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Client Information Bulletin

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Planning ahead now can avoid future complications

If you are a co-owner of a small company or a partner in a partnership, supervising the business takes most of your time during the day. That leaves little downtime for anything else -- including planning for contingencies. However, it is important to protect your family's interests in the event you should become disabled or die prematurely.

Fortunately, you can resolve many of the thorniest issues by formulating a **buy-sell agreement** with the other business owners.

How it works: In brief, a buy-sell agreement is a legally binding contract

that provides for an orderly sale of a business interest upon the happening of a specified event. Usually, the agreement is structured so the event is the death of a business owner, but the obligation to buy and sell may also be triggered by disability, retirement or some other significant occurrence.

Naturally, the deceased owner's family is the seller. Who is the buyer? It depends on the type of buy-sell agreement in force. There are **three basic types**.

1. With a cross-purchase agreement, the surviving owners or partners essentially agree to buy each other out. Let's say that Xavier, Yolanda and Zachary are equal owners in XYZ Corporation. Under a cross-purchase type of agreement, if any one of the owners dies, the two survivors purchase the interest from the deceased owner's estate.

2. If you use a redemption agreement -- also referred to as an entity agreement -- the business itself purchases the interest of the deceased owner. In certain circumstances, a cross-purchase agreement may be combined with a redemption agreement.

3. Finally, a buy-sell agreement may accommodate a sale of the business interest to key employees who know the operation inside-out. The key employees might be members of your family who are already employed by the business.

There are several immediate benefits resulting from a buy-sell agreement, including the following:

- ◆ Upon the death or disability of the owner, there is an obligated buyer for the business at a fixed price or formula. In the absence of such an agreement, the estate or the disabled owner may be forced to sell the business at a bargain-basement price.
- ◆ It provides a smooth transfer of the business in a manner agreed upon by the owners in advance of the triggering event. This can help

minimize disruptions to customers or clients while the business is in the process of recovering.

- ◆ The proceeds from the sale of a deceased owner's interest can go toward certain **estate settlement expenses** (e.g., death taxes and estate administration costs). In addition, part of the proceeds may be allocated to help pay the living expenses of the deceased owner's family members. If the owner is disabled, the proceeds may be used to pay all of the family's living expenses.
- ◆ The price established in the buy-sell agreement may be used to provide a valuation for federal estate-tax purposes. However, the estate-tax value is determined without regard to any right or restriction contained in the agreement unless (a) there is a bona fide business arrangement, (b) the right or restriction is not a tax-avoidance device for transferring property to the family at a reduced value, and (c) the agreement is comparable to similar arrangements that are considered arm's length transactions.

Final point: Typically, the agreement is funded by acquiring life insurance policies on the lives of each one of the owners. With assistance from an experienced professional, you can have a buy-sell agreement tailored to your specific needs.

IRS Gives a Green Light for Qualified Vehicles

New regulations exempt certain trucks and vans from luxury-car rules

The IRS has just issued final regulations that exempt qualified trucks and vans from the imposition of the so-called luxury-car rules (Reg. Sec. 1.280F-6). Following up on proposed regulations issued last year, the final regulations provide a **tax refund opportunity** for certain taxpayers.

Background: Under the luxury-car rules, the amount of depreciation you can claim for a passenger vehicle in a particular tax year is strictly limited. In addition, the Section 179 expensing allowance is not available for luxury cars. Similar limits apply to leased vehicles under an inclusion rule requiring you to report taxable income. For this purpose, a **passenger vehicle** is defined as any four-wheel vehicle manufactured primarily for use on public streets, roads and highways that has an unloaded gross weight of 6,000 pounds or less. In the case of a truck or van, the 6,000-pound limit applies to its gross loaded weight.

However, certain types of vehicles -- such as ambulances, taxis and limousines for hire -- are exempt from the luxury-car rules.

New exceptions: The new final regulations add qualified trucks and vans

to the list of vehicles that are officially exempt from the luxury-car rules. A qualified truck or van includes a vehicle which, by reason of its design, is not likely to be used more than just a minimal amount for **personal use**. For example, trucks and vans that have been specially modified for business use (e.g., maintaining only a front bench for seating, installing permanent shelving and painting the company's name on the sides) are qualified vehicles.

The proposed regulations issued in 2003 only applied to qualified vehicles placed in service after **July 6, 2003**. However, the new final regulations allow taxpayers to benefit from the exemption for qualified vehicles placed in service before that date. Thus, some truck and van owners may be entitled to a refund for vehicles depreciated under the luxury-car rules.

An amended return claiming a refund under the final regulations must be filed by December 31, 2004. Note that these vehicles are now also eligible for the Section 179 allowance. For 2004, the allowance permits you to currently deduct up to \$102,000 of the cost of business assets placed in service during the year.

Five Rollover Mistakes to Avoid

Potential tax pitfalls for IRA-to-IRA rollovers

As you are probably aware, you can now roll over distributions from a qualified retirement plan to a regular **Individual Retirement Account** (IRA). If all the requirements are met, the rollover is **tax-free** and exempt from the usual 10% tax penalty on early withdrawals before age 59-1/2. However, you can also roll over funds tax-free from one regular IRA to another regular IRA. (Special rules apply to conversions to Roth IRAs.)

Why would you do this? There are several possible reasons. You may be dissatisfied with the investment return from the IRA or interested in pursuing other **investment opportunities**. Or you might need a quick infusion of cash. If you redeposit the funds in an IRA within 60 days, there is no current tax. A 20% withholding requirement applies to transfers that do not go directly from one trustee to another.

