4-1999

CPA Client Tax Letter, April/May/June 1999

American Institute of Certified Public Accountants (AICPA)

CPA CLIENT TAXLETTER

APRIL / MAY / JUNE 1999

THIS ISSUE

Roth IRAs: Is Converting Still Worth It in 1999?

Last year, you may have heard a lot of hype about Roth IRAs—how to convert a regular IRA to a Roth IRA and the tax advantages of doing it in 1998. The basic Roth IRA rules allow individuals with AGI of $100,000 or less to convert a regular IRA to a Roth IRA at any time, but the amount converted is includable in income in the year of the conversion. However, a special rule allowed taxpayers to roll over a regular IRA to a Roth IRA by the end of 1998 and have the amount included in income spread over four years. For most taxpayers, spreading the tax bill over four years gives them the benefit of using and generating earnings on those tax dollars not yet paid. If you did not convert in 1998, you might feel you "missed the boat" and that it's not worth converting to a Roth IRA now. But if converting to a Roth IRA was worth doing in 1998, it most likely is worth doing in 1999, even without the special four-year rule.

Traditional IRA vs. a Roth IRA

With a traditional IRA, contributions may be tax-deductible, but taxes are owed on the withdrawals. In addition, investors must start taking withdrawals after they reach age 70½. And your heirs must pay *income* taxes on assets inherited in a traditional IRA.

With a Roth IRA, contributions are not deductible against current income, but distributions from Roth IRAs are tax-free if they are received: 1) five years after your initial contribution, and 2) upon reaching age 59½, becoming disabled, purchasing a first home, or due to death. The amount of the distribution that is tax-free includes not only your contributions, but also all earnings on those contributions. Furthermore, there are no minimum distribution requirements, and contributions can be made to your Roth IRA even after you reach 70½. Since there is no mandatory withdrawal schedule, your Roth IRA can continue to grow tax-free, and you can continue to contribute to your Roth IRA as long as you have earned income. Also, your heirs won't pay income taxes on any assets inherited in a Roth IRA. (*Note: Both traditional IRAs and Roth IRAs are subject to estate taxes.*)

Roth IRA basics

Eligibility. Individuals of any age, with earned income below $110,000 for single filers and $160,000 for those married filing jointly are eligible. The contribution limit is phased out for single filers earning between $95,000 and $110,000, and for those married filing jointly earning between $150,000 and $160,000.

Contributions. Unlike a traditional IRA, contributions to a Roth IRA are not deductible against current income. But the

continued on page 2

CPACLIENT
TAXLETTER

Roth IRAs—*continued from page 1*

AGI limit is higher than for traditional IRAs, even if you are covered by an employer-sponsored plan. Like traditional IRAs, you are allowed to make a maximum contribution of $2,000 per year to your Roth IRA. However, your contributions to all your IRAs, including your Roth IRA, are counted toward the $2,000 maximum. If your compensation is at least $4,000, your nonworking spouse can also make a $2,000 contribution.

Distributions. If you decide to take a distribution before 59 1/2, the distribution will first be made out of your contributions, so they will not be subject to tax. However, once you exhaust the amount you contributed and begin withdrawing the earnings, you will be taxed on the earnings, and a 10% penalty may apply if five years have not elapsed.

A Roth IRA is a good way to fund a future expense. For example, you can withdraw all your contributions for the purchase of a first home tax-free after five years, even if you have not reached 59 1/2. This allows you to use your contributions as you need to but still have the earnings continue to grow as a part of your future retirement nest egg.

Determining the five-year holding period. Rolling over to a Roth IRA and using the money at a later period has gotten even easier. The 1998 tax laws changed the way the holding period is determined for qualified rollover contributions. Previously, for each rollover contribution that was made to a Roth IRA, the five-tax-year holding period began with the tax year in which the rollover contribution was made. This meant that each conversion to a Roth IRA had a different holding period. The new law eliminated the separate five-tax-year holding periods. Now the holding period for Roth IRAs will begin with the year in which a contribution is first made to a Roth IRA. A later conversion won't start a new five-year period.

Example: P makes a qualified rollover contribution in year one of $5,000. In years three and four, P makes two more qualified rollover contributions of $15,000 each. In year seven, P turns 59 1/2 and decides to withdraw $20,000. The withdrawal is a tax-free qualified distribution, since the holding period requirement has been met.

