



DYER & ASSOCIATES, P.C.

Certified Public Accountants

7201 Wisconsin Avenue, Suite 780

Bethesda, MD 20814

(301) 654-6200 FAX: (301) 654-3937

Client Information Bulletin

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Follow These Tax Directions for Auto Deductions

How to choose the right method for you and your business

Typical situation: Jim Jackson, a small-business owner, spends a lot of time in his automobile. He uses the car to visit clients, supervise jobs at remote locations and commute back and forth from the office. In addition, Jim frequently drives his children to soccer practice and runs other personal errands.

Can Jim **deduct** any car expenses on his tax return? Yes. The cost of using car for business travel is a deductible expense. But the cost attributable to personal travel—carpooling the kids, running errands or whatever—is not.

Commuting to and from work is considered a personal expense. The amount that Jim may deduct for legitimate business travel depends on

whether he uses the actual expense method or the standard mileage allowance.

Actual expense method: You deduct your **out-of-pocket** expenses (e.g., gas, oil, repairs, insurance) attributable to business driving plus a depreciation allowance. The depreciation deductions may be claimed over a five-year period, but are generally limited for luxury cars.

Note: Luxury car drivers may qualify for a special “**bonus**” depreciation deduction available for cars acquired after September 10, 2001 and placed in service before January 1, 2005. As an alternative to depreciation deductions, you may elect the Section 179 expensing allowance for a car placed in service this year.

If you lease a car, you can deduct the portion of the lease payments attributable to business use. Special rules require business drivers to **report** an inclusion amount that creates the same practical effect as the luxury car limits. **Note:** Certain heavy vehicles, including many SUVs, are exempt from the luxury car limits because they do not qualify as passenger vehicles. Therefore, depreciation deductions may be higher for these vehicles.

Standard mileage allowance: In lieu of deducting actual expenses, you can use an IRS-approved **shortcut**. Each year, the IRS establishes a flat rate to be used for all of your business driving, including a built-in component for depreciation. The standard mileage rate for 2004 is 37.5 cents per business mile (plus tolls and parking fees). If you use the standard mileage rate, the cost of the car doesn't matter.

As a rule of thumb, the standard mileage allowance may be preferable if you drive on business extensively. This method also **reduces** the recordkeeping

burden (although you still must meet strict substantiation requirements). If you use the car for business infrequently, you will probably come out ahead with the actual expense method. Furthermore, the actual expense method is much more appealing in 2004 if you qualify for the bonus depreciation deduction.

Key point: You can't simply choose the method that provides the best result each year. Once you begin using the actual expense method, you **can't switch** to the standard mileage allowance. If you start out using the standard mileage rate, you may switch to the actual expense method, but it requires a depreciation adjustment.

Although personal driving expenses are nondeductible, you may deduct automobile costs attributable to trips for charitable activities or medical care. Instead of deducting your actual expenses, you can use a flat rate of 14 cents per mile (plus tolls and parking). Of course, medical expenses are subject to a 7.5%-of-AGI threshold.

Family Limited Partnerships: A Valuable Tax Planning Tool

Advance planning can eliminate pitfalls

Set up properly, the **family limited partnership** (FLP) can provide an affluent family with estate, gift and income tax savings. However, as a recent Tax Court decision illustrates, there are pitfalls for the unwary. The basic idea behind an FLP is that it allows parents to shift business or investment assets to their children without giving up control and without paying a hefty tax. The assets are transferred to a limited partnership, and limited partnership interests are given to the

children. The parents are the general partners and make all of the key decisions regarding the partnership.

Gift taxes: The transfer of partnership interests to the children is, of course, subject to gift tax. Due to the lack of control and marketability, the partnership interests generally have a lower gift-tax value than the underlying assets.

Estate taxes: Partnership interests given to children are generally **not included** in

the parents' estates. So appreciation in the value of the interests after the gift escapes both gift and estate tax.

