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Client Information Bulletin

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Handling Travel Expenses with an Accountable Plan *Four steps to avoiding potential tax problems*

INSIDE

Tax Points for Departing Employees

Protecting Your Computer from Viruses

Protect Your Privacy When Sharing a Computer

Estate Planning for Collectibles

Facts and Figures

Keeping track of business travel expenses can be time consuming, but that's only half the story. As an employee, you may be taxed on cash advances or reimbursements for travel expenses, even if you are an owner of the company. To make matters worse, any deductions for your unreimbursed expenses must be claimed as miscellaneous expenses subject to a 2%-of-adjusted gross income (AGI) threshold.

Fortunately, both employers and employees can avoid tax pitfalls if the company establishes an “**accountable plan**” for travel expenses. With an accountable plan, the employer may deduct the reimbursements without incurring any payroll tax liability. The

employee owes no tax on the payments and avoids tax return complications. It's a win-win situation.

To qualify as an accountable plan, the plan must be established in **writing** and meet the following requirements:

1. Business connection: There must be a **valid** business connection to the reimbursements. For instance, the payments must cover expenses that would have been deductible if they had been paid by the employee and that the employee is reasonably expected to incur. On the other hand, if your company provides cash advances to an employee who never travels, the payments are treated as taxable compensation.

2. Separate payments: The reimbursement must be **separate** from other payments or, at the very least, the reimbursement must be identified separately from the other payment amounts included in the same check.

3. Documentation: The employees must provide the same basic records that are required to substantiate deductions on their tax returns.

4. Return of excess reimbursements: Employees must be required to return, in a reasonable period of time, advances that exceed substantiated reimbursements. **Note:** As long as an accountable plan meets the first three requirements, only the excess payments will be treated as compensation subject to tax.

If your company reimburses employees for their travel expenses, you may use an IRS-approved per diem allowance for lodging, meals and incidental expenses, instead of paying the actual amount of expenses. The **per diem allowance**

automatically satisfies the requirements for accountable plans. Employees must still provide records of the time, place and business purpose of the trip, but they don't have to account for amounts spent while they were traveling on business. However, a per diem allowance cannot be used for an employee who has a 10%-or-more interest in the company.

The per diem allowance used by the company may be based on either (1) the amount that the federal government uses to reimburse its employees or (2) a **"high-low"** rate for specific destinations. For 2004, the per diem for designated high-cost areas is \$207 (\$161 for lodging only); it's \$126 (\$90 for lodging only) for all other areas. Your company may choose either of these two methods for a particular employee.

Reminder: *The IRS often scrutinizes deductions for employee travel expenses. By using an accountable plan, your company should be able to avoid potential tax problems.*

Tax Points for Departing Employees

Understanding key rules can ease the transition

Whether you are being downsized or are moving on up to a new job opportunity, leaving a job can be disconcerting. As a result, taxes are probably the last thing on your mind. Nonetheless, there are some key tax rules you should bear in mind—and some important tax decisions you will have to make.

Severance pay: Pay is the operative word when it comes to severance. Severance pay is **taxable** like any other compensation for employment. In addition, severance pay is generally subject to Social Security and other employment taxes.

Job-hunting expenses: As a general rule, job-hunting expenses are treated as **miscellaneous** itemized expenses, which are deductible to the extent that they exceed 2% of adjusted gross income (AGI). Deductible expenses may include classified ads, employment agency fees, job counseling and referral services, professional career-consultant fees, resumes (including printing and postage), long-distance toll calls connected with a job search and travel expenses.

Retirement plan payouts: A job change often involves a payout from a former employer's qualified retirement plan. A plan payout is generally taxable and will be subject to a **10% penalty** if it is received before age 59½. However, no tax is due if a payout is properly rolled over into an IRA or another eligible plan.

Rollovers fall into two types: (1) a direct, trustee-to-trustee, rollover and (2) an indirect rollover. With an indirect rollover, the plan participant receives a payout check and has 60 days to deposit it in an IRA or another eligible plan.

However, unless you have a pressing need for temporary access to the funds, a direct rollover is generally preferred. With an indirect rollover, the former employer's plan must withhold a **20% tax** on the payout. However, to avoid tax, you must place an amount equal to the entire payout—including the amount withheld—into the IRA or new plan. So if you choose an indirect rollover you will have to use other funds to make up the 20% withheld and then wait until your tax return is filed to get a refund. With a direct rollover, there is no withholding and you are never out of pocket.

Health care coverage: Continuing health coverage during a hiatus between jobs or making sure there is no coverage gap between employer plans is often of primary importance to job changers.

The **Consolidated Omnibus Budget Reconciliation Act** (COBRA) health care continuation coverage rules require most employer-sponsored group plans (other than plans of employers with fewer than 20 employees) to offer continued health care coverage to employees and their dependents following termination of employment for up to 18 months. COBRA coverage generally must be offered whether an employee resigns voluntarily or is involuntarily terminated. However,

COBRA coverage generally is not a “freebie.” An employer can charge 102% of its cost for the coverage. COBRA premiums are **deductible** medical expenses. However, medical expenses are deductible only to the extent they exceed 7.5% of AGI, so many taxpayers do not benefit from the deduction.

A terminated employee should receive notice of COBRA continuation rights

within **45 days** of termination of employment and will have 60 days after that to elect coverage. Once elected, COBRA coverage is retroactive to the date of termination of employment.

Therefore, you may be able to take a wait-and-see approach to electing coverage. For example, if a new job with health coverage is in the offing, a COBRA election may be unnecessary.