Easing the tax burden

The special tax rule for 1998 allowed investors to pay any taxes due on a conversion from a traditional IRA to a Roth IRA over four years. If you didn't

or could not convert in 1998, it doesn't mean you shouldn't convert to a Roth. For example, suppose you converted $50,000 in 1998 and you are in the 33% combined federal and state tax bracket; you would owe $16,500. In 1998, you could have elected to pay the tax over four years. If you convert that same amount in 1999, you must pay the entire amount by the year 2000 filing deadline. But, you could ease the tax burden and get a similar effect by converting a quarter of the amount this year, another quarter next year, and so forth. And because of the new five-year holding rules, the holding period won't be extended if you roll over a quarter at a time.

Making a decision

Whether to convert from a traditional IRA to a Roth IRA is a decision that depends on many factors that vary for each individual, so it is difficult to state hard and fast rules about who should or should not convert. Because so many assumptions have to be made—e.g., expected tax rate at retirement, how many years you will invest, and the expected rate of return—a conversion can be confusing. For example, if your tax rate during your retirement years is likely to decline, it may not make sense to convert, because you would pay a higher rate now than you would pay on your withdrawals from your regular IRA later. But if you also consider how many years you will hold your Roth IRA and the rate of return on it, you

continued on page 3

LIST OF PRIVATE DELIVERY SERVICES UPDATED

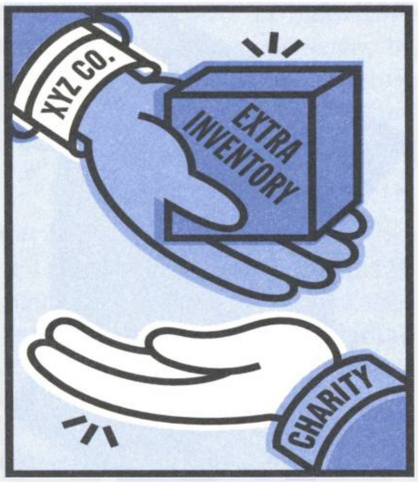
In 1997, the IRS announced that certain private delivery services, and not just the U.S. Post Office, could be used by taxpayers and qualify for the "timely mailing as timely filing-paying" rule, e.g., if your return is postmarked by the filing date, it is considered timely filed. The IRS has reissued, without changes, the list of permissible private delivery services that qualify. Only the following companies qualify:

- **Airborne Express:** Overnight Air Express, Next Afternoon Service, Second Day Service.
- **DHL Worldwide Express:** DHL "Same Day" Service and DHL USA Overnight.
- **Federal Express:** FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day.
- **United Parcel Service:** UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M.

Your Business and Taxes: How to Deal with Excess Inventory

For many businesses, a common year-end problem is excess inventory. Excess inventory can be costly since it takes up valuable storage and warehouse space, requires safeguarding, and needs continuous recordkeeping for accounting purposes.

Generally, the IRS does not allow a deduction for this type of inventory, unless it is actually sold or discarded. Tax regulations do allow a taxpayer to value goods at bona fide selling prices, minus the direct cost of disposition, for finished goods in inventory "which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange." "Bona fide selling price" means the actual offering price of the goods during the period ending not later than 30 days after the year-end. Many taxpayers cannot satisfy these requirements, so they cannot take the tax deduction under these rules.



However, in certain situations, you can get a tax deduction by donating the inventory as a charitable contribution. C corporations (but not S corporations) can do so without the requirements of "bona fide selling price" rules. This deduction can exceed the cost basis of the donated goods. S corporations and other entities may only deduct the cost basis of inventory given to charity.

In order to be able to take the deduction that is not limited to cost basis, i.e., a "qualified contribution," four conditions must be satisfied:

1) The use of the property by the charity is related to the charity's purpose or function and the property is to be used by the charity solely for the care of the ill, the needy, or infants.

2) The property is not transferred by the charity for money, other property, or services.

3) The donor-corporation receives from the charity a written statement representing that its use and disposition of the property will conform to 1) and 2) above.

4) If the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable FDA requirements on the date of the transfer and 180 days prior thereto.

