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New Roth IRA Opportunities for Higher Income Taxpayers

Roth IRAs were first established in 1996 and have become a widely used tool in planning and saving for retirement. Unlike traditional IRAs that can provide tax advantages when you contribute to the account, Roth IRAs actually provide tax advantages when you withdraw funds at retirement. Because Roth IRA contributions are nondeductible, distributions from such accounts are typically not included in taxable income when received. Withdrawals from traditional IRAs are taxable as ordinary income.

Currently, the maximum contribution allowed to a Roth IRA for individuals under the age of 50 is \$5,000 annually, with an additional \$1,000 “catch-up” contribution allowed for individuals who are age 50 or above. (These contribution limits will increase in \$500 increments beginning in 2009 based on inflation.) These maximum contributions are limited to “earned” income (for example, wages or other income from self-employment) and are phased out when income exceeds certain thresholds.

Individuals wishing to convert a traditional IRA to a Roth IRA may do so if income (determined with certain adjustments) does not exceed \$100,000 for the year. The amount converted is treated as a distribution from the traditional IRA and a contribution to the Roth IRA. The taxable portion of the amount converted is treated as taxable income in the year of the conversion.

The enactment of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) has brought about new opportunities for converting to a Roth IRA by eliminating the income limitations noted and by allowing taxpayers to spread the resulting taxable amount over a two-year period instead of reporting it all in the conversion year. These changes are effective for tax years 2010 and later.

“Despite the 2010 effective date, now is the time to plan in order to maximize tax savings on conversion to a Roth IRA.”

Despite the 2010 effective date, now is the time to plan in order to maximize tax savings on conversion to a Roth IRA. Specifically, taxpayers should contribute the maximum allowable amount to their IRA. Even for those not allowed to make deductible IRA contributions because of participation in an employer-sponsored retirement plan, tax benefits can be realized by making nondeductible IRA contributions. Such contributions will not be subject to income tax upon conversion to a Roth IRA. Contributions to SEP and SIMPLE IRA accounts should also be maximized, as these balances can also be converted to a Roth IRA beginning in 2010.

(CONTINUED ON PG. 4)

TAX & FINANCIAL SOURCE

The Watkins, Meegan, Drury & Company, L.L.C. Tax & Financial Source welcomes feedback and suggestions for articles to assist business leaders and other professionals in meeting their organizations' objectives. If you wish to submit an idea, request use of any information in this issue, or be added to our mailing list, please contact Kevin Jones at (301) 664-8164. Or e-mail us at Kevin.Jones@WatkinsMeegan.com

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TAX CALENDAR

October

Wednesday, October 15, is the last day an individual can file Form 1040 for 2007 without penalty if an extension has been granted, pursuant to Form 2688.

Wednesday, October 15, is the last day a calendar year partnership can file Form 1065 without penalty if an extension has been granted, pursuant to Form 7004.

Wednesday, October 15, is the deadline for employers to deposit income, Medicare, and social security taxes withheld from their employees' salaries in September if the monthly depositor rules apply.

Friday, October 31, is the deadline for employers to file quarterly Form 941 for income, Medicare, and social security taxes withheld from their employees' salaries in July, August, and September. If the tax for the quarter has been deposited in full and on time, employers have until Monday, November 10, to file the return.

Friday, October 31, is the deadline for employers to make the third quarterly deposit of FUTA taxes for July, August, and September. Use the Federal Tax Deposit Coupon. However, a deposit is not required provided your cumulative liability (first, second, and third quarters) does not exceed \$500.

Friday, October 31, is the due date to file Form 720, Quarterly Federal Excise Tax Return, for the third quarter of 2008.

November

Monday, November 17, is the deadline for employers to deposit income, Medicare, and social security taxes withheld from their employees' salaries in October if the monthly depositor rules apply.

Monday, November 17, is the final deadline for all calendar year exempt organizations who filed extensions to file Forms 990, 990-PF, and 990-T.



New Return Preparer Penalties Affect Both You and Your Tax Advisor

Over thirty-five years ago, in response to a growing trend of unethical or fraudulent practices by tax return preparers, Congress enacted penalties on preparers who engaged in such practices. These provisions sanctioned income tax return preparers who prepared returns taking an unrealistic position which was not disclosed in the return. An unrealistic position was defined as one in which there was less than a one in three chance the position would be sustained on the merits.

The preparer penalties remained virtually unchanged from inception until recent changes made by the Small Business and Work Opportunity Tax Act of 2007 and the Emergency Economic Stabilization Act of 2008 (the “Acts”). The amended penalty provisions establish a broader application of the penalty and establish a higher standard for preparers to meet to avoid imposition of penalties for overly aggressive tax positions.