However, be aware that there are several potential pitfalls with **IRA-to-IRA rollovers**. Five common mistakes you should do your best to avoid are:

Mistake 1: You miss the 60-day deadline. The rollover must be completed within 60 days after the date you receive a distribution from the old IRA. For years, the IRS ruled that the 60-day requirement could not be waived -- even when the delay was not the taxpayer's fault. Recently, the IRS has shown that it's more willing to grant a waiver under extenuating circumstances, but it is still best to play it safe.

Mistake 2: You don't roll over the assets that were distributed. To qualify for a tax-free rollover, the cash or other assets that are withdrawn from the old IRA must be transferred to the new IRA within 60 days. You cannot substitute other property. **Example:** In a recent Tax Court case, an individual withdrew cash from his IRA and used the money to acquire stocks. Then he transferred the stocks to a new IRA within 60 days. The Tax Court said that the transfer was taxable.

Mistake 3: You roll over to the wrong IRA. The tax break is valid only if you make a timely rollover to an IRA that you own. Therefore, if you mistakenly transfer the rollover funds to your spouse's IRA or some other account, the transfer is fully taxable.

Mistake 4: You roll over more than once during the year. You are allowed to roll over funds from one IRA to another IRA **only once a year**. The one-year period begins on the date that you receive the distribution -- not the date on which you roll over the funds into the IRA. The **one-year rollover rule** applies separately to each IRA that you own.

Mistake 5: You roll over a mandatory distribution. The law requires you to begin minimum distributions from an IRA by April 1st of the year after the year in which you turn **age 70 1/2**. You cannot avoid the minimum distribution rule by rolling over the distribution into another IRA.

Note: You may be able to avoid these required distributions from a qualified company retirement plan if you have not retired. However, this exception is not available for IRA distributions.

What about rollovers to Roth IRAs? In general, the rollover from a regular IRA to a Roth IRA is completely taxable, but the funds will be tax-free if they are withdrawn after five years. Your tax advisers can help you make the best choice for your situation.

Are You a Stock Trader or Investor?

There is a big tax difference between being a trader in securities and an investor. Significantly, a trader is entitled to deduct losses against ordinary income, while losses incurred by an investor have a more limited tax value. After offsetting capital gains, an investor's annual loss may offset only up to \$3,000 of ordinary income. Thus, someone who is active in the stock market may claim to be a trader for tax purposes.

New case: Mr. Chen was paid approximately \$75,000 a year for his full-time job as a computer-chip engineer. He engaged in 323 trades during the first six months of the year, but 303 of those trades occurred during a three-month period. Chen held most of the securities for less than a month.

Chen claimed he was a trader in securities and deducted a loss of \$85,000. However, the Tax Court disagreed. It focused on (1) the taxpayer's investment intent, (2) the nature of the income derived from the activity and (3) the frequency, extent and regularity of the transactions. Chen maintained his job as a computer-chip engineer the entire year, but he actively traded securities primarily during a three-month stretch.

Result: His loss could offset only \$3,000 of ordinary income (Chen, T.C. Memo 2004-132).

Don't Write Checks Unless You Are Covered

New legislation eliminates float time for consumers

A new federal law taking effect on October 28, 2004 may change the way you handle your banking transactions. This is particularly true if you have ever used "float time" to draw on funds that aren't actually in your account. The changes affect both individual and business accounts.

The new law evolved after the Federal Reserve began pushing for faster access to funds following the suspension of air traffic after 9/11.

Details: Under the **Check Clearing for the 21st Century Act** -- sometimes referred to as "Check 21" -- financial institutions will be permitted to use electronic images of paper checks rather than originals for payment clearance and

settlement. As a result, the checks you write may clear within 24 hours -- or even almost instantly. Currently, it takes several days for clearance, enabling payers to write checks on the funds that have not been deposited yet or have been earmarked for other purposes.

For example, a business operation can no longer write a check to a supplier or vendor on Monday and cover the payment with a deposit on Wednesday. It is now critical to have the funds in the account **at the time** you write the check. To be on the safe side, you should not even rely on a deposit that will be made later that same day. Otherwise, you run the risk of being overdrawn.

Unfortunately, things will not work the same on the flip side. It is expected that you will not have near-instant access to the funds for checks that are written out to you or your business. **Reason:** Although the check you receive from another party will clear much faster, Check 21 does not require financial institutions to reduce their hold time. As a result, financial institutions -- and not the consumers -- will be able to take advantage of the float.

Furthermore, you will not be receiving original checks any longer because they will be destroyed. Paper checks will be converted to **image replacement documents** or other substitute checks that may be transmitted online. However, you will be able to obtain

replications of those checks for a fee. Check 21 does not set any limit on the amounts the banks can charge for this service.

While the banking changes under the new law are significant, some vestiges of the old system will remain. For instance, you will still be able to cancel checks and you can have disputed check payments recredited to your account within ten business days.

***More to come:** You can expect increased media coverage of Check 21 as the red-letter day of October 28th nears. Once the new law takes effect, using float time for cash flow will be a thing of the past.*

Facts and Figures

Timely points of particular interest

➔ **Disability Insurance Plans** -- A company can provide a disability insurance plan that gives employees a choice. Normally, the employer pays the premiums and any benefits received are taxable. But the IRS now says a plan can be amended to allow employees to choose to pay the premiums themselves on an after-tax basis. Thus, any future benefits would be tax-free (Rev. Rul. 2004-55).

➔ **Tax Prescription** -- The IRS says that medicines you buy from abroad cannot be deducted as medical expenses. **Reason:** Federal laws prohibit imports of prescription drugs from Canada and other countries. As a result, the cost of the drugs cannot be reimbursed by flexible spending accounts or health reimbursement arrangements either. Consider this aspect when you weigh the savings of buying imported drugs.