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Client Information Bulletin

INSIDE

**Tax Complications: New Rules
For Dependency Exemptions**

**Put Your Estate Plan
In Gear Now**

**Pumping Up Your
Business Deductions**

**Five Tips for Finding a
Computer Consultant**

Facts and Figures

How to Reduce the Tax on Real Estate Sales

Realizing tax benefits for installment-sale reporting

Real estate is a valuable asset for many taxpayers. If you sell property that has appreciated in value over the years, you can walk away with a sizable profit. However, you may also face a huge tax liability on the gain.

One possible tax solution is to sell property on the **installment-sale basis**. Instead of receiving the full payment in one year, you arrange to receive installments over several years. As a result, the tax you must pay is spread out over time, reducing your overall tax liability.

How it works: To qualify for installment-sale reporting, you must receive the payments over two or more years. The taxable portion of the payments calculated under the **gross profit ratio** is treated as capital gain in the year received. Thanks to a 2003 tax law change, the maximum tax rate on long-term capital gain is only 15% (5% for low-income taxpayers). Therefore, you are able to defer the tax on part of your gain and benefit from the lower rate at the same time.

The gross profit ratio is determined by dividing the gross profit from the real estate sale by the contract price.

Hypothetical example: Mr. Smith bought commercial real estate a few years ago for \$500,000. The property has an adjusted basis of \$300,000. Smith agrees to sell the property for \$750,000 in three annual installments of \$250,000 each. Since the gross profit is \$450,000 (\$750,000 - \$300,000), the taxable percentage of each installment received is 60% ($\$450,000 \div \$750,000$). When Smith reports the sale on his 2005 tax return, he pays tax on only \$150,000 of the gain (60% of \$250,000).

Any depreciation claimed on the property must be recaptured as ordinary income to the extent it exceeds the amount allowed under the **straight-line method**. The adjusted basis of the property is increased by the amount of recaptured income, thereby decreasing the gain realized in future years.

Caution: If the sales price of your property (other than farm property or per-

sonal property) exceeds \$150,000, interest must be paid on the deferred tax to the extent that your outstanding installment obligations exceed \$5 million.

Note that installment-sale treatment is automatic. However, if it suits your purposes, you can elect out of installment reporting. For example, you might expect to have little other capital gain income this year and a lot next year. Similarly, you might have capital losses or suspended passive losses for this year that will offset the tax on your installment-sale gain. Thus, you are better off reporting the entire gain in the year of the sale rather than spreading it out over a period of years.

Final points: Installment-sale treatment is not available to “dealers” such as real estate developers. In any event, you cannot use installment-sale reporting for property sold at a loss. Other special rules may apply, including restrictions on sales to related parties, so seek professional tax assistance.

Tax Complications: New Rules for Dependency Exemptions

2004 tax law creates new definitions and categories

The Working Family Tax Relief Act of 2004 revises the rules for claiming dependency exemptions on your tax returns. For some taxpayers, there will be no change at all, but the revisions may affect others. To complicate matters, some of the “old rules” and the “new rules” now exist side-by-side.

Basic premise: You are allowed to claim one personal exemption for each dependent you claim on your tax return as well as exemptions for yourself and

your spouse. The personal exemption amount for 2005 is \$3,200 (up from \$3,100 for 2004). For instance, if you are entitled to claim four exemptions on your return, you can effectively deduct a total of \$12,800. **Note:** The tax benefit of personal exemptions begins to phase out for certain high-income taxpayers.

Beginning in 2005, the new tax act creates a uniform definition of child for income tax purposes. Under the new law, a child is a natural or adopted child, a

stepchild or an eligible foster child (i.e., a child legally placed in your home). A child is considered to be adopted when placed with a taxpayer for legal adoption.

In addition, a tax dependent is now categorized as either a qualifying child or a qualifying relative. The most notable change for a qualifying child is that the requirements do not include the gross income test or the half-support test. These two tests are replaced by a residency requirement. However, the other three tests for dependency exemptions still apply (see box).

The residency requirement: A child claimed as your dependent must share the same principal place of abode for more than half of the year. However, if the parents are divorced or separated, the custodial parent can waive the exemption in favor of the noncustodial parent. If a qualifying child is claimed as a dependent by two or more taxpayers (e.g.,

a parent and grandparent living in the same home), you go to **tiebreaker rules**.

In the first tiebreaker, a parent wins out over other claimants. If the dispute is between two parents, preference is given to the parent who has more custodial time. In the event a child has resided with each parent for the same amount of time, the parent with the **highest adjusted gross income (AGI)** is entitled to the exemption. If neither claimant is a parent, the taxpayer with the highest AGI prevails.

Therefore, it may be easier to claim dependency exemptions for some older children. If a working child lives at home, you still qualify for the exemption no matter how much he or she earns or how much support you provide. However, the exemption is not allowed for a self-supporting child (i.e., a child who provides more than half of his or her support).

Five Tests for Dependency Exemptions

Under the rules in place before this year, you must pass five tests to qualify for a dependency exemption.

- 1 The person claimed as a dependent must live with you for the entire year as a member of your household or a relative.
- 2 The person must be a United States citizen or resident, or a resident of Canada or Mexico, for at least part of the year.
- 3 The person must not have an annual gross income exceeding the personal exemption amount. However, the gross income test does not apply to your child who is either under age 19 or is under age 24 and is a full-time student.
- 4 You must provide more than half of a person's support for the entire year to claim him or her as your dependent.
- 5 The person you claim as a dependent cannot file a joint return with his or her spouse.

