

ANNUAL NEWSLETTER

12904 Harbor Drive
Fairfield Office Park
Woodbridge, VA 22192
Woodbridge, VA 22192

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703/690-4257

703/491-2794

Fax: 703/492-6829

Fax: 703/492/6829



The next tax season is just around the corner and with all of the tax changes that have been enacted into law, I felt it was important to bring everyone up-to-date. Instead of simplifying the preparation of income taxes, the 1997 Taxpayer Relief Act has made things more complex than ever. Twenty-six provisions have been changed retroactively, 114 took effect on August 5th, and an additional 69 will take place in 1998 with five in 1999 and beyond. This update letter will touch on the areas that most commonly affect our client base.

The first bit of news is in regards to a new addition to our staff. We are happy to have on board Laurie M. Barre, CPA who joined us the first week in September. Laurie has an accounting degree from the University of West Florida and 10 years of accounting and tax preparation experience.

In addition to our main metro line (703) 690-4257, we have a new local phone number (703) 491-2794. Please feel free to use either line.

And Now for the Updates....

UPDATE #1 (Capital Gains)

In general, the good news is that the capital gains tax has been reduced to 20% effective May 6, 1997. Assets must be held for more than 18 months to achieve the new beneficial tax rate.

It is possible that with the new rates, some taxpayers may be paying as low as a 10% capital gains tax. The actual calculation of the tax is very complex and depends on the length an asset is held, the date the asset is sold, the kind of asset that is sold (i.e. stocks, collectibles, rental properties), and the tax rate of the taxpayer. Since this is a year of transition, each capital gain that a taxpayer has may need to be

Lifetime Learning Credit - This credit is available for qualifying expenses incurred for any post-secondary education which could include

handled differently.

UPDATE #2 (Gains from Sale of Principal Residence)

A Universal Exclusion for the gain from a principal residence took effect on May 6, 1997. After that date, taxpayers no longer have to worry about buying up to avoid the capital gains on the sale of their personal residence if the taxpayer owned and used the property sold as their principal residence for two years or more during the previous five-year period. An exclusion for the gain of up to \$250,000 for individuals and \$500,000 for married taxpayers is now available. This should eliminate record keeping for capital improvements made to your home for most people. The gain cannot be completely avoided if an office-in-the-home deduction was taken or if the home was used in the past as a rental property.

UPDATE #3 (Educational Incentives)

Clients have been waiting for these educational tax breaks for years. The educational incentives do not begin until 1998! Please be aware that there are phase out limits on these credits for high income earners.

HOPE Scholarship Credit - This is available for expenses that relate to tuition and fees (no room, board, or books) for the first two years of post-secondary education. The credit is available for the taxpayer, the taxpayer's spouse, and the taxpayer's dependent. The maximum annual credit is \$1,500 per student. The credit is only for the first two years of post-secondary education and the student must be at least a half-time student to qualify.

vocational or trade schools. Unlike the HOPE Scholarship Credit, this credit is only for 20% of the expenses incurred. These expenses include

tuition and fees but not books, room, or board. The credit applies to expenses that will be paid starting July 1, 1998! The maximum eligible expenses are \$5,000 annually until the year 2003 (making the maximum available credit = \$1,000). Beginning in 2003 the maximum annual eligible expenses will be \$10,000 (making the maximum available credit = \$2,000). In contrast to the Hope Credit, the student does not need to be at least a half-time student during the year to qualify. The Lifetime credit applies to tuition costs of undergraduates, graduate students, and those acquiring or improving their job skills through a training program.

Educational IRAs

An educational IRA can be set up for individuals under 18 years of age. The maximum amount of contribution allowed annually is \$500. This contribution is nondeductible to the taxpayer, but is distributed tax-free (including the earnings) if the distribution is used to pay qualified educational expenses.

Deduction for Interest on Educational Loans

Interest expenses on qualified educational loans will be deductible as an adjustment to gross income beginning with payments made after 12/31/97. The loan had to be obtained to pay qualified educational expenses of the taxpayer, his or her spouse, or any dependent. The student had to attend at least half-time. The maximum deduction is \$1,000 per year and is limited to the first 5 years of the payments made on the loan.

UPDATE #4 (IRAs)

Under the old law, if a taxpayer was married and either the taxpayer or spouse was covered by a pension plan, the amount contributed to an IRA frequently was not deductible due to phase-outs.

Under the new law if a taxpayer is covered by an employer-sponsored plan but the spouse is not, the noncovered spouse may contribute to an IRA without regard to the phase-out rules. This begins in 1998.

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 for tax years after 1997, there are two new important exceptions:

1) The penalty does not apply for withdrawals up to \$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 only

need not to have owned a principal residence within the two-year period before the purchase of the new home!

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.

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 that the distribution be tax-free, it must be made 5 years after the initial contribution or after the taxpayer is older than 59 1/2, disabled, or using the distribution to pay up to \$10,000 of qualifying first-time home buyer expenses. The annual contribution limit for the Roth is \$2,000 but not more than the taxpayer's earnings.

Contributions can be made to the Roth IRA after age 70 1/2 and the minimum required distribution rules do not apply. Once again this is not available until 1998.

UPDATE #5 (Child Tax Credit)

This credit will not be available until the 1998 taxable year. The maximum credit is \$400 per qualifying child. The credit increases to \$500 for subsequent years. The credit will be phased out for taxpayers above a certain adjusted gross income level.

BUSINESS OWNER'S UPDATES

The first of the year is a good time to have employees fill out new W-4s and make sure you have an I-9 on file for each employee. The penalty for not having the I-9s on file start at \$100 per employee. Please contact our office if you are in need of these forms. As of September 1, 1997 the minimum wage went up to \$5.15 per hour. Virginia has a law that requires the employer to report all new hires within 35 days of hiring that employee. Our office can provide you with the form that is used to inform Virginia of your new employees.

If you are a sole proprietor, you may want to put your spouse or children on as employees to shift income. The family member has to do legitimate work for their compensation. If the spouse is an employee, the company could pay the health insurance premiums for family coverage (making them 100% deductible).

We are currently working on staying up-to-date with all of the changes, but as you can see there

are many. Not every provision is clear as of yet;
and some will have technical corrections

forthcoming, which we will update you on when
necessary.