

# ANNUAL NEWSLETTER

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The 1998 tax season with all its many changes will be here soon. This update is intended to help in your tax planning strategies before year-end and to aid in gathering information to prepare your tax return.

We are happy to announce that Patricia A. Watts has joined Laurie M. Barre, CPA and myself.

## **UPDATE #1 (Child Credit)**

A credit of \$400 is available for each qualifying dependent child who is under the age of 17 as of 12/31/98. This credit will increase to \$500 for 1999 and years thereafter. The Child Credit is limited for high income earners. It begins to phase-out with adjusted gross income of \$110,000 (Married Filing Jointly) and \$75,000 (Single).

## **UPDATE #2 (Educational Incentives)**

**Hope Scholarship Credit** - The Hope Credit is available for the 1<sup>st</sup> two years of secondary education for students who attend school at least half-time. This credit is available per student with a maximum credit of \$1,500 per qualifying student for the 1998 tax year. The education expenses must be paid in the 1998 year and only cover tuition and fees (not books, room, or board). These expenses can be paid from the student's earnings, a loan, a gift, or an inheritance. The taxpayer, spouse, or dependent can qualify for the Hope Credit. This credit also phases out for higher income earners.

It is not available to taxpayers with adjusted gross income higher than \$100,000 (Married Filing Jointly) and \$50,000 (Single). Since school years usually run from September to June, a student could have up to 3 different calendar years that qualify as first & second years of secondary education. Since the Hope Credit can only be taken for 2 tax years, proper

tax planning to optimize the credit is important.

**Lifetime Learning Credit** - The Lifetime Learning Credit for 1998 is based on 20% of the expenses paid from July 1, 1998 to December 31, 1998. Maximum eligible expenses are \$5,000 annually with a maximum credit available of \$1,000 through the year 2002. The annual limit will increase beginning in the year 2003 to \$10,000 - increasing the maximum available credit to \$2,000. The Lifetime Credit is per taxpayer unlike the Hope Credit which is per student. Each student can only be used for either the Hope or Lifetime credit each year. The Lifetime Credit has the same phase out limitation for higher income earners (\$100,000 - Married Filing Jointly and \$50,000 - Single). There are no limits on the number of years that this credit may be claimed. The Lifetime Credit applies to tuition and fees (no books, room, or board) for undergraduates, graduate students, and anyone improving their job skills through a training program. The student does not have to attend full-time or half-time to qualify for this credit.

\* TAX ALERT - Each taxpayer's situation is unique. Deciding which credit and which years to take the credits will be necessary to maximum the tax benefit.

\* TAX ALERT - Taxpayers can prepay in 1998 for academic periods beginning January through March 1999 and claim the credit on their 1998 returns.

## **Deduction for Student Loan Interest**

A deduction for interest paid on secondary educational loans may be taken on the 1998 tax return. In order to claim this deduction, the taxpayer does not have to itemize. The maximum deduction for 1998 is \$1,000. Once again, there are phase-out limitations due to adjusted gross income starting at \$60,000 for

Married Filing Jointly and \$40,000 for Single. The loan must have been incurred to pay qualifying expenses (tuition, fees, books, room, board, etc.). The deduction is for interest payments paid after 12/31/97 and is available only for the first 60 months that the payments are required to be made.

### **UPDATE #3 (IRAs)**

Individual Retirement Accounts are generally hit with a 10% penalty tax if the withdrawal is made before age 59 1/2. There are some exceptions to that rule and starting in 1998, there are two new important exceptions:

1) The penalty does not apply for withdrawals up to a lifetime cap of \$10,000 that are used to purchase a principal residence for a "qualified first-time buyer." In order to be a qualified first-time buyer, you need only to **not** have owned a principal residence within the two-year period before the purchase of the new home! The qualified first-time buyer does not have to be the IRA owner.

2) Distributions from IRAs to pay higher education expenses will not incur the 10% penalty. These expenses include tuition, room, board, fees, books, supplies, and equipment required for post-secondary education. Qualified expenses can be incurred by the taxpayer, spouse, or any child or grandchild.

### **Educational IRA**

Oddly enough this account has nothing to do with retirement. Contributions to an Educational IRA do not affect a taxpayer's eligibility to contribute to a regular or Roth IRA. Contributions can not exceed \$500 annually per beneficiary and the beneficiary has to be under the age of 18. Anyone can make the contributions on behalf of the child but it must be made by the end of the year. The Educational IRA is nondeductible but is tax-free upon withdrawal if the money is used to cover qualified higher educational expenses. (The money may not be used for elementary or high school expenses.) If the Educational IRA is not used by the beneficiary, it can be rolled into another educational IRA for a member of the beneficiary's family within 60 days of distribution. If the child does not go to college and does not have a family member to roll the IRA over to, the funds must be withdrawn by age 30. The earnings are then taxed and subject to the 10% penalty.

and board) for the taxpayer, spouse, or dependent.

