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August 2004

# Client Information Bulletin

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## Don't Be Caught Napping on AMT Liability

*Cause for alarm for a growing number of taxpayers*

The **alternative minimum tax** (AMT) was originally designed to apply to only the most affluent taxpayers. That's not the case anymore. Eventually, this alternative tax may become the **regular** tax regime for the majority of middle-income and upper-income taxpayers, as well as a sprinkling of low-income taxpayers.

Just take a look at the numbers. A recent report by the Treasury Department estimates that over three million taxpayers will face AMT liability. Seven years ago, only 600,000 taxpayers were affected by the AMT. The number may skyrocket to 16 million by next year and

40 million in ten years unless Congress provides substantial relief.

If you haven't been paying attention to the AMT thus far, it's time to wake up.

**How it works in a nutshell:** The AMT runs on a separate track beside your regular tax liability. After you have figured out your regular taxable income, your AMT liability must be computed. There are four basic steps.

**1.** Add certain **tax preference** items to your taxable income and make other technical adjustments required by law.

2. Subtract from this figure a special exemption amount based on your filing status.
3. Apply the AMT rate to the net amount. For the 2004 tax year, the applicable rate is 26% on the first \$175,000 of AMT income; 28% for amounts above \$175,000.
4. Compare your AMT liability with your regular tax liability. If the AMT is higher, you are required to pay the excess in addition to your regular tax liability.

The list of preferences and technical adjustments is a long one. Suffice it to say that the AMT computation requires you to add back certain itemized deductions and personal exemptions. That is one of the reasons why more taxpayers have become **unintentional victims** of the AMT. There have been several highly publicized cases where couples with numerous dependents have been hit by the AMT, despite having annual incomes of \$50,000 or less. Furthermore, taxpayers who reside in states with high income tax rates and make high mortgage interest and property tax payments are likely to encounter AMT problems.

Another reason for the increase in taxpayers affected by the AMT liability is **inflation**. Although Congress has tinkered with the exemption amounts

the last few years, it has failed to provide an annual inflation adjustment. Under the 2003 tax act, the exemptions for 2004 are \$58,000 for joint filers; \$40,250 for single filers and heads of household; and \$29,000 for married couples filing separately. Even worse: These higher exemption amounts are only temporary. After 2004, the figures revert to their pre-2001 tax act levels of \$45,000 for joint filers; \$33,750 for singles and heads of household; and \$22,500 for married couples filing separately.

To compound the problem, the exemption amounts are phased out for high-income taxpayers. Each exemption is reduced by 25 cents for each dollar of AMT income over \$150,000 for joint filers; \$122,500 for single filers and heads of household; and \$75,000 for married couples filing separately. These figures have not been adjusted in recent years.

*Have an estimate made of your current AMT liability. If necessary, try to postpone tax preference items or shift deductions to your tax benefit. If there is no way out – you absolutely will have AMT liability for 2004 – you might accelerate income into this year if your regular tax bracket is above 28%. **Reason:** The additional income will be taxed at either the 26% or 28% rate.*

## Do's and Don'ts for Creating Performance Files

### *Offers protection against lawsuits by ex-employees*

Donald Trump isn't the only employer who fires employees. If an employee has caused problems in the office, is habitually late or absent, or simply isn't performing up to an acceptable level, you may be forced to let him or her go.

Unfortunately, that may not be the end of the matter if you haven't **properly documented** the reasons for the termination.

**The best defense is a good offense:**

Establish a performance file for each employee. The file should include records of meetings with employees, such as annual salary reviews, as well as notations of unusual behavior and other occurrences during the year. This file will be invaluable in case you are ever called into court by the terminated employee. When you are assembling information for a performance file, keep the following “do’s and don’ts” in mind.

**Do** be **consistent**. If you write up one employee for a certain type of behavior, you must do so for other employees. Similarly, if you look the other way for one, do it for all.

**Don’t** let your emotions cloud your judgment. You should **avoid** personal impressions or unsubstantiated conclusions such as “I think she’s a complainer ...” or “He hasn’t performed the same since his divorce.” If a statement is inappropriate in general conversation, it is not appropriate for the file either.

**Do** document behavior with **specific** data. Instead of simply stating that “he has been late several times this last month,” or “she has consistently failed to meet deadlines,” it is better to provide details.

**Don’t** leave issues unresolved. For example, if tardiness has been a recurring problem, document the

**consequences** for failure to correct the behavior. Provide dates when warnings have been given and note that the employee was informed that termination of employment will be the result of the next unexcused occurrence.

**Do** accentuate the positive as well as the negative. The file should also include references to extraordinary work and accomplishments. Try to present a proper **balance**. If the file is completely one-sided, it may strengthen the employee’s discrimination claim if he or she is eventually fired.

**Don’t** omit critical facts. In fairness to employees, there may be extenuating circumstances that can mitigate certain types of behavior. Be sure to provide a complete and **unbiased** summary.

**Do** have employees read and sign any documents that are going in his or her personnel file. If the employee refuses to sign a particular document, indicate that fact in the file.

**Don’t** forget to **follow up**. Employees should be allowed to respond in writing to the comments you have made. Include the responses in the file.

*Obviously, the performance file will also be useful for positive employee reviews. It can help you determine salary adjustments and in-house promotions. Include a summary of any notable changes in the file.*

# IRS Takes Narrow View of a Business-tax Credit

## *Physical requirements for the disabled access credit*

If certain requirements are met, a small business may be eligible to claim a **special tax credit**—a dollar-for-dollar reduction of its tax bill—for accommodating disabled individuals. However, the Chief Counsel of the IRS has made it clear that the upgrades must be made to a physical structure. In doing so, the IRS denied the disabled access credit for expenses attributable to improving a company's web site (CCA 200411012).