Income taxes: Income from the assets is **passed through** and taxed directly to the partners in proportion to their interests. By giving partnership interests to their children, parents effectively move a portion of their income out of their higher tax bracket and into their children's lower brackets.

Proceed with caution: While an FLP can be a valuable tax planning tool in the right situation, there are several areas where your tax plans can go astray if you are not careful. The IRS closely scrutinizes FLPs to find their weak spots.

For example, normally you can claim an annual gift-tax exemption (currently \$11,000) for gifts to your children. But the gift-tax exemption is available only for gifts of "**present**" interests—where the recipient gets an immediate economic benefit. If you impose too many restrictions on your children's right to dispose of their partnership interests, you may not be able to claim any exemptions for the gifts.

A recent Tax Court decision points up another potential problem area. If you give property to your children, but retain the right to the income from the property for the remainder of your life, the **net effect** is about the same as if you transferred the property through your will. The tax law requires that the property be included in your taxable estate, just as if you never made the gift (Est. of Abraham, T.C. Memo 2004-39).

In the case, assets of an elderly widow were transferred to three FLPs and partnership interests were given to the widow's children. The widow retained the right to all partnership income to the extent needed for her support. Income in excess of her support amount was to be divided among the partners. When the widow died, the IRS argued that the entire value of the partnerships should be included in her estate. In the IRS's view, the partnership agreement effectively allowed her to **retain a right** to the income from the gifted partnership interests. The Tax Court upheld the IRS's position.

If you want to know more about an FLP and how it might work in your particular situation, please contact us.

Check Up on Internal Controls

An evolving process that saves time and money

It's been said in military circles that "**loose lips sink ships.**" From a business owner's perspective, loose controls can end up sinking a business, or at least damaging it severely. As a result, it is just as critical for small-business owners to establish and adhere to **internal controls** as it is for international conglomerates.

Every business operation is different and, therefore, the internal controls for any business should be structured to meet its particular objectives and needs. Nevertheless, here are a few general guidelines for common areas of concern.

Sales: Accurate sales figures are necessary to establish company revenue

and direct inventory purchases. Written procedures should be **established** for cash, check and credit card sales.

- ◆ Use an invoicing system for shipping any goods from the business.
- ◆ Ensure that sales figures are correct and commissions are not paid until funds are received.
- ◆ Reconcile sales with payments. Double-check sales against original invoices.
- ◆ Obtain proof of delivery when goods are shipped.

Accounts receivable (A/R): Failure to collect past-due accounts can create **cash-flow** problems and erode profit. Establish credit and collection policies in writing and follow through on their implementation.

- ◆ Age accounts regularly and have an independent review of the report conducted.
- ◆ Separate the A/R function from cash reporting.
- ◆ Cross-check noncash credits and bad debt writeoffs.
- ◆ Establish numerical or batch-processing controls over billing.
- ◆ Initiate security measures for outside communications.

Accounts payable (A/P) and purchases: This is an area where many companies are prone to make mistakes. Establish clear **procedures** for personnel to follow.

- ◆ Document all purchases and A/P procedures.
- ◆ Put controls in place for cross-checking and identifying duplications.

- ◆ Periodically check pricing information and prices from competing vendors.
- ◆ Separate responsibilities for selecting vendors and approving payments.

Cash accounts: A business that processes a significant amount of cash transactions can easily fall prey to misappropriation, especially if internal controls are weak or nonexistent.

- ◆ Safeguard checkbooks and other methods of disbursing funds.
- ◆ Have employees balance cash at the end of their shifts.
- ◆ Reconcile all bank accounts on a regular basis.
- ◆ Separate mail functions from cash deposits at the bank.
- ◆ Divide responsibility for cash disbursements and purchases from the approval process.

Payrolls: With recent technological advances, it is easier than ever for employees to commit payroll fraud if tight internal controls are not established.

