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Client Information Bulletin

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Know the Tax Boundaries for Investment Interest

Critical decision may be made on your tax return

There are times when it may make sense to borrow money to make an investment. Can you deduct the interest paid on the loan for your personal tax return? The short answer is “yes,” but there are limits on the deduction.

To further complicate matters, you may have to make a crucial decision at the time you file your tax return. It involves the tax treatment of capital gains and dividends.

Basic rules: You may only deduct investment interest that is directly attributable to investment purposes. For instance, if you take out a loan for a personal vacation, the interest is nondeductible. It is a purely personal expense.

If a loan is made partially for investment purposes and partially for personal reasons, you must make an allocation based on the appropriate percentage. Your tax adviser can help with the necessary calculations.

Qualified interest may be deducted on your personal tax return only up to the amount of your net investment income. This is the amount of your investment income reduced by investment expenses other than interest.

For purposes of this tax law limit, investment expenses are income-producing expenses that are allow-

able deductions after applying the 2% limit on aggregate miscellaneous itemized expenses. A few examples of these deductible income-producing expenses are certain fees for investment advisory services, safe deposit box rentals (for investments other than tax-exempt securities), etc.

Investment income includes such items as interest, dividends, royalties, gains from sales of investment property and income from annuities. However, net long-term capital gain and dividends qualifying for the preferential tax status generally do not count as investment income for purposes of the investment interest deduction, unless you make a special election.

Key point: You can choose to include long-term gain and low-taxed dividends in your net investment income computation, but you must reduce the gain eligible for the maximum tax rate by the same amount. Currently, the maximum tax rate for long-term capital gain and most domestic dividends is 15% for taxpayers with a regular income tax bracket higher than 15%.

For other taxpayers with a regular income tax bracket of 10% or 15%, the preferential tax rate on long-term capital gain and qualified dividends is only 5% for 2007.

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Even better: This 5% tax rate is scheduled to drop to 0% for 2008 through 2010.

Finally, other special tax rules, such as limits on passive activities, may also come into play when the computa-

tions are made. This requires a thorough examination of your personal facts and circumstances.

Practical approach: *Don't jump to any conclusions. Discuss your personal situation with a knowledgeable tax adviser.*

IRS Serves Up New Cafeteria Plan Regulations

Guidelines for providing a menu of fringe benefits

A so-called “cafeteria plan” generally allows the employees of a company to choose from a wide variety of tax-free fringe benefits. The result is a two-way winner.

(1) The employees opt for those benefits that best fit their situation. (2) The employer may reduce its overall costs by providing only those fringe benefits that the employees choose. Both sides can come out ahead on the deal.

Now the IRS has issued new proposed regulations that provide some much-needed guidance in this area.

Basic premise: Typically, an employer sets up a written cafeteria plan and notifies its employees.

Those who participate must be given a choice between at least two options. The available benefits are those that employees are permitted to receive tax-free under law. Employees can also be given the option to receive cash in lieu of some or all of the available benefits.

The employer generally will pay for certain benefits, such as basic medical and disability coverage. The employee then customizes the rest of the benefits package by choosing the “extras” such as dental coverage and up to \$50,000 of group-term life insurance coverage.

The new proposed regulations cover the following points:

Nondiscrimination rules: Any tax-free fringe benefits that are provided to highly compensated employees and key employees are treated as taxable income if the cafeteria plan is discriminatory in nature. The new regulations impose tests concerning eligibility, contributions and benefits. Previously, there was no substantive direction in this area.

Plan basics: A cafeteria plan must be formally established in writing. Only employees may participate, but former employees may be allowed to participate if they

do not predominate. Sole proprietors, partners, corporate directors and 2%-or-more shareholders of S corporations are not treated as employees for this purpose.

Benefit options: A cafeteria plan enables an employee to choose from a statutory tax-free benefit or a taxable benefit. The new regulations state that such a plan is the only mechanism that may be used for this purpose. This was not entirely clear under prior regulations.

Furthermore, a cafeteria plan will be treated as having violated the rules if it offers a taxable fringe benefit.

Election of benefits: The election to choose a specific benefit must be made by the earlier of the first day of coverage or when benefits are first available. This irrevocable election cannot be revised during the year unless there is a change relating to the participant's status (e.g., marriage, divorce or birth of a child).

Health insurance: An employer-sponsored health and accident plan may qualify as a tax-free fringe benefit. Furthermore, it may provide a 2½-month “grace period” at the end of the year for coverage of health care expenses. A similar grace period is permitted for dependent care expenses.

Flexible spending arrangements: A flexible spending arrangement (FSA) reimburses employees for certain expenses such as health care costs and dependent care assistance. Under the “uniform coverage rule,” the maximum benefit from a health FSA must be available at all times, regardless of the amount of contributions. **Caveat:** A health insurance FSA cannot be used to pay for health insurance premiums.

The new proposed regulations do not officially take effect until 2009. However, the IRS says that employers may rely on them currently.



Seven Steps for Better Cost Management

How to improve your company's bottom line

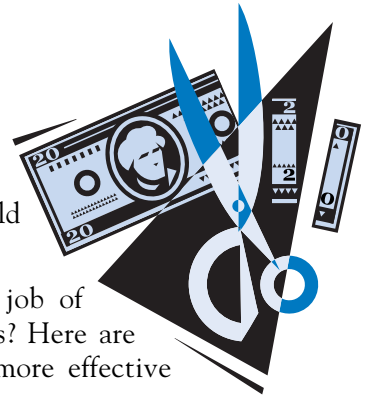
In today's uncertain economic climate, cutting costs has become one of the main objectives of many business owners and managers. But cost cutting is not always the best solution for solving business woes. While reducing costs often has a short-term impact, it may not produce the long-term results you had hoped for. Before you know it, you are faced with the prospect of making an additional round of cuts.

