Method**

- Generally produces a larger annual amount than either the Life Expectancy Method or the Amortization Method
- Amount you receive is fixed - perform the calculation only once
- Calculation - based on the annuity factor related to the individual's age in the first year of the distribution

There are several web-based 72(t) calculators you can access, or contact our office for assistance with making an accurate calculation.

Please be aware of the following traps and pitfalls:

- 72(t) is an irrevocable decision.
- Payments must be made at least annually.
- Payments must run for at least 5 years or until age 59 ½, whichever is longer.
- You can not change your payments, except as required under Method 1 - Life Expectancy Method annual recalculation.
- You must use the approved "reasonable rate" for Methods 2 & 3.

To make this newsletter as helpful as possible, we welcome your input. Please call us toll-free or e-mail comments, suggestions or questions to us. Answers to questions of general interest may be published.

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- **Reasonable Rate - A rate of interest that is not more than 120 percent of the federal mid-term rate published in revenue rulings by the IRS - determined in accordance with section 1274(d) of the Code for either of the two months immediately preceding the month in which the distribution begins.**

f) You must substantiate the original IRA account balance and how the calculation was made.

g) You can not add funds or withdraw additional funds from the IRA account which has been used to establish the early distributions under IRS Code Section 72(t).

h) If an individual begins receiving payments under either the fixed amortization method or the fixed annuity method, that individual may change to the required minimum distribution method in a subsequent year. However, under Rev. Rule 2002-62, once a change is made, it must be followed in all subsequent years.

i) Distributions that are deemed non-qualified under the 72(t) exception will be considered premature and the 10% penalty will be applied retroactively to all distributions.

An obvious concern is that 72(t) is an "irrevocable decision." Once you have commenced the distribution program, there are relatively few options that would allow significant changes. Our next newsletter article will address this issue and provide insight on how to maximize your options and increase flexibility related to 72(t).

Quotable Quotes:

Follow the three R's:

~ Respect for self

~ Respect for others

~ Responsibility for all of your actions

- Dalai Lama

"Wealth consists not in having great possessions but in having few wants."

- Esther de Waal

"Seek moderation in everything except knowledge."

- Aristotle

Tracking Lump Sum Factors:

For those nearing retirement and contemplating a lump sum buyout, there is a possibility that lump sum factors may be slightly higher for 2006. Economic conditions are such that short-term interest rates have risen significantly whereas long-term rates have actually decreased. If the GATT interest rate for the final months of 2005 is lower than it was for the same period in 2004, lump-sum factors will increase. You must also take into consideration your date of birth and actuarial age to determine the optimum lump sum distribution strategy. Call us if you need further clarification and help in making well informed decisions.



IN SUMMARY

IRS 72(t) is a powerful planning tool that has allowed many working individuals to retire early and enjoy the fruits of their labors while they are still relatively young and healthy. With proper planning and a careful investment approach, the individual should be able to achieve a comfortable retirement income and retain control of their assets. After the 72(t) period has ended (5 years or age 59 1/2, whichever is longer), the retiree may have the ability to enjoy an annual cost of living allowance or access additional capital for life enhancing purchases.

Remember, 72(t) is an irrevocable decision and non-qualified distributions will incur severe taxation penalties. Consult a professional to assure your calculations are accurate and substantiated, and you have built in the flexibility you need.



Transport Workers Tax Corner

● **Unsubstantiated Returns**

There is a myth that e-filing your return minimizes the potential of an audit. In fact some preparers may encourage this approach. *We would like to make two points:*

1) For any taxpayer - If the return is properly prepared and fully substantiated, the risk of an IRS audit creating any problems or difficulties is greatly reduced, or even eliminated all together.

2) For merchant mariners - You have generous tax deductions that are virtually unique to your industry. It is critical to submit full, detailed substantiation of these deductions with your returns. ***This is not possible when you e-file.***

There have been instances where valid deductions were disallowed simply due to lack of substantiation. Whether you prepare your return or have a professional prepare it on your behalf, be certain to attach substantiation for all your mariner deductions. This **can not** be accomplished by e-filing your return - why risk losing the substantial tax savings you are entitled to by not following IRS procedures.

REVIEW YOUR PAY-OFF SHEETS

REMEMBER: It is your responsibility to review your withholdings and ensure the correct W-4 (withholding allowance) information is being applied. Do not assume that it is carried over correctly from a previous voyage. We have seen too many examples of "tax shock" at filing time due to lack of withholding.

Anytime you are on the ship, make sure you have the captain verify that your W-4 (withholding allowance) is correct. This is also applicable when collecting your vacation pay. If you need assistance in calculating the minimum requirements please see our website at www.transport1040.com or contact us at 1-866-777-8987.



IN SUMMARY

As merchant mariners, your tax preparation needs are very unique. Be assured you have submitted an accurate return which is fully substantiated. In most cases, you should seek assistance from a tax professional who understands the complex issues specific to your industry, and is experienced in filing an accurate tax return on your behalf.