Put Your Estate Plan in Gear Now

Steps to take for your family's protection

Do you have an estate plan in place? It's more than just drafting a will. A legally enforceable will won't do your family much good if they cannot locate assets such as bank accounts, retirement plans and life insurance contracts.

An **estate plan** can ensure that the objectives of your will are carried out. It may also protect your family from con artists who prey on widows, widowers and other heirs. Here are several steps to put in motion.

- ◆ Make an inventory of all of your **assets**. You might list any bank accounts, individual retirement accounts (IRAs), pension and profit-sharing plans, broker accounts, mutual funds, annuities, etc. Don't forget about pensions from previous jobs. This inventory should include an **estimate of the value** of each item. **Reminder:** Indicate where the assets are located so they can be easily found.
- ◆ Prepare **emergency instructions**. Your family must notify certain people in case of a tragedy, such as your boss at work, your attorney and other key advisers. In addition, you may have to provide for someone to watch small children on a short-term basis. Don't overlook such trivialities as where the spare keys for the house and car are located.
- ◆ Provide **copies of documents**. Be sure to make at least two copies of important documents (e.g., your will, birth certificate and powers of attorney). It's generally not a good idea to keep these documents in a safe deposit box that may be sealed upon your death. Instead, you may give copies to your attorney or other trusted financial advisers.
- ◆ Review the **beneficiaries on your accounts**. You may need to update some accounts as a result of a change in circumstances. For example, you might delete the name of a deceased relative or an ex-spouse or add a newborn child or grandchild.

- ◆ Estimate your **family's needs**. After the mortgage, burial costs and other necessary expenses are paid, cash can disappear quickly for a bereaved family. If survivors do not have access to bank accounts, they may need to tap into other sources. **One possibility:** Increase the amount of your life insurance protection. In general, the money is available to survivors within a short time after the death of the insured person.
- ◆ Suggest **investment advice**. It doesn't have to be written in stone, but you can provide investment guidance -- especially for the short term. It is helpful if you have a financial adviser you can rely on.

Note: Your spouse may be able to avoid current tax on a payout from a retirement plan by rolling over the funds into an IRA or another eligible plan within 60 days.

- ◆ Take care of **funeral arrangements**. You should let your family know how elaborate or simple you prefer a funeral to be. Whether written burial instructions must be carried out depends on state law.

In summary: A will is a good start, but it's not the finish. By making other provisions, you can help ease your family through a difficult time.

Pumping Up Your Business Deductions

As a general rule, you can deduct only those business expenses that are ordinary and necessary for the operation of your business. Nevertheless, you may be able to deduct some unusual expenses that are out of the ordinary for most businesses.

Case in point: In a new case, a professional bodybuilder deducted the cost of power shakes, consisting of mostly vitamins and minerals, and bison meat. He ate the bison meat because it had higher protein levels than regular beef. The taxpayer also deducted the cost of special lotions and body oils that he would apply before posing or working out.

The Tax Court denied the bodybuilder's deductions for the power shakes and bison meat.

Reason: Even though they enhanced his appearance, these are nondeductible expenses that may also be used by nonprofessionals. However, it did allow the deductions for the lotions and body oils. Although nonprofessionals can also purchase these, they are specifically marketed to professional bodybuilders through magazines and are not readily available to the public.

Five Tips for Finding a Computer Consultant

Expert assistance is a necessity, not a luxury

Unless you are a computer whiz or are already employing experts, you might need to hire a **computer consultant**. It has become a standard operating procedure for businesses of all sizes. Frequently, you will be able to rely on consultants who can provide related services at the same time. Here are five practical

suggestions that will help you in the search.

1. Begin with expectations about what you can accomplish. If the system you are using **doesn't meet your needs**, the best computer consultant in the world will not be able to help much. Typically,

a consultant can make recommendations for improvements that are tailored to your situation.

2. Do your homework. Talk to your key business advisers and other referral sources. For instance, **accounting firms** often provide excellent support services in this area. It may be beneficial for your business to mesh traditional accounting and financial services with support for your computer system. If that is not a viable option, your business advisers may be able to refer you to a reputable consultant.

3. Visit your local computer store. Even if the staff there has only superficial knowledge, they should be able to give you an idea of the capabilities available in the top-selling packages. This information will help when you speak to a consultant about your specific requirements.

4. Try to read up on applications in some of the trade publications and computer magazines. Many publications are

geared to specialized industries and are written for nontechnical readers.

5. If you are still in a quandary, you might rely on **other people** in your industry, trade referrals, computer clubs and user groups. For example, if you need help with desktop publishing, look for local user groups for the most popular desktop publishing software. Finally, some hardware and software manufacturers have authorized dealer programs for those who have been specially trained in their products.

Be aware that some, but not all, computer consultants also sell products. A consultant who doesn't offer products may analyze your needs and develop a proposal that you can then take to a computer dealer.

Reminder: This process can be a minefield for the unwary, but you don't have to go it alone. We would be glad to provide assistance concerning computer-related services.

Facts and Figures

Timely points of particular interest

➔ **Camp Counseling** -- Do you send your children under age 13 to a summer camp? The entire cost of a day camp can qualify for the child care credit even if the camp is a specialized athletic or academic camp. The credit is generally equal to 20% of the first \$3,000 of qualified expenses for one child; \$6,000 for two or more children. Note: The cost of an overnight camp does not qualify for the credit.

➔ **Funny Money** -- Not only does crime not pay, it can't pay your taxes either. In a new case, a taxpayer paid an outstanding tax bill of \$2 million owed to the IRS. However, the Tax Court said that the payment did not absolve the taxpayer of his tax liability. Reason: The full amount of the funds was subject to criminal forfeiture as part of a money-laundering scheme.