The amount of the tax deduction for a qualified contribution of inventory to a public charity is the cost of basis of the property plus one-half of the excess of the property's fair market value. For example, if the cost basis of the inventory is $5,000, and the fair market value is $9,000, then the allowable deduction would be $7,000.

If meeting all the requirements for a "qualified contribution" seems too time consuming, consider using an intermediary charitable organization. This can be very helpful in satisfying the requirement for the property to be used, directly or indirectly, for the care of the ill, the needy, or infants. These organizations are skilled at redistributing various types of property to qualified charities that meet all the requirements, and generally they do not charge the donor corporation a fee for their services.

One such organization is the National Association for the Exchange of Industrial Resources (NAEIR). They can be contacted through their Web site at http://www.freegoods.com or at 1-800-562-0955. They will send you a free information packet detailing what you need to do.

1999 DOLLAR LIMITATIONS FOR QUALIFIED RETIREMENT PLANS

The Internal Revenue Code provisions regarding qualified pension and profit-sharing plans contain many dollar limitations that are adjusted annually. For 1999, the limitations are as follows:

- The maximum elective deferral under a Section 401(k) or Section 403(b) plan remains at the 1998 level of $10,000.
- The maximum elective salary deferral under a SIMPLE plan remains unchanged at $6,000.
- The maximum annual benefit for a defined benefit plan remains unchanged at $130,000.
- The annual limit on contributions to a defined contribution plan remains the same at $30,000.
- The maximum annual compensation that may be used for determining a) benefits under a defined plan, or b) contributions under a defined contribution plan, remains at $160,000.
- For certain types of plans, nondiscrimination testing to identify "highly compensated employees" must occur. A highly compensated employee is someone who was a 5% owner at any time during the current or preceding year or someone who had compensation from the employer in excess of $80,000 for the preceding year. This 1998 limit of $80,000 remains unchanged. If an appropriate election is made, a person making over $80,000 in the preceding year will not be deemed a highly compensated employee if the person was not in the group of employees that made up the top 20% of employees ranked by compensation paid during the preceding year.

Roth IRAs—*continued from page 2*

might get a better result from converting now, even if your tax rate declines. If you are still in doubt about converting your traditional IRA to a Roth IRA, remember, you can just open a new Roth IRA and contribute directly to it.

If you have any questions regarding Roth IRAs or are unsure whether it might be to your financial advantage to convert from a traditional IRA to a Roth IRA, please contact our office.

CPACLIENT
TAXLETTER

Y2K, TAXES, AND THE IRS

Deducting costs

What do you do if you have a Y2K problem in your business and you incur costs fixing it? How do you treat it for tax purposes? Currently, the tax law allows you to deduct most software development costs. However, not all costs involved in fixing the problem will be connected to software development. Some will be related to hardware, labor, and consulting, which may be more difficult to classify. Some could be considered replacement costs—for example, replacing a computer chip. However, if you have to replace an entire system, the IRS may consider it part of a renovation plan and require the company to capitalize and amortize the costs. For tax purposes, make sure any fixes to your computer system are well documented and properly characterized.

1999 tax season at the IRS

Extra care should be taken when sending anything to the IRS next year. IRS Commissioner Rossotti says he doesn't expect a meltdown at the IRS due to Y2K problems, but he is concerned about "localized" problem areas. Therefore, businesses should be especially careful when sending tax-related data and funds to the agency next year. Businesses should also sit down now with IRS personnel and review potential problem areas to ensure that information and funds are being recorded properly and credited to the correct account. Individual taxpayers should send their returns and correspondence for the IRS by registered or certified mail, return-receipt requested, as evidence of mailing.

Year 2000: Plan Now to Prevent Headaches Later

By this time, you have heard and read endless stories about the "year 2000 problem" (also known as the Y2K problem). This problem can occur in computer programs where the year has been entered as two digits instead of four, e.g., '98 instead of 1998. Computers and mechanisms with a two-digit year field in its memory will read the year 2000 as the year 00. This could cause the program to go to its "default" setting, and depending on the program, may cause no problems or some large ones. The Y2K problem will not only affect personal computers but may include accounting software, computer operating systems, programs that run VCRs, time-controlled vaults, and hundreds of other types of date-dependent electronic equipment and programs with a two-digit year field instead of four-digit field.