**Background:** As part of the general business credit, a qualified small business can claim a tax credit for making its business premises more **accessible** to disabled individuals. For this purpose, a small business is an operation that had gross receipts of \$1 million or less or did not employ more than 30 full-time employees in the preceding tax year.

The disabled access credit is equal to 50% of up to \$10,000 of qualified expenses. In actuality, the first \$250 of expenses is excluded, so the credit applies to expenses up to \$10,250. **Result:** The maximum credit allowed under law is \$5,000.

What sort of expenses qualify for the credit? The expenses must meet the **requirements** established in the Americans with Disabilities Act (ADA).

For instance, your company can claim the credit for the costs of removing barriers to physical access or communication; providing interpreters or readers for individuals with visual or hearing impairments; modifying equipment; and supplying similar materials or services.

Typically, a business that has installed ramps and elevators to make the premises easier for disabled individuals to navigate has qualified for the credit.

Now the IRS has cast a new light on the existing rules. In the new Chief Counsel Advice, it says that the accommodations for disabled individuals must be to a **physical structure** where the public has access in order to comply with the ADA requirements. Specifically, the credit is not available for software improvements to a company's web site that enable visually- or hearing-impaired individuals to better access the web site. **Result:** The IRS denied the credit for subscriptions to enhanced software products over multiple years.

*The upshot: The physical access requirement is problematic for the ever-increasing number of employers who do business solely on the Internet. Apparently, the credit will be limited to those businesses that provide physical premises for customers or clients to visit.*

## Deducting Fees for Continuing-care Facilities

In a new Tax Court case, a couple deducted a percentage of the service fees paid to a continuing-care facility as a medical expense. This method provided a higher deduction – almost twice as much, in fact – than the amount prescribed by the IRS (Baker, 122 T.C. No. 8).

**Key facts:** Village West, a gated retirement community in California owned by a nonprofit organization, has four different levels of living accommodations: independent living, assisted living, special care and skilled nursing. In 1989, the Bakers moved into the independent living unit. At that time, they paid an entrance fee of \$130,000 and ongoing monthly service fees, entitling them to lifetime residence. They deducted \$35,000 of the entrance fee as a medical expense on their 1989 return.

However, the couple eventually needed to move to the skilled nursing unit. Based on the calculations of a committee comprised of residents, the Bakers deducted about 40% of the monthly service fees – approximately \$16,500 – as a medical expense. Using an actuarial method based on longevity and the actual use of health care resources, the IRS limited the deduction to \$10,000.

**Tax care:** The Tax Court approved the method used by the Bakers. It is a reasonable and simple way to determine the amount of the deductible expenses.

## Seven Ways to Shape Up Your Budget

### *A top priority for small business owners*

Typically, an upper-to-middle income family operates under some sort of household budget. Yet, it's not unusual for small-business owners to treat budgeting as a foreign concept. After all, annual budgets are only required by the corporate giants ... right?

Wrong. In fact, creating a **detailed budget** is as important to small-business owners – if not more so – than it is to the CEOs of Fortune 500 companies. The very survival of the business may be at stake.

Keeping that in mind, here are seven suggestions for getting your budget ship-shape.

**1.** Don't carve your budget in stone. Essentially, a corporate budget is a **projection** of the income and expenses of your ongoing enterprise. In other

words, it's based on calculated estimates at the beginning of the year. **Key point:** The budget doesn't have to be completely accurate and all-inclusive, so try to build some flexibility into your estimates.

**2.** Be **conservative**. It's far better to err on the side of understating income and overstating expenses than vice versa. That will help eliminate unpleasant surprises at the end of the year. If things work out better than anticipated, consider the excess income to be a pleasant surprise.

**3.** Separate the predictable from the unpredictable. Certain costs, such as the monthly rent bill, are generally fixed throughout the year. Other types of expenses, such as equipment purchases, may fluctuate from month to month. Identify the **unpredictable** expenses and

keep them in a separate category. Not only will this provide a better view of the nature of your business, it may lead to strategies for minimizing costs.

4. Track your budget during the year. When your business pays its bills each month, see how the numbers match up against your projections. Usually, this comparison will enable you to **make adjustments** to bring your budget in line with actual income and expenses.

5. Use your budget for **discipline**. The fact that you have a written plan can help you curtail unnecessary expenses. For instance, you might drive down to the local computer store to buy the latest gizmo as soon as you receive a big check from a client. By referring to your budget, you can determine that the

check has been earmarked for other expenses.

6. Use your budget for **long-term planning**. Once you become adept at pinpointing business patterns through your budget, it will become easier to plan your future growth and development.

7. Don't procrastinate. Although putting together a detailed budget is preferable, a rudimentary version is generally better than no budget at all. Do the bulk of the work well before the start of each year. Learn from your past successes and mistakes.

***Best of all:** You don't have to go it alone. You can rely on the expertise of your professional advisers to help you develop a budget that meets the needs of your particular business.*

## Facts and Figures

### *Timely points of particular interest*

→ **Deals on Meals**—The IRS has issued a new Revenue Procedure providing guidance for deducting meals and incidental expenses that are exempt from the usual 50% disallowance rule. This includes company-provided meals to employees during working lunches or overtime. The new guidelines enable companies to use a statistical sample that alleviates them from the burden of scrutinizing every applicable expense (Rev. Proc. 2004-29).

→ **Last-known Address**—If you don't file a change of address with the IRS, you are barred from contesting an issue because you weren't notified in time. In a

pinch, however, you might be able to rely on other filings with the IRS. **New case:** The Tax Court ruled that an individual had provided "clear and concise" notification of an address change by filing a power of attorney form, even though no other notice was provided (Hunter, T.C. Memo 2004-81).