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Client Information Bulletin

INSIDE

**Taking Precautions Against
Employee Embezzlement**

**Be Aware: Your Computer
Is Watching You**

Locking in the Home-sale Exclusion

Facts and Figures

Two New Tax Acts Take Center Stage

New laws play a key role in tax planning

Just before it adjourned for the national elections, Congress passed two significant new tax laws in rapid succession. The first new law, the **Working Families Tax Relief Act of 2004**, extends several key tax breaks for individuals and businesses that were set to expire at the end of last year. The second, the **American Jobs Creation Act of 2004**, has been called by some the most significant corporate tax law in the last 20 years.

Act I: The Working Families Tax Relief Act of 2004

The new **Working Families Tax Relief Act** revives and enhances a number of important tax provisions. Here are some of the highlights:

Alternative minimum tax (AMT): The AMT continues to affect a large number of middle-income and upper-income taxpayers. The complex AMT calculation involves various technical adjustments and an exemption amount based on the taxpayer's filing status. For 2003 and 2004, the exemption amount had been temporarily increased to \$58,000 for joint filers (\$40,250 for single filers), but it was then scheduled to drop to \$45,000 for 2005 (\$33,750 for single

filers). The new law preserves the higher exemption amounts for another year.

Child tax credit: The child tax credit can be claimed by parents for a qualified child who is under the age of 17. For 2004, the credit is \$1,000 per **qualified** child, but this figure is scheduled to be reduced to \$700 next year. Under the new law, the credit remains at \$1,000 per qualified child for the next five years.

Expanded tax brackets: The 10% income tax bracket was initially expanded only for the 2003 and 2004 tax years. This expansion effectively reduces taxes for individual taxpayers across-the-board. Under the new law, the first \$14,000 of income for joint filers is taxed at the 10% rate (\$7,000 for single filers). The new law keeps this tax break intact through 2010.

Marriage penalty relief: Similarly, the new law retains an expanded 15% tax bracket for joint filers for the next four years in order to provide a measure of tax relief from the so-called “marriage penalty.” It also preserves a higher standard deduction for couples who may be affected by the marriage penalty.

Research and development credit: The incremental credit for research and development expenses, which officially expired on June 30, 2004, has been extended for yet another year. However, Congress steadfastly refused to make the credit available to more companies.

Business tax incentives: The new law also extends more than 20 other tax incentives for businesses, including the welfare-to-work and work opportunity tax credits, environmental remediation

expensing, enhanced deductions for corporate contributions of computers to schools and libraries, and a wide range of energy-conscious provisions.

Finally, the new law includes numerous technical corrections and clarifications of issues ranging from the tax definition of dependents to the applications of carrying back net operating losses.

Act II: The American Jobs Creation Act of 2004

Following close on the heels of the **Working Families Tax Relief Act**, the **American Jobs Creation Act** cracks down on various corporate and individual tax shelters and certain other perceived abuses. On the other hand, it also provides tax incentives for a wide range of businesses and individuals as well as special tax breaks for certain industries. The new law generally takes effect in 2005.

Here are some of the key provisions of general interest to businesses and individuals.

Corporate tax cuts: The new law effectively cuts tax rates by 3% for qualified domestic manufacturing companies, phased in through 2010. Other businesses still face a top tax rate of 35%. The tax cut helps to offset the elimination of a special tax exclusion affecting large exporters.

S corporations: The new law adopts a package of reforms for S corporations, including an increase in the maximum number of shareholders allowed from 75 to 100. In addition, family members can elect to be treated as a single owner.

Section 179 allowance: The maximum Section 179 expensing allowance, which had been quadrupled from \$25,000 to \$100,000 by tax legislation in 2003, was scheduled to revert to the \$25,000 figure after 2005. The new law preserves the maximum \$100,000 allowance (with inflation adjustments) through 2007.

Sport utility vehicles (SUVs): In a related provision, the maximum expensing allowance for SUVs weighing between 6,000 and 14,000 pounds is reduced to \$25,000. **Note:** An SUV that was placed into service before the new law's date of enactment still qualifies for the higher allowance.

Nonqualified deferred compensation: The new law codifies and clarifies the tax rules for nonqualified deferred compensation plans. It imposes strict new requirements and could result in current taxation and penalties for taxpayers who fail to meet these requirements.

Leasehold improvements: The new law allows landlords to write off improvements over 15 years using the straight-line method. This new tax break is available for improvements made after the date of enactment and before 2006.

Note: The faster depreciation period is also available to restaurants.

Charitable donations of cars: Beginning in 2005, the charitable deduction for a donation of a car generally will be limited to the amount of the proceeds received by the sale of the vehicle. In addition, the donor must obtain a written acknowledgement from the charity. The new rules also apply to donations of boats and planes.

State sales taxes: Under the new law, you can choose to deduct either your state and local income tax or your state and local sales tax -- but not both. This new tax break is especially valuable to residents of states with no or a low state income tax. It is available on 2004 and 2005 returns.

Damage awards and settlements: Taxpayers involved in discrimination lawsuits can deduct attorney fees above-the-line for judgments and settlements after the date of enactment.

***Reminder:** This is just a brief overview of the two new tax laws enacted at the end of last year. Consult with a tax adviser for the impact on your situation.*

Taking Precautions Against Employee Embezzlement

Four potential steps to combat the threat from within

While business owners may be quick to look for ways to cut costs, they are often oblivious to signs of embezzlement. Unfortunately, this problem is usually compounded when the criminal activities involve trusted employees.

