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Client Information Bulletin

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Roundup of New 2006 Tax Law Provisions

Key tax breaks and extensions in the new law

After months of wrangling in Congress, the President signed the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) into law on May 17, 2006. As expected, this new tax legislation extends several important tax provisions that were scheduled to go off the books. However, the new law also contains a few tax "surprises" for affluent taxpayers that were added as the bill moved towards approval.

Significantly, the new tax law will enable more individuals to take advantage of Roth IRA (individual retirement account) conversions in the future, but will also increase the time period that fami-

lies are subject to the "kiddie tax." Let's look at the main tax provisions in the new law that are of interest to individuals and businesses.

Roth IRAs: Unlike a traditional IRA, contributions to a Roth IRA are never tax-deductible. However, distributions from Roth IRAs may be completely tax-free, providing an advantage over traditional IRAs. In addition, you do not have to take mandatory lifetime distributions from a Roth IRA.

In the past, a taxable conversion to a Roth IRA was allowed only in a year in which your adjusted gross income did

not exceed \$100,000. Effective for the 2010 tax year, the new law removes the \$100,000 cap for Roth IRA conversions. For conversions in 2010, you may elect to spread the resulting tax ratably over a two-year period.

Kiddie tax: Under the kiddie tax, a child's unearned income above a specified limit (\$1,700 for 2006) is taxed at the top marginal tax rate of the child's parents. Prior to the new tax law, this tax rule applied to children under the age of 14. However, the new law hikes the age limit to 18, effective for the 2006 tax year.

Capital gains and dividends: Currently, the maximum tax rate on long-term capital gains and qualified dividends is only 15% (5% for low-income taxpayers) as opposed to ordinary income rates reaching 35%. This preferential tax treatment was scheduled to be repealed after 2008, but the new law extends it through 2010.

Alternative minimum tax (AMT): The AMT continues to affect a wide range of middle- and upper-income taxpayers.

Congress had created higher exemption amounts in the AMT calculation through 2005. The new law grants an additional one-year reprieve with even slightly higher exemption amounts for 2006.

Section 179 allowance: Under Section 179, a business can currently deduct the cost of assets in the year they are placed in service, within certain limits. The maximum expensing allowance under Section 179 was quadrupled from \$25,000 to \$100,000 by the 2003 tax act. This dollar cap has been subsequently increased slightly over a period of years. Originally, the allowance was scheduled to revert to \$25,000 in 2008, but the new law extends enhanced write-offs for two more years.

Note that a separate "trailer law" includes revivals of expired tax breaks for research and development costs, special "targeted jobs" credits and optional state sales tax deductions. As of this writing, this tax legislation is being debated.

Do not hesitate to inquire about the effect of the new tax law. We would be glad to provide the necessary assistance.

The Tax Truth About Gambling Activities

Follow tax rules for gambling income and losses

If you enjoy gambling, whether your activities are extensive or not, you must comply with the tax rules in this area. Unfortunately, many taxpayers have preconceived notions that are simply not true. The following are several common falsehoods and the reality behind them.

Falsehood: I do not have to report gambling income if my losses exceed my winnings.

Reality: Regardless of the amount of losses you have, you must report your gambling winnings on your personal tax return. The income received from gambling activities is taxed at ordinary income rates.

Falsehood: I never have to pay any tax if my losses exceed my winnings.

Reality: It's true that you can deduct gambling losses up to the amount of your winnings on your tax return. However, these deductions are claimed as miscellaneous itemized expenses. In other words, if a taxpayer does not itemize deductions, he or she gets no tax benefit from the gambling losses.

Falsehood: Gambling losses may be limited because of the 2% limit on miscellaneous deductions.

Reality: In this case, the tax rules actually work in your favor. Generally, you can deduct miscellaneous expenses only

to the extent the total for the year exceeds 2% of your adjusted gross income. However, certain types of miscellaneous expenses, including gambling losses, are deducted without applying this limit.

Falsehood: I don't have to pay federal income tax on any lottery payoffs or similar type of winnings from charitable organizations.

Reality: Tax-exempt organizations such as charities are required to meet the same reporting and withholding rules as other entities providing lotteries, sweepstakes and other forms of gambling. The payor must generally report winnings of more than \$600 to the IRS.

Falsehood: If I gamble online, I do not have to pay tax on my winnings.

Reality: Although there have been no definitive rulings from the IRS, the basic rules that apply to gambling at other venues also apply to online gambling activities. Therefore, you must report your online gambling winnings on your personal tax return. In turn, you may be able to offset the tax liability with gambling losses, assuming you itemize deductions.

Your professional tax advisers can provide assistance with respect to the tax consequences of gambling activity. Do not hesitate to seek assistance.

Personal Services Corporations Are Left