### **Roth IRA**

The new Roth IRA basically allows the taxpayer to set up an IRA account that is nondeductible going in but tax-free coming out. In order for the distribution to be tax-free, it must be made 5 years after the initial contribution and after the taxpayer is older than 59 1/2, or becomes disabled, or is used for qualifying first-time home buyer or education expenses. The annual contribution limit for the Roth is \$2,000, but not more than the taxpayer's earned income. Contributions can be made to the Roth IRA after age 70 1/2 and the minimum required distribution rules do not apply. A taxpayer can contribute to a Roth IRA even if covered by another retirement plan. The phase-out limits for a Roth contribution are reached at adjusted gross income of \$160,000 for Married Filing Jointly and \$110,000 for Single filers.

### **UPDATE #4 (Paying Tax by Credit Cards)**

Starting in 1999, taxpayers who file electronically will be able to pay their federal income taxes using a credit card. The IRS is in the process of making agreements with credit card companies that will be offering this service. A charge for this service will be made based on the amount of the tax.

### **UPDATE #5 (Capital Gains)**

Beginning in 1998, the most favorable tax treatment is given to capital assets that have been held for **more than one year** (instead of more than 18 months). The maximum tax rate on net capital gains is now generally 20% and reduced all the way to 10% for taxpayers in the 15% bracket. Before the end of the year is the time to make decisions about buying and selling your investments in order to net gains against losses.

### **REMINDERS - All new for 1998**

- 1) A tax return should be filed for children who have unearned income of more than \$700.
- 2) Your name on the tax return must match exactly as it appears on your social security card. Be sure to inform the social security administration if your name has changed.
- 3) Individuals who drive their own vehicles to and from for volunteer work can claim a deduction of

14 cents per mile.

4) You should receive written acknowledgment from

charities for donations of \$250 or more.

5) The earned income credit is available to taxpayers

with income as high as \$30,095 who have qualifying dependents (this includes a person

### **BUSINESS OWNER'S UPDATE - Fall 1998**

**Estimated payments** - Estimated payments for corporations are due 12/15/98. Estimated payments for taxpayers who are self employed are due 1/15/99. Please contact our offices before the end of the year if you have concerns regarding increasing or decreasing your estimated payments.

**W-4s** - It's a good idea to have employees fill out new W-4s in January.

**I-9s** - All employees should have filled out an I-9 which verifies an employees citizenship. The employer penalty for not having the I-9 form on file starts at \$100.00 per employee and can go as high as \$1,000 per employee. The I-9 form must be on file by the end of the third business day after the employment date; and must be retained for the longer of 3 years or 12 months after termination.

**Independent Contractors** - If you are paying an individual as an independent contractor instead of an employee, be sure to have a written agreement that spells out all conditions along with the individual's address & social security number for reporting purposes. We advise having the independent contractor fill out IRS form W-9 (Request for Taxpayers Identification Number & Certification).

**Minimum Wage** - Minimum wage is currently at \$5.15 per hour. Some law makers are trying to increase this to \$5.65 for 1999.

**Health Insurance** - Health insurance for the self employed is 45% deductible for 1998 as an adjustment to the taxpayer's total income. There is proposed legislation to increase this to 100% deductible for 1999.

**Employing Your Spouse & Children** - If you are operating a sole proprietorship, it can be beneficial to employ your spouse and children. You do not have to withhold social security and medicare taxes if your child is under the age of 18. Both the spouse and the children are

of any age if disabled and living in the home).

I will be giving away 1999 pocket calendars during tax season. If you would like one before year-end, please call the office and we'll get one out to you!

exempt from federal and state unemployment taxes. Since family members are earning income, they can contribute to IRA accounts on their own behalf. Even better, a retirement plan can be set up which would reduce the federal tax liability of the sole proprietor and defer income of the employees (the spouse and children).

**Retirement Plans** -Just a reminder that retirement funds are an excellent way to defer/reduce taxes. In order to take advantage of the tax breaks associated with retirement funds, it is necessary to have the fund set up properly within IRS compliance. Meeting with a financial advisor may be helpful so that your specific needs can be addressed. There are **severe** penalties if you have set up a retirement plan and it is not being funded, maintained, or deducted on your income tax return properly.

**Vehicle Mileage Rate** - The mileage rate for 1998 is 32.5 cents per mile. Remember to record your odometer reading on 12/31/98 for ending and beginning mileage documentation.

**Shareholder Loans** - Closely held corporations are regularly subjected to IRS scrutiny because of loans made to stockholders. The IRS often takes the position that the loans are really disguised dividends.

This results in the loan being included in the recipient's income, where it is taxed without an off- setting deduction for the corporation. Usually, some care on the part of the taxpayer can prevent the IRS from asserting that the loan was a dividend. To achieve this:

\*The loan should be authorized in the corporate minutes.

\*A note or debt instrument evidencing the indebtedness should be used.

\*The loan should have a due date and a specific payment schedule.

\*Interest on the loan should be stated.

\*The withdrawal should be recorded on the corporate

books as a "loan receivable".

\*The loan should be repaid rather than extended

when it comes due.  
\*A limit should be placed on the total amount the stockholder may borrow.  
\*Shareholder loans should bear no relationship to the ownership interest of the stockholder.

**Corporate Minutes** - Keeping complete and accurate minutes of your shareholders' meetings may seem like a bothersome task. But, the time

spent now can save your corporation a great deal of money later on. Please take a few minutes to update your corporate books before year-end.

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Please give the office a call if you need any forms or have questions concerning your year-end tax planning issues.