



SJ MONEY

by Martin H. Abo, CPA, CVA

Don't You Just Love Tax Surprises?

No? Then start planning ahead.

We know. You don't even want to hear about taxes this time of year. But now is the time to plan ahead. Was the bottom line of your last tax return a major surprise to you?

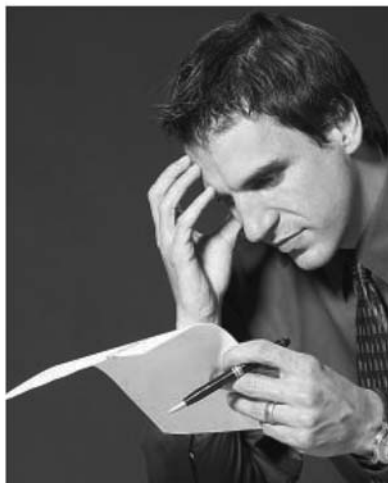
If so, you probably haven't done all you can in the area of tax planning. You may have thought your tax estimates were "safe" based on prior year returns. However, amounts paid on estimates certainly don't guarantee the amounts due at year-end or even April 15th.

Don't prepay taxes before payment is required. However, failure to know the approximate amount due means that total planning may not have been done. This lack of planning means you may or may not have achieved your optimum tax situation for the year. While we certainly recommend that any unusual situations and/or changes be discussed, we don't believe that this single circumstance discussion replaces total tax and financial planning.

Here are a few ideas to get you going:

Take advantage of retirement plan options. In most retirement accounts the earnings are tax-deferred. (With Roth IRAs, they're normally tax-free.) Thus, the sooner you fund such an account, the quicker the tax advantage begins. If you can come up with the cash now, there's no need to wait until year-end or the April 15 tax-filing deadline to make your annual contributions. Plus, if you're self-employed and don't already have a retirement plan for your business, make this the year you resolve to start one.

Monitor personal use of vacation homes. Renting a vacation home can



Even people who make estimated tax payments benefit from reviewing their tax plan now.

help offset the cost of owning and operating the property. However, the vacation home rules generally limit rental deductions if the owner uses the property for personal purposes more than the greater of 14 days or ten percent of the rental days during the year. Personal use includes any day the property is rented at less than fair market value, and normally includes all the days the unit is used by the owners or their family members. By monitoring personal use for the rest of the year, you may be able to avoid the limitation on rental expenses and report a tax loss for the year.

Match your investments with the proper time frame. Because of its volatility, the stock market may not necessarily be the place for short-term investments. Thus, funds that you'll need for a down payment on a house later this year, next year's tuition, or perhaps just to live on when you retire in two or three years may be best invested in something more conservative. Otherwise, you risk having to sell just when the bottom falls out of the market. If you need to take some funds out of the stock market now, check with your tax or financial advisor to make sure you do it in the most tax-efficient way possible.

Consider selling rather than trading in business vehicles. The tax rules limit the amount of annual depreciation that can be claimed on most cars and light trucks. Thus, when it's time to replace the vehicle, it's not unusual for its tax basis to be higher than its value. If you trade a vehicle in on a new one, the undepreciated basis of the old vehicle simply tacks onto the basis of the new one. However, if you sell the old vehicle rather than trade it in, any excess of basis over the vehicle's value can be claimed as a deductible loss to the extent of your business use of the vehicle. ■

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Tax Aspects of Personal Injury Awards

By Martin H. Abo, CPA, CVA

For years, confusion and litigation abounded concerning the taxability of punitive damages and damages for non-physical injuries such as gender and age discrimination, or in harassment cases. When The Small Business Job Protection Act was signed into law in 1996, years of litigation ended by stating that punitive damages — whether or not related to physical injury — are not excludable from gross income. Awards for nonphysical injuries are excludable only to the extent of amounts paid for medical care attributable to emotional distress. Consider these:

Punitive damages will generally be included in gross income and taxed when received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. For example, Tax E. Vater was awarded by the jury \$200,000 for physical injuries received from an accident at his job. \$150,000 of the award was attributable to his actual physical injuries while the balance was punitive as a result of repeated OSHA violations at his employer's factory. Tax E. Vater should include the \$50,000 punitive portion of the award in his taxable income while the \$150,000 payment for his actual physical injuries can be excluded.

Damage recoveries for other than physical injuries or sickness will be taxed. Emotional pain and suffering or emotional distress is not considered a physical injury or illness excludable from taxation. Other than for the actual medical expenses incurred, damages received for a "wrongful discharge" claim, race and age discrimination, injury to reputation accompanied by a claim of emotional distress, and similar nonphysical claims will all be included in gross income. For example, her employer awarded Jane Denim \$70,000 for sexual harassment.

The entire award was for her pain and suffering but because the award was for a non-physical injury, the entire \$70,000 would be taxable.

We indicated that damage awards (nonpunitive) received because of physical injury or sickness will not be taxed. Similarly, awards for emotional distress or other non physical injuries to the extent attributable to a physical injury will be excluded. In this first instance, if Sally Jones received \$50,000 for physical injuries she received in a car accident, she would not be taxed on anything since the entire amount was for the actual physical injuries she suffered. Similarly, if her husband received another \$30,000 for his loss of consortium with Sally resulting from her injuries, the entire award would still not be taxed because the award had its origin in a physical injury.

Nonpunitive awards for nonphysical injuries will not be taxable to the extent they are paid for medical care attributable to emotional distress. For example, Jane Martin was granted \$100,000 from a jury for her sexual harassment claim. If \$20,000 of the award were to reimburse her for the medical expenses due to her treatment of the emotional distress caused by the harassment, only \$80,000 of the award for her pain and suffering would be included in income.

Interest included in an award of damages for personal injury is includable in gross income.

The Appellate Courts have generally been split on the issue of whether contingent attorney fees paid by a taxpayer are excludable from gross income. The IRS generally has been taking the position of requiring the full amount of an award or settlement to be included in gross amount (generally permitting the taxpayer to deduct the attorney fee as an itemized deduction with resulting limitations).

Contrast this to only including in income that portion of an award that is the net of the contingent fee paid to the taxpayer's attorney. The recently enacted American Jobs Creation Act now at least permits, beginning in 2005, attorney's fees and court costs incurred in prosecuting claims based on unlawful discrimination and certain other federal claims, including but not limited to whistleblower actions, to be deductible from gross income as an above-the-line deduction. Because the deduction is above the line, it will not be subjected to the limitations otherwise alluded to (i.e. not subject to the reduction of itemized deductions for higher-income individuals and may be claimed against the alternative minimum tax).

What's it all mean? In some cases, it's been noticed plaintiffs holding out for more money to make up for an increased tax liability. Also, some lawyers believe a greater number of claims have been made alleging physical injuries in some harassment or discrimination cases.

How do CPAs involved in litigation support services get used? Well, helping lawyers by analyzing, quantifying or preparing claims for damages or settlement offers. Also, possibly discussing with lawyers the tax or financial impact of filing a claim under several different scenarios, giving consideration to maximizing the after-tax recovery. CPAs also might consult with defense counsel, preparing reports or counter-reports where necessary, and even advising them on settlements of legitimate claims that might minimize income taxes, which could result in lower payments by their clients/payors.

This article was provided by the Voorhees firm of Abo & Company, LLC, Certified Public Accountants. For additional information visit www.aboandcompany.com.