Hopefully, you have already ensured that your personal and business computer systems are compliant, and that you have back-up plans in case they are not. But you may have not considered other areas of your business or personal life that could be affected. These "small things" could have a big impact on your daily life. For example, if you are in an office or apartment building, check with the landlord or management company to see if the building systems, such as security systems, elevator, etc., are compliant.

Local taxes and utilities

Other areas to look into are local taxes and utilities. Some local entities may have started too late to fix the Y2K errors in their programs, or might be taking a "wait and see" attitude. As a result, some home or business owners may receive bills for payments they have already made. To protect yourself, make sure you keep payment records and check any new bills for discrepancies. And you should also keep a photocopy of the bill and the check that is sent as payment.

Almost every company has a telephone/voice mail system, and all should be checked to make sure they are Y2K compliant. If the system is not corrected, it could put out the wrong message on the wrong day. For a small business that is dependent on phone orders, this is a major problem; billing details could be erroneous, and date-stamped messages in voice mail could also be incorrectly recorded. To find out if your phone system is compliant, call your vendor or look at its Internet page.

Miscellaneous hardware devices

Many individuals now own personal digital assistants (PDAs) or sophisticated calculators. All of these should be checked for compliance. Other hand-held devices, such as ones used for inventory control or point-of-sale ordering, must be considered as well. One large area of concern for credit card companies are the credit card readers that many retail vendors have—many are not compliant and should be tested. When credit card companies began issuing new cards with a '00 expiration date a few years ago, many

continued on page 5

IRS Addresses Deductions for Commuting Between Home and Workplace

On January 15, the IRS issued Revenue Ruling 99-7, discussing the deductibility of daily transportation expenses of a taxpayer who commutes between his or her residence and a work location.

Section 162(a) of the Internal Revenue Code allows a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business. But Section 262 prohibits any deduction for personal, living, or family expenses. Commuting between a residence and a place of business is usually considered a nondeductible personal expense.

However, a third provision, Section 280A(c)(1)(A), allows a taxpayer an expense deduction for that portion of a residence that is used on a regular basis as the principal place of business for any trade or business. Generally, the costs of going between one business location and another business location are deductible.

The new revenue ruling outlines three exceptions to the general rule that transportation expenses between a residence and place of business or employment are nondeductible:

1) Expenses incurred in going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works.

2) Expenses incurred going between the taxpayer's residence and a temporary work location in the same trade or business in which he or she has one or more regular work locations away from the residence.

3) Expenses incurred going between the residence that is his or her principal place of business within the meaning of Section 280(c)(1)(A) and another work location in the same trade or business, regardless of the distance or whether the work location is regular or temporary.

This revenue ruling also modifies the definition of temporary work location in regard to the above three exceptions. A work location is temporary if employment there is realistically expected to last—and does in fact last—for one year or less, absent facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last more than one year, or there is no realistic expectation that the employment will last for one year or less, the employment is not temporary.

Year 2000—*continued from page 4*

card readers were found to be non-Y2K-compliant. The best way to check these devices is to contact the manufacturer or visit the manufacturer's Web site and search for Y2K instructions.

Who else do you depend on?

Does your local town or county have emergency plans? Do you know what they are? In your business, are your customers and suppliers compliant? Even if your company does not have bugs of its own, it may be affected by the problems of suppliers, customers, business partners, and others. One way to protect your business is to ask your associates about their potential Y2K problems and how they are handling them. It will serve both of you to make contingency plans. No one can guarantee that they've fixed all their Y2K problems until the day actually arrives, so it is best to be prepared for anything.

Don't correct a failing system

Y2K should not be looked at as just a problem but also as an opportunity. Suppose you installed a software inventory system seven years ago that was to clean up your inventory woes, but ended up giving you more problems than it solved. Now, in addition, it has a Y2K problem. Instead of trying to fix a system that doesn't work for you, perhaps the Y2K issue is a good reason to change systems. Any new or updated software program should guarantee that it has no Y2K issues. You can then concentrate on things that will truly help your business, such as better inventory tracking, faster order fulfillment, and so forth.