On the other hand, "cost management" can be an effective strategy for both today and tomorrow.

Key distinction: While cost cutting is essentially a reactive process, cost management is a proactive one. With cost management, the emphasis is on eliminating wasteful resources. At the same time, your business can concentrate on the activities that will produce the largest revenue stream.

These efforts should show up on the bottom line.

So how can you do a better job of managing your company's costs? Here are seven steps you can take for more effective cost management.



Rehiring Workers: Points of Contention

Should you consider rehiring a worker whom you recently had to let go or one who elected to quit?

One key advantage is that you pretty much know what to expect from that individual. Also, you will save on recruiting costs and avoid the hassle of interviewing prospective candidates.

However, there are several potential pitfalls to avoid. Consider the following points before you make an offer.

- ◆ You may be legally obligated under state laws to hire certain employees in the wake of layoffs.

Similarly, your company may have a definitive policy in place regarding rehires.

- ◆ If you are hiring back certain workers—but not all of them—you could end up triggering a discrimination lawsuit. Check with legal counsel.

- ◆ Make sure you specify the nature of the job you are rehiring the person to perform. It does not have to be exactly the same job as before.

- ◆ The workers you hire should be able to perform the jobs that satisfy your current needs, not what they did in the past.

No matter what your inclination is, do not let feelings of guilt factor into the decision. That will not do the worker or your company much good in the long run.

1. Know your business inside and out. In order to better manage your costs, you must be able to clearly identify and understand the main sources of income and expenses. Don't forget to examine your overhead costs and other items not directly related to producing revenue.

2. Keep it simple. By "returning to the basics," you may be able to eliminate unnecessary duplication and streamline your business operation. **Practical advice:** Diagram a chart of the company's work flow to help point you in the right direction. In addition, try to seek out faster and more efficient ways for moving vital information from one department to another.

3. Supply the leadership your company needs. Remember that cost management starts at the top. When you display effective problem-solving and decision-making skills, you show your employees how to enhance productivity while maintaining a tight rein on costs.

4. Get everyone else in the company involved. Once your employees understand your company's main objectives, they may have valuable insights into controlling costs. After all, who should know how to do a job better than the person actually doing the job? Don't dismiss an idea simply because it comes from the lowest-paid worker.

5. Make cost management a top priority on a company-wide basis. Both you and your employees need to identify opportunities as soon as they present themselves. If you continue to do business the same way you always have, the same problems are likely to recur.

6. Put procedures in writing. The best ideas in the world will not do your company any good if they are not properly executed. By taking a systematic approach, you can ensure that your cost-management directives are being followed.

7. Plan for the long term. Try to avoid stop-gap measures that will merely delay the inevitable. For example, you should consider cost-management policies as part of your annual business plan. This may help smooth out some of the highs and lows of your cash flow.

Five Ways to Speed Up Your Computer

Basic ideas for enhancing PC performance

“My computer is running way too slowly.” This is a common complaint among PC users. But you don’t necessarily have to trash your machine in frustration or run out and buy a new one. Here are five basic tips for improving performance.

1. Apply Windows updates. If you run Windows and you use the Internet, you should keep up-to-date with system patches concerning privacy and security issues. To obtain fixes and configure your system for automatic updates, open Internet Explorer, click on Tools and then Windows Update.

2. Scan your system for spyware, adware and the like. A good antivirus program featuring automatic updates can help out. Viruses and bad software programs can slow down your system because they take resources to generate popup ads and often interfere with the operation of good programs.



Give Us A Call!

Do you have any questions or comments about this newsletter or your individual situation? Please do not hesitate to contact our office. We would be glad to serve you in any way we can.



3. Remove useless software. You may have software packages on your hard drive that are no longer needed or never were. This might include toolbars, file-sharing programs, free e-mail enhancers, online shopping “companions” and download managers. They can put an unnecessary drag on your computer. Go to the Control Panel and view Add/Remove Software to see what packages are installed. Search online to find out what you need and what you don’t.

4. Clean your hard drive. Both Windows and application programs leave temporary files that will take up space on your hard drive. A hard drive that is close to being full can cause Windows to act erratically. Wipe out unneeded files and scan for disk errors to speed up the system. Go to “My Computer,” right click on your “C” drive and under “Properties,” click on “Disk Cleanup.”

5. Run a defragmentation of the hard drive. Begin by clicking on “Tools” after you have clicked on “Properties.” Then click the “Check Now” button to scan your disk for errors. After the scan is complete, click the “Defragment Now” button. This reorganizes your hard disk so Windows can access files more efficiently. It is recommended that you close all programs and disable your screen saver before running a defragmentation.

These are just the preliminary steps you can take to optimize performance. Other measures are best left to the computer experts.

Facts and Figures

Timely points of particular interest

➔ **Social Security Wage Base**—For the first time ever, the Social Security wage base has cleared the “century” mark. The wage base for 2008 is \$102,000 (up from \$97,500 for 2007). But the OASDI tax rate on wages up to the amount of this threshold remains at 6.2%. Also, the 1.45% HI portion of the tax continues to apply to all wages. These tax rates are doubled for self-employment tax purposes, but a self-employed individual can deduct half of his or her self-employment tax.

➔ **Online IRA Rollovers**—What happens if you make a mistake with an online rollover to an IRA? The IRS will not be very lenient. **New private ruling:** A taxpayer inadvertently designated funds for a non-IRA account by checking the wrong box on an online form. Technically, the taxpayer failed to meet the 60-day requirement for a timely rollover. **Result:** The IRS said the transfer was taxable. Note that additional time might be granted for failures that are the fault of a financial institution.

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