



DYER & ASSOCIATES, P.C.

Certified Public Accountants

10415 Armory Avenue

Kensington, MD 20895

(301) 654-6200 FAX: (301) 692-1990

September 2004

Client Information Bulletin

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Alphabet Soup: Answering FAQs About LLCs

Spelling out the key aspects of limited liability companies

For years, the S corporation form of business ownership was touted by many tax practitioners. **Reason:** It provides certain tax advantages -- such as the pass-through of tax losses to shareholders -- without an overabundance of restrictions. However, an S corporation does not provide the same protection from creditors as a regular C corporation.

Increasingly, entrepreneurs who may have opted to operate their business as an S corporation are turning to an alternative that combines the **tax breaks** of an S corporation with the **legal**

protection of a C corporation. It's called the limited liability company -- or LLC, for short. As of April 1, 1997, all 50 states and the District of Columbia have enacted statutes pertaining to LLCs.

Here are the answers to several frequently asked questions (FAQs) about this relatively new form of business ownership.

What are the main advantages of an LLC?

The owners of an LLC generally report the income or losses from the business on their personal tax returns. As with an

S corporation, items of income and loss are passed through to the LLC shareholders. The LLC itself is not a separate tax entity. Therefore, it is not subject to **double taxation**. Conversely, shareholders of C corporations are effectively taxed twice -- once on the corporate level when the business has earnings and once on the individual level when dividends are paid out.

Like a C corporation, however, LLC owners are protected from personal liability for business debts and claims. For example, if the business owes money or is a party to a lawsuit, only the assets of the business itself are at risk. An LLC owner's personal assets, such as a house or a car, are normally off-limits to creditors.

How do you form an LLC?

Generally speaking, you must file **articles of organization** (sometimes called a certificate of organization or certificate of formation) with the state. Most states have a standard form that can be obtained through the mail or on the state's web site. In a few states, you must also publish in a newspaper your intention to form an LLC.

Are there any other requirements?

Although it is not legally required in most states, you may also want to prepare an LLC operating agreement.

The agreement states the rights and responsibilities of the LLC owners. If you don't have a written operating agreement, the LLC laws of your state will govern.

Do you have to keep corporate minutes for an LLC?

No. Unlike C corporations, LLCs can operate on an informal basis. If you so choose, you can hold formal meetings documented by written minutes, but it is strictly voluntary. For instance, you might call for a formal meeting to discuss a sizeable **real estate acquisition** or the **termination** of a company officer. It is recommended that you document those types of meetings.

Can you convert an existing business to an LLC?

Yes. The procedures are generally the same as setting up an LLC for a new business under the prevailing state laws. This may be an easy way for S corporation owners and sole proprietors to avoid personal liability without making other drastic changes.

This brief article highlights answers to some of the key questions about LLCs. Obviously, this form of business ownership is not for everyone, but it may suit your particular needs. Consult with your professional tax adviser for more details.

Keeping Your Investment Portfolio in Balance

Avoid tipping the scales in your future

One of the primary rules of investing is, “Don’t put all your eggs in one basket.”

The reason is simple: You don’t want to risk losing everything if a single investment doesn’t pan out. Instead, you should make sure that your “eggs” are distributed among several different “baskets.”

Case in point: Let’s say that your portfolio is divided in the following fashion: 60% of the total value in stocks, 25% in bonds and the remaining 15% in cash equivalents such as a money market fund. (Be aware that this example is for illustrative purposes only.) You may feel that this allocation sufficiently reduces your overall risk. Of course, everyone’s situation is different and the actual percentages and types of investments that you use can easily be adjusted to fit your needs.

As practically everybody knows, the value of most investments tends to go up and down. Due to fluctuations in the marketplace, a portfolio that was well proportioned several years ago might have **shifted in balance**. In fact, if you haven’t looked recently, you may be surprised to find that you are bearing a greater risk than you would normally like.

What can you do about the situation? With the help of professional advisers, you should sit down and carefully review your investment portfolio. Hopefully, by taking the time to do this, you will be able to adjust your investment choices in a way that

provides an opportunity for favorable return without undue risk.

Let’s go back to our previous hypothetical example. Say that your stock holdings are now worth 75% of your total portfolio (up from 60%), due to some astute investment decisions on your part. That’s more exposure to the ups and downs of the market than you had originally planned. Consequently, you may decide to recognize some paper gains and move the profits into other investments. **Result:** Your portfolio is now rebalanced in accordance with the goals you want to achieve and the amount of risk you want to take.

There’s no hard-and-fast rule for how often you should rebalance your portfolio. Depending on its size, you may want to do it once a quarter, once a year or once a lifetime. Or you can simply wait until one of your investments exceeds a specific threshold (e.g., 70% in stock holdings in the example above).

There are several other complications to consider, including the **potential costs** of switching from one investment to another. For instance, trading stocks can be more expensive than moving within a family of mutual funds. Of course, you must consider all the relevant economic factors when you make any kind of investment.

Reminder: *The main reason for rebalancing your portfolio is not necessarily to make money (although it can’t hurt) -- it’s to reduce overexposure. While you might be better*

off keeping 70% of your money in stocks in our hypothetical example, you could also be taking a risk you may not be able

to afford down the road. Everyone has to find their own comfort level and then try to stay within it.

Worming Your Way Out of Computer Trouble

Steps to take to prevent network damage from worms

Most business people using computers are familiar with viruses that can affect their systems. But users must also take precautions against worms that may be as devastating as computer viruses.