Protecting Your Computer from Viruses

Following these six precautions can save you time and money

Every year millions of people come down with viruses that prevent them from working and can cost companies billions of dollars. Your computer can get a virus, too. And just like the sniffles and fever that you may catch, a contaminated computer can bring your work to a halt and infect others.

A computer virus is a **software program** that is often attached to a legitimate program or e-mail. Its creator may disguise the virus with the name of a game, an image or a title such as “Call me.” The bug can load onto your computer without your knowledge, and then it can use up memory, slow down operations or cause your system to stop working completely.

There are about 60,000 known viruses with approximately 500 more surfacing each month. These invasions cost companies tens of billions of dollars each year due to lost worker productivity, data repair and bug-killing software. And they are becoming more destructive.

One recently circulating virus, titled W32/Mydoom@MM, is a high-outbreak-risk, mass-mailer that has flooded e-mail servers worldwide. When it is run, it can steal addresses from your computer and automatically send e-mails that will appear to be from you. The recipients will believe that you are the sender and open the message. The virus infects their computers, the damage spreads and the cycle repeats itself.

The government has **passed laws** against unleashing computer viruses and promises that enforcement will get tougher. However, only a handful of offenders have been prosecuted. Therefore, you need to assume the responsibility of protecting your computer and ridding it of any viruses that it may get.

You can start with the following precautions at home and at work:

- 1.** Install anti-virus software. Continually run the programs and keep them current.
- 2.** Keep your computer updated with the latest information from your operating system’s program provider.
- 3.** Don’t open suspicious e-mails or files.
- 4.** Regularly back up files that you cannot afford to lose.
- 5.** Only install software and download files from legitimate, commercially distributed sources.
- 6.** Do not share software with anyone. Not only may it be against the law, it is also a way to spread viruses.

Just because your computer is acting strangely does not mean that there is a virus. But if you haven’t used a good, up-to-date anti-virus program, do that first. It may turn out that there are software configuration errors or other problems that have nothing to do with a virus. Nevertheless, if you find that there is a virus, follow your anti-virus

program's instructions for getting rid of it.

There is no exact figure on the amount of damage that computer viruses have caused throughout the world. And

businesses and governments are fighting an uphill battle to stay one step ahead of the perpetrators. Therefore, keep on your toes and you'll stand a much better chance of protecting your system and to avoid becoming a statistic.

Protect Your Privacy When Sharing a Computer

If you share your machine with others such as co-workers or family members, you should take precautions to ensure that your information stays private.

- ◆ Use removable disks to store sensitive files so no one else can access them.
- ◆ Empty the recycling bin after you delete files. See if your computer or virus-scanning program has an option to completely erase files.
- ◆ Delete your e-mail address and all e-mails when using web-based e-mail. Your server may have an option that automatically drops your address from its memory when you close the browser.
- ◆ Clear your memory cache after browsing. This will ensure no one will know where you have been on the Web.
- ◆ Create unique passwords that would be difficult to guess. Enable password protection on files and folders.
- ◆ Avoid entering personal information when using public terminals.

Finally, use common sense. Before you turn off the computer, think about what you have recently done and how much of that you would really want the next user to see.

Estate Planning for Collectibles

Special assets require special consideration

Estate planning is about passing your possessions to those whom you leave behind. Stocks, bonds and other financial assets are generally simple to transfer. Also, because they are easily valued, there is usually no dispute with the IRS or among your heirs as to what a particular asset is worth. Your collectibles, however, could be a different story. Without **special preparation**, your antiques, paintings and other prized valuables could become a source of frustration, added expense or even disputes within your family.

It's hard to put a value on many collectibles. Furthermore, the tax laws on disposing or transferring of such assets have become more complex. Other problems can arise if your estate does not have **sufficient** liquidity to pay taxes and has to sell your collection. And if you want to divide the property among the next generations, they may end up squabbling and even end up in court.

You could sell your collection. But any long-term capital gain on collectibles is subject to a maximum tax rate of 28%, rather than the 15% rate that applies to many other assets. However, if you still want to sell, be sure to look at your total portfolio. It may make sense to also sell investments that have a loss and use those losses to offset your collection's gains.

On the other hand, you might consider keeping your collection to enjoy and passing onto your family. You could set up a **separate entity**, such as an S corporation, a limited liability company or a trust, to hold your possessions. The entity would maintain inventory and document expenses. In addition, it could possibly reduce the size of your taxable estate or act to purchase life insurance to help pay estate taxes.

Another option is to give your collection to a charity while you are alive. You'll get an immediate income tax deduction, reduce your taxable estate and help a worthy cause. The amount of the deduction varies depending on the gift and "**related use**" of the charity. Make sure you receive professional advice beforehand.

Thinking about what will happen to your prized possessions after you are gone is not an easy task. Nevertheless, taking the time to consult with your advisors and family will assure that your current needs will be met and your collectibles will pass to those who cherish them the most.

Facts and Figures

Timely points of particular interest

- ➔ **Physical Demands**—In a new case, a talent agent received four substantial monetary payments in the settlement of a lawsuit for breach of conduct. However, the agent was not able to prove he suffered a physical injury or illness as a result of his termination. Since the tax law was changed in 1996 to require this proof, he is liable for tax on the three payments received after the law changed (Polone, T.C. Memo 2003-339).

- ➔ **Contingent Fees**—The Second Circuit Court of Appeals has ruled that the full amount of a jury award in a wrongful termination case is taxable. The taxpayer, a resident of Vermont, received a \$900,000 payout before his law firm took a \$300,000 cut for its attorneys' fees. Since the taxpayer controlled the lawsuit, he was liable for tax on the full amount. The circuit courts remain divided on this issue (Raymond, CA-2).