With respect to the broader application of the penalty, the Acts apply the penalty provisions to preparers of all returns (income, payroll, estate, gift, excise), not just income tax returns. With respect to higher standards of practice, the preexisting rule that an undisclosed position had to have a realistic possibility of being sustained on its merits was changed. The amended standard imposes the penalty on preparers when a return contains an “unreasonable position” that has not been disclosed in the return.

For this purpose, a position is unreasonable if:

- the preparer knew, or reasonably should have known, of the position;
- there is or was not substantial authority supporting the position; and
- the position was not disclosed, or there was no reasonable basis for the position.

The “substantial authority” requirement is defined as less stringent than a more than 50% likelihood standard and more stringent than a reasonable basis standard. In any event, the substantial authority requirement means that preparers are now subject to a higher standard than the one in three standard noted above and previously applicable.

For purposes of determining whether the tax return preparer has a reasonable belief that there is substantial authority for a position, and for purposes of determining whether the tax return preparer



has a reasonable basis for a position, a tax return preparer may rely in good faith without verification on information furnished by the taxpayer or a third party. Thus, the preparer is not required to independently verify or review the items reported on tax returns, schedules, or other third party documents to determine if the items meet the reasonable belief standard. However, the preparer cannot ignore the implications of information furnished to the preparer or that is actually known. The preparer also must make reasonable inquiries if the information furnished by a third party appears to be incorrect or incomplete. In addition, a signing tax return preparer will be deemed to meet the requirements for avoiding the penalty with respect to a position that, even though it does not meet the substantial authority standard, has a “reasonable basis” and is disclosed in the return. The concept of reasonable

basis is somewhat amorphous, but requires more than an “arguable” or “colorable” claim and must be based on one or more specifically recognized authorities.

Finally, it is important to understand who qualifies as a return preparer. A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any federal tax return or claim for refund of tax. Those not included in the definition of return preparer include: employees of the IRS; individuals working for various volunteer assistance organizations; an individual preparing a return or claim for refund of a person by whom the individual is regularly employed or compensated or in which the individual is a general partner; and individuals who provide only typing, reproduction, or other mechanical/administrative assistance in the preparation of a return or claim.

A person need not prepare the entire return or refund claim in order to become a return preparer; preparation of a “substantial portion” is adequate. A substantial portion is determined based upon the facts and circumstances of the tax return; for example, length of return, complexity, tax liability, or refund involved. Attorneys, accountants, and other tax advisors who do not prepare the actual return can become “return preparers” by merely counseling the taxpayer on a particular item reported on the return.

As a result of these new standards, you may notice that your tax professional is asking more questions and taking a harder look before taking aggressive positions on your return. We hope this explanation will help in understanding the reasons for our additional inquiries.



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IN THIS ISSUE:

- 1** New Roth IRA Opportunities for Higher Income Taxpayers
- 2** Tax Calendar
- 3** New Return Preparer Penalties Affect Both You and Your Tax Advisor

plan can then be rolled back over to a traditional IRA after the conversion takes place, or simply left in the new plan. Individuals without access to a qualified plan, such as a 401(k), should consider taking steps to become eligible under such a plan. This can be accomplished by establishing a new plan that allows for rollovers or amending those plans currently in existence.

Although Roth IRAs prove to be advantageous for some taxpayers, they do not make sense under all circumstances. Please contact us if you would like to discuss the tax effects of converting your traditional IRA to a Roth IRA, or the mechanics of accomplishing a rollover with minimal tax consequences.

free) if the taxpayer's IRA or aggregate of IRA accounts contain both deductible and nondeductible contributions. Taxpayers can avoid the proration of distributions between taxable and nontaxable by transferring all of the funds that would otherwise be taxable out of the traditional IRA before enacting the conversion. This can be accomplished tax-free by rolling that portion that would be taxable (i.e., all deductible and nondeductible contributions and account earnings) to another qualified plan, such as an employer-sponsored 401(k). As a result, only the nondeductible contributions will remain in the IRA, and that amount can then be converted to a Roth IRA with no tax consequences. The money that is rolled into the employer

In situations where an IRA contains only nondeductible (after-tax) contributions, converting to a Roth IRA will result in tax on only the earnings of the account because tax has already been paid on the contributions.

However, if the account contains both deductible and nondeductible contributions, the distribution is deemed to consist of a pro rata portion of the taxable and nontaxable funds. Thus, so long as an IRA account contains both deductible and nondeductible contributions, it will not be possible to completely avoid tax on a conversion, although the tax is spread over two years. Said another way, it is not possible for a taxpayer to decide that the portion of the account converted is only attributable to nondeductible contributions (which would be tax-