Review documents regularly

If you normally throw away your bank, mutual fund, and other financial statements unopened or stick them into a shopping bag or drawer, take the time to change your habits by mid-year. Start now to review these statements regularly, so that in January 2000 you will be able to go back and check against your 1999 statements to ensure that your accounts are being properly credited and maintained.

Take, for example, bank statements. Begin by checking new statements against old ones and reconciling your bank account; this is the way to catch any computer-related errors. If there is a discrepancy, you can show the checks you wrote and how you reconciled the statement. In addition, verify that any direct deposits or payments have been credited to your account. While a bank failure is not likely, the FDIC reminds depositors that accounts are insured up to $100,000 at any one insured institution. The federal insurance program may also cover deposits over $100,000 at one bank if some of the money is held in different types of ownership accounts, such as a joint account or a retirement account.

CPA CLIENT
TAX LETTER

New Social Security Thresholds for 1999

The Social Security Administration (SSA) has announced that the maximum earnings subject to Social Security tax will rise in 1999 to $72,600, up from $68,400 in 1998. The employee rate of Social Security tax will remain the same at 7.65%.

For recipients of Social Security, the cost-of-living increase will be 1.3%, the lowest in 11 years. But the amount of exempt retirement earnings will rise in 1999; individuals ages 65 to 69 will be able to earn up to $15,000 a year without a reduction in Social Security benefits. Retirees under 65 will be able to earn up to $9,600 a year.

For 1999, a self-employed person with income up to $72,600 is taxed at a rate of 15.3%; 12.4% is for the basic, old-age survivors and disability insurance, and 2.9% is for the Medicare hospital insurance. On all self-employment income above $72,600, only 2.9% is paid. In computing the amount of self-employment income subject to the rates listed above, a deduction of 7.65% of net earnings is allowed. This means that the 12.4% and 2.9% rates are really applied to 92.35% of net earnings from self-employment. (Net earnings are computed without this deduction.)

For income tax purposes, an individual is allowed to deduct one-half of the self-employment tax in computing adjusted gross income. This reduction of adjusted gross income will decrease the loss of itemized deductions (these deductions must be reduced by 3% of adjusted gross income over $126,000) and also reduce income taxes at the marginal tax rate.

If you don't think that keeping tabs on what you pay in Social Security is important, remember that mistakes in crediting your Social Security account can happen and any mistakes must generally be corrected within three years and three-and-a-half months. To verify the accuracy of your account, you can periodically obtain a statement of earnings credited to your account from the SSA. The SSA will provide a free personal earnings and benefits estimate upon request. This statement shows estimates of your monthly retirement benefits, the benefits your survivors would receive after your death, and your potential disability benefits. The request can be made by mailing a "Request for Earnings and Benefits Estimate Statement" (Form SSA-7004) to the SSA. To obtain a form, call 1–800–772–1213. You can also request an estimate through the SSA's Web site at www.ssa.gov.

1999 Standard Mileage Rate Reduced, Effective April 1

In December 1998, the IRS announced that it was lowering the automobile standard mileage rate for 1999 to 31 cents. In early 1999, the IRS followed up by announcing that it was delaying the effective date of this change to April 1, 1999. The IRS postponed the effective date because of complaints it received that more time was needed to implement the new rate. The lowering of the mileage rate is unprecedented, but the IRS explained in its original announcement that it was due to reduced oil prices and operating costs. The agency also indicated that an additional reduction might occur in 2000.

The standard mileage rate for use of a car to obtain medical care or in connection with a job-related move remains at 10 cents per mile. The mileage rate for charitable use of a car also remains at the 1998 figure of 14 cents per mile. For 1999, the fixed and variable rate method that employers may use to reimburse employees for the business use of their personal cars remains at its 1998 level of $27,100.

* * *

1999 Per Diem Rates

Although the standard mileage rate was reduced, the IRS increased the per diem rates for business travel away from home for 1999. The per diem rate increases from $180 to $185 for travel to any high-cost locality, and from $113 to $115 for travel to any other locality within the continental United States.

In addition, the rates for meals and incidental rates under the optional high–low method have increased from $40 to $42 for high-cost localities and from $32 to $34 for other localities. The annual revision of the list of high-cost localities also contains some notable changes. For example, Los Angeles has been removed from the high-cost list.