What's the difference? Worms are similar to viruses in that they often interfere with the normal operation of a computer or program. Unlike computer viruses, worms do not attach themselves to other files or programs. Worms exist as **separate entities** and can spread over the network from one computer to the next. They thrive on the automatic file sending and receiving features that were designed to make electronic communication easier.

Here are a few suggestions for protecting computer systems against an infestation of worms:

- ◆ Create a signature in your e-mail application and use it all the time. **Reason:** Worms generally will not create a new message using your signature. Make sure that all your regular contacts know to expect your signature in an e-mail.
- ◆ Warn recipients that you will be sending an **attachment** before you actually send it. This will let them know it is safe to open the attachment when it arrives. Don't make a habit of forwarding e-mail to huge volumes of recipients.
- ◆ Assume that every suspicious-looking message is a **hoax** until you know better. Subscribe to a security mailing list or visit security sites to learn more about prevalent worms and viruses.
- ◆ Keep your system up-to-date with patches, such as the ones readily available for PCs using the popular Windows-based operating system. Remember to reboot after you install the patch -- otherwise, it might not take effect.
- ◆ Upgrade your PCs to a newer operating system. It's easier to stay on top of security issues with the latest upgrades. The initial expenditure will be well worth it when compared with the cost of rebuilding a system affected by worms.
- ◆ Use a **firewall** to protect your system from Internet access. Even a home-networking router makes it more difficult for a worm to infiltrate your system.
- ◆ It is a good idea to have **anti-virus software** installed. But remember that the software is not the be-all and end-all. Generally, the product will protect you from known viruses, but not a new worm.

Caution: Don't assume that worms or viruses must originate in e-mail communications. In fact, the Blaster

worm that appeared in 2003 affected users who merely had Internet access. No e-mail was required.

The nature of the Internet is constantly evolving. It seems that as soon as a fix to

worms and viruses is made, another lethal version is created. It is critical to continue to make computer-network security a top priority.

Hold the Phone:

No Deductions Without Tax Records

The tax law imposes special rules on listed property such as automobiles, computers and cell phones. In particular, you must follow strict record-keeping requirements and substantiate the business use of listed property in order to deduct your expenses. The courts are not inclined to give you any leeway.

New case: A self-employed motivational speaker from Illinois deducted almost \$16,000 in business expenses stemming mainly from the use of his car, computer, telephone, cell phone and home office. However, the taxpayer failed to provide any records substantiating the use of the listed property or any documentation of his business trips. Furthermore, he offered no evidence to prove that his home office was used exclusively and regularly for business purposes.

Although it was clear that the taxpayer did incur some level of business expenses, the Tax Court stuck to the strict letter of the law. **Result:** The deductions were denied in their entirety (Woods, T.C. Memo 2004-14).

Moral of the story: There is no substitute for keeping proper records. The best approach is to maintain a contemporaneous diary of your business travel and computer use. You can use your cell phone bills to substantiate business usage.

Handling the Tax Fallout from a Divorce

Lump-sum payment did not qualify as deductible alimony

Breaking up is hard to do. If you are required to make alimony payments under a divorce decree, at least the payments are fully deductible on your tax return. Conversely, the payments are taxable to the recipient. However, the mere fact that payments are characterized as alimony by both parties does not ensure that they will be deductible.

To qualify as **deductible alimony**, the following requirements must be met:

- ◆ The payment must be made in cash or its equivalent;
 - ◆ The payment must be received by (or on behalf of) a spouse under a divorce or separation agreement;
 - ◆ Such an agreement cannot designate the payment as being nontaxable to the recipient spouse and nondeductible by the payer spouse;
 - ◆ The payer spouse and the recipient spouse cannot be members of the same household at the time of the payment;
 - ◆ There is no liability to make a payment for any period after the death of the recipient spouse or to make a substitute payment in such a situation; and
- ◆ The spouses cannot file a joint tax return with each other in the year of the payment.

One of these requirements proved to be a stumbling block for a taxpayer. **New case:** Mr. Mukherjee, a resident of Georgia, made a cash lump-sum alimony payment to his ex-wife pursuant to a final divorce judgment. However, the IRS challenged the deductions because it claimed that Mukherjee's obligation to make the payment would have survived his ex-spouse's death.

The Tax Court determined that the obligation was non-terminating, in part, because the divorce decree did not include specific language indicating that the obligation would end upon the ex-spouse's death. Furthermore, under Georgia law, a lump-sum payment is considered to be in the nature of a property settlement that is non-terminating. Therefore, the deduction for the lump-sum alimony payment was denied (Mukherjee, T.C. Memo 2004-98).

This new case points out the importance of structuring a divorce decree to achieve the desired tax results under both federal and state law. Make sure that your tax advisers and legal advisers are on the same page.

Facts and Figures

Timely points of particular interest

- **Rollover Waiver** -- Generally speaking, a rollover from one qualified retirement plan to another must be completed within 60 days. But there are certain exceptions in extenuating circumstances. **New ruling:** A surviving spouse transferred plan assets to an investment account maintained by the employer of her deceased husband. However, the employer failed to advise the surviving spouse about the rollover requirements. The IRS granted a waiver of the 60-day rule in this situation (Ltr. Rul. 200424007).
- **Duty Calls** -- The person who is responsible for ensuring that payroll taxes are paid in a timely fashion may be personally liable for any unpaid taxes. **New case:** The live-in girlfriend of a company officer was designated as a “figurehead” president because of her paramour’s credit problems. Nevertheless, she had official authority to sign checks. Reversing a lower court’s decision, a district court in Florida concluded that the figurehead president was a **responsible person** who was liable for payroll taxes (Marino, DC-FL, 5/12/04).