- ◆ Ensure that electronic passwords are protected and changed frequently.
- ◆ Review bank deposits to ensure that wages are being disbursed properly.
- ◆ If possible, separate responsibilities for payroll preparation, disbursement and distribution.
- ◆ Investigate variations in payroll expenses and monthly budgets.
- ◆ Train a back-up for critical payroll responsibilities.

Physical assets: It is also relatively easy for physical assets to be misplaced or misappropriated. **Protect** valuable property from external, as well as

internal, access, except in cases where access is absolutely necessary.

- ◆ Lock away laptop computers and similar equipment.
- ◆ Record all asset purchases and maintain detailed records.
- ◆ Assign responsibility for supervising physical assets to a particular employee and a back-up.

- ◆ Divide responsibilities involving expensive equipment among employees, if possible.

This brief overview provides only a glimpse into the internal controls that may be implemented by a business. A comprehensive plan can be developed that is tailored to the needs of your operation. We would be happy to discuss how.

Limited Liability Companies

Protection and flexibility for your personal assets

A **limited liability company** (LLC) is an entity with characteristics similar to a sole proprietorship or partnership, while offering its owners the **protection** of a corporation. This form of business has been gaining popularity and is becoming the primary status under which many nonpublic companies conduct business.

An LLC does **not** pay federal income taxes. As a result, your share of the profits and losses will flow to your personal tax return just as they would from a sole proprietorship or partnership. You do, however, have the option to have your LLC taxed like a corporation. This may be of interest if you need to keep a large amount of profit within the business.

Much like the owners of a corporation, LLC owners have limited liability for business debts and claims. Consequently, if your business gets into legal or financial trouble, only the company's assets are at risk. This means that your personal property is normally protected, and you stand to lose no more than the money that you had invested in the firm. Of course, this

assumes that neither you nor the other owners:

- ◆ personally and directly injured someone;
- ◆ personally guaranteed a business debt that the LLC cannot pay;
- ◆ failed to deposit payroll taxes;
- ◆ acted fraudulently or illegally; or
- ◆ treated the LLC as an extension of personal affairs.

It's easy to mix personal and business finances. But if you do, a court might determine that you are actually doing business as an individual, and the LLC is a sham. Then you could be held personally liable for company debts. There are steps that you can take to make sure that this doesn't happen to you: 1) open a business-only checking account; 2) get a federal employer identification number; 3) keep personal finances out of the LLC's books; and 4) fund your LLC with sufficient cash to operate your business. An LLC could be appropriate if you are worried about the personal risk of lawsuits. Suppose you own a retail business and realize that a slip-and-fall claim could possibly exceed your liability coverage. Or if you own rental properties, you may feel that insurance cannot cover every

conceivable wrongdoing. If you manage your business as a sole proprietorship or partnership, you can convert to an LLC without changing your tax structure. The process is state regulated and varies. Some jurisdictions may offer a simple conversion form while others might require articles of organization.

Establishing your business as an LLC may require more work than starting a sole proprietorship or partnership. However, it will be easier to run than a corporation and that extra personal protection an LLC gives you may provide peace of mind.

Facts and Figures

Timely points of particular interest

- **Rising Wage Base**—Despite concern over a potential shortage in the Social Security system, there's no end in sight to increases in the wage base. For 2004, the first \$87,900 in wages is subject to the 6.2% OASDI portion of the Social Security tax (all wages are subject to the 1.45% HI portion). This figure is projected to increase to \$89,700 for 2005; \$93,000 for 2006; \$97,500 for 2007; and top the six-figure mark at \$101,400 for 2008.
- **Information Sharing**—The IRS is getting greater cooperation in combating abusive tax-shelter schemes. It recently announced that it has started sharing leads on more than 20,000 taxpayers with 45 states, New York City and the District of Columbia. The only states that have not yet joined the group effort are Michigan, Nebraska, Nevada, Texas and Wyoming. The IRS is also stepping up its efforts to monitor offshore trusts.