



DYER & ASSOCIATES, P.C.

Certified Public Accountants

10415 Armory Avenue

Kensington, MD 20895

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

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Client Information Bulletin

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Prepare to Hand Over the Business Reins

How to provide for a business succession plan

Sooner or later, it happens to virtually every small-business owner: He or she must prepare for the day when one or more relatives will take over the operation. Yet the government reports that only one out of every three family-owned businesses is successfully passed from one generation to the next. Frequently, this failure can be traced to the lack of a formal plan of succession.

Most importantly, such a plan appoints a successor for the entire world to see. It can also cover contingencies for the retirement, disability or death of a business owner.

Although there are no guarantees, a plan of succession increases the odds that the business will stay within the family. Here are seven steps that can help provide for a smooth transition of power.

1. Begin by assembling the family and discussing your intentions. This is usually the best time to address any personal conflicts that could cause problems later on. In addition, you should consider the possibility of utilizing outside consultants or key employees.

2. Designate your successor(s): Make it clear who will be "running the show" when you are no longer around. Although this may force you to make some

difficult choices right now, it can avoid future in-fighting that might ultimately destroy your business. Make sure the other key employees will remain on board.

3. Secure adequate **life insurance** for yourself and other key executives. The proceeds from a life insurance policy can be used to pay for estate taxes if the owner should suddenly die.

4. Devise and execute a **buy-sell agreement**. This agreement typically spells out the terms for a buyout of the owner's interest upon his or her death, disability or retirement. For example, it may cover the valuation of the business, the source of proceeds for the buyout and various other provisions. However, this valuation is not necessarily binding for estate-tax purposes.

5. Have a **power of attorney** drafted. This legally binding document may be

used to keep the business operating if the owner is unexpectedly incapacitated. It names the person to take over in the event this occurs.

6. Consider the potential impact of **estate taxes**. For instance, the succession plan can provide for the payment of estate taxes to effectively be spread out over 14 years when a closely held business is involved. **Note:** At this writing, Congress is debating estate-tax reforms.

7. Last, but not least, tie up all the **loose ends**. The plan may provide guidelines for any other unusual circumstances or specifics relating to your particular profession or industry.

***Reminder:** The sooner you begin to draw up a plan, the better. After all, the idea is to provide for contingencies. Don't wait until it's too late.*

Seven Ways to Delegate Work to Others

Be more productive and improve employee morale

Do you want to get more work done in less time? The key is learning the **art of delegation**. By parceling out certain jobs among your staff, you should be able to devote more of your time to areas with greater profit potential. Plus, you can develop a workforce of thinkers, not just doers -- and that can help keep your turnover rate down. Here are seven ways to get started.

1. Explain the concept. At first, your employees may be hesitant to change the way they do things, particularly if they have been on the job for a long time. Begin by laying out all the ground rules. This would include which employees will do which jobs, what their goals will be, when assignments are due, how the work will be evaluated, etc. If everyone starts on the same page, the process should go much smoother.

2. Be a “matchmaker.” Not all employees thrive under a delegation system. The best approach is to begin with employees who have demonstrated the ability to think on their feet. Otherwise, you might end up with an endless stream of people coming to you for help -- a sure sign that the delegation process isn't working out too well.

3. Grant authority. In order for delegation to work well, you must empower your employees to make their own decisions. Do not make “delegation” just another word for the same old way of doing things.

4. Obtain a commitment. In return for receiving greater authority, your employees have to understand that they will

now be held more accountable for their decisions. To get this point across, spell out the rewards for those employees who succeed and the repercussions for those who fail.

5. Monitor the work. In the beginning, you should keep a close watch on how well your staff is handling the delegation process. This is a tricky area. If you do too much monitoring, you are back to doing things on your own; too little, and you can lose track of what your personnel are doing.

One approach is to use an assignment book or a similar computer ledger. **How it works:** List all the tasks employees have been assigned, when assignments will be completed and what, if any, problems have been encountered. The ledger is a good way for you to keep track of what is going on without getting too involved.

6. Evaluate the work. Once a project is done, set aside time to evaluate the employee's work. Has everything been completed to satisfaction and on time? If not, explain where the person went wrong and what you expect the next time. Try to offer specific and constructive criticism so that the person can learn from the experience.

7. Leave professional services to the professionals. For instance, you would not expect an attorney, accountant or business consultant to know everything there is about running your business -- why would you assume that you know theirs? Obtain professional advice when it is appropriate.

Don't Fall Into a Life Insurance Trap

Avoiding estate tax for incidents of ownership

One way you can protect your family's future is to secure adequate life insurance. But what about federal estate-tax consequences? If you are not careful, they can dilute the benefits your heirs will receive when you are gone.

However, with the proper planning, your beneficiaries should be able to receive life insurance proceeds without any tax erosion.

Background: Under the current estate-tax rules (as of this writing), your gross estate includes the proceeds from a life insurance policy on your life if those proceeds are payable to the estate (or are received by someone else for the benefit of the estate). Obviously, it is relatively easy to avoid a problem by designating beneficiaries other than the estate and giving them full control over the proceeds.