How can you protect your company from the "threat from within?" A good place is to start with an examination of

your **bookkeeping procedures**. Be sure to completely separate the accounts payable from the accounts receivable. In addition, have two employees handle the payroll -- one to write the checks and the other to distribute them. Having just one person handle both of these critical jobs may provide an irresistible temptation to embezzle.

Furthermore, the owner of a small business should approve all checks **over a certain amount**. Payments should be made with an original invoice -- not a copy. Finally, have all bank statements reconciled and audits performed periodically.

Of course, even with these safeguards in place, there is no guarantee that you will not be victimized. What should you do if you find out an employee has embezzled from the company? Consider these four steps.

- 1.** Consult with an attorney to find out the civil and criminal legal remedies that may be available to you. For instance, you might sue the employee to recover the embezzled money.
- 2.** Contact the authorities. Frequently, owners feel partly to blame for allowing the theft to take place, but hiding it does no good. In most cases, the employee will simply move on to the next victim and you will be left holding the bag.
- 3.** Try to recover the funds. Reporting the crime doesn't mean you will be reimbursed in full. Before paying claims, insurance companies want solid proof of embezzlement, which is not always easy

to provide. For example, when inventory is stolen, it is hard to show that the loss is actually theft and not an inventory mistake.

One possible way to get your money back is to have the dishonest employee return it. If the employee is basically an honest person, he or she may jump at the opportunity to make restitution in exchange for another chance. **Caution:** If you allow the employee to stay on and you suffer another loss, be aware that your insurance claim on that loss will most likely be denied. The insurance company may consider your actions as a conscious business risk.

- 4.** Notify the IRS about the embezzlement. This becomes an added incentive for the employee to make restitution, since embezzled funds are considered to be taxable income. If you report the crime to the IRS, the employee will owe tax on the total amount stolen. This amount will be reduced to the extent that restitution is made by the employee.

***Final note:** If your business involves sensitive matters or security is a critical issue, you might obtain a bond to cover your employees as a precautionary measure.*

Be Aware: Your Computer Is Watching You

How so? The identification numbers that track the activities on web sites you visit -- known in technology parlance as “cookies” -- may be passed to your computer. A web site that places a cookie keeps a database of all the computers visiting that particular site. While some sites track their cookies internally, others track your cookies wherever you travel on the information highway, mainly for advertising purposes.

Note that cookies are not always a bad thing. For example, if a particular web site tracks your activities, it may offer goods or services similar to the offerings you have investigated before. This may simplify or even improve your online shopping habits.

On the other hand, you might prefer to use your computer without being “spied” upon. In that case, you may refuse cookies or request notification of their presence from web sites that you visit. Depending on the site, access may be restricted when you make this choice.

Locking in the Home-sale Exclusion

New regulations focus on partial exclusions

Under the giant home-sale exclusion, you can realize a tax-free gain of up to one-half million dollars when you sell your principal residence. Now the IRS has issued new final regulations that make it easier to qualify for a **partial exclusion** if you sell your home due to a change in circumstances (IRC Reg. Sec. 1.121-3).

How it works: If you sold your home in 2004, you can elect to exclude from tax up to \$500,000 of gain (\$250,000 for single filers) from the sale. To qualify for this tax exclusion, the home must have been owned by you and used as your principal residence at least two of the five years prior to the sale.

However, if you fail to meet the “ownership and use” requirements or you sold another home within the last two years, you can still qualify for a partial exclusion if you sell your home under an IRS-approved “safe harbor.” In that case, the maximum gain that can be excluded

from tax is **pro-rated**, based on the time spent in the home.

The new final regulations clarify the rules for claiming a partial exclusion through three safe-harbor methods.

1. If the home sale is due to a change in employment, you qualify if your new job is located at least **50 miles** further from the sold home than the home was from your previous place of employment (or there is at least 50 miles distance between the new job and the sold home if you didn’t previously have a job).

2. The sale is treated as having occurred by **reason of health** if the sale is due to the treatment of a specific illness or disease or the sale is based on the recommendation of a physician. However, a move for general health benefits does not qualify.

3. You may qualify for a partial exclusion if the sale is due to **unforeseen cir-**

circumstances from an event that you “could not have reasonably anticipated.” The IRS will approve a partial exclusion if the sale was made under the following circumstances:

- ◆ An involuntary conversion of the residence;
- ◆ Natural or man-made disasters, acts of war and acts of terrorism that result in a casualty to the residence;
- ◆ Death, divorce or legal separation of a qualified individual;

- ◆ Loss of employment where a qualified individual is eligible for unemployment compensation or if change in employment status renders the individual unable to pay housing costs and reasonable basic living expenses; or
- ◆ Multiple births resulting from the same pregnancy.

Note: The new regulations generally apply to sales after August 12, 2004. However, if you would otherwise qualify for the exclusion of a sale after May 6, 1997, you can apply the rules retroactively and file an amended return.

Facts and Figures

Timely points of particular interest

➔ Social Security Tax -- The Social Security Administration has announced the annual increases in the Social Security wage base. For 2005, the first \$90,000 of wages is subject to the 6.2% Old Age, Survivors and Disability Insurance (OASDI) portion of the tax. The 1.45% Hospital Insurance (HI) portion applies to all of your wages. The tax rates are doubled for self-employment income, but self-employed individuals can deduct half of the tax they pay.

➔ No Tax Cheer -- The cost of “diminimis” fringe benefits provided to employees is exempt from tax. This includes an employer’s gift of a ham, turkey or fruit basket around the holidays. However, in a new Technical Advice Memorandum, an employer gave each of its employees a \$35 gift coupon that could be used in several grocery stores. Since the coupons had an ascertainable value, the IRS said the benefits were subject to tax.