In other words, this condition is satisfied if you simply name a spouse or child as a beneficiary with the freedom to use the funds as he or she sees fit. But that is only part of the problem.

Even if the proceeds are not receivable by the estate, they are included in the insured person's taxable estate if he or she possessed an **incident of ownership** in the policy on the date of death. This also applies to any incident of ownership transferred within three years of death.

What is an incident of ownership? The term does not just mean technical legal ownership. It refers to the right to the economic benefits of a policy. The list of incidents of ownership includes such items as the power to

- ◆ Change beneficiaries;
- ◆ Revoke an assignment;
- ◆ Obtain a loan against the cash value;
- ◆ Pledge the policy for a loan; and
- ◆ Surrender or cancel the policy.

On the other hand, the right to receive dividends or the right to veto the sale of an insurance policy by a trustee of an irrevocable trust is not an incident of ownership.

If you acquire a life insurance policy on your life and you transfer all incidents of ownership in your policy more than three years before your death, all of the proceeds are exempt from federal estate tax. While the transfer is subject to gift tax, the overall tax bite generally is much lower than the estate tax that would be imposed if you had retained the policy. Furthermore, the transfer may be sheltered from gift tax by the annual gift-tax exclusion and the gift-tax credit. **Note:** Estate-tax reforms are currently being considered in Congress.

Obviously, this requires coordination of several financial-planning and tax aspects. Don't hesitate to seek professional assistance when it is appropriate.

**Medical Expenses:
Making the Tax Grade**

Is your child going off to college this fall? Depending on your situation, you may be able to write off part of the cost as a medical expense.

Background: Typically, if you make monthly payments to a school or pay the entire year's tuition in one or two lump sums, the bills include an insurance premium for health care services. The IRS has approved medical expense deductions for student costs that are attributable to health care. However, the cost qualifies for the tax deduction only if a breakdown is provided or it is "readily obtainable" from the school, so don't hesitate to ask if you do not receive one.

On the other hand, if your child attends a special school to compensate for specific disabilities (e.g., he or she is hearing-impaired and requires special instruction), you can deduct the entire tuition cost as a medical expense.

Note that you can deduct unreimbursed medical expenses only to the extent the annual total exceeds 7.5% of your adjusted gross income.

Can You Deduct Donations of Old Computers?

New case shows importance of keeping records

Instead of tossing out your old computer equipment -- such as personal computers and printers used at home -- you might donate it to a charitable organization. Usually, you can deduct the full fair-market value of the equipment as of the date of the contribution. However, you must keep detailed records in case the IRS ever challenges your charitable deductions.

Background: As a general rule, you can claim deductions for personal property that you donate to a qualified charitable organization. The deduction amount for **ordinary income property** (i.e., appreciated property that would have produced ordinary income if you sold it instead) is equal to the property's fair-market value less the amount that would be ordinary income. On the other hand, with property that would have produced a long-term capital gain if sold or property that has depreciated, you can deduct the full fair-market value.

In either event, you have to meet strict recordkeeping requirements to nail down a deduction for gifts of property. For starters, you must obtain a receipt for each contribution given to charity. The receipt should include the name of the donee, the date and location of the contribution and a detailed description of the property (to the extent it is possible). When you file your tax return, you must provide additional information for property donations (other than certain publicly traded securities). Finally, for contributions valued at more than \$5,000, you must furnish the IRS with an independent written appraisal of the property's value.

If you don't have the necessary proof in hand, you are not entitled to the deduction.

New case: A taxpayer claimed deductions for donations of used computer equipment, software and office equipment exceeding \$40,000 over two tax

years. However, the taxpayer failed to provide any written proof of the contributions nor did he attempt to verify the identity of the donees.

For the third tax year in question, the taxpayer produced a receipt for donations totaling over \$15,000, but the receipt did not describe the property contributed or its location. Furthermore, even if the receipt had been valid, the taxpayer did not substantiate the identity

of the donee organization or obtain the written appraisal required for noncash contributions over \$5,000. **Result:** The Tax Court denied the entire amount of the deductions.

Of course, you will have to pay a fee to obtain an independent appraisal, but it is usually well worth it. You are allowed to deduct the appraisal itself as a miscellaneous expense (subject to the usual limits).

Facts and Figures

Timely points of particular interest

➔ **Learning a Tax Lesson --** Usually, the cost of a child's tuition is deductible as a medical expense only if he or she attends a special school (see page 3). **New private ruling:** A couple has two children who have been diagnosed with dyslexia. They enrolled the children in a school with a special education program that enables disabled children to progress to a regular school. **Result:** Since the principal reason for attending the school is to overcome a disability, the tuition cost qualifies as a deductible medical expense.

➔ **Taxpayers Off-key --** In a new Tax Court case, parents established a sole proprietorship for their musically talented children. The children gave musical lessons for fees, the principal source of income for the business, but the parents were listed as the owners on the business certificate. They deducted expenses such as the cost of musical instruments and other miscellaneous items. **Result:** The IRS denied the deductions, since the business expenses should be deducted by the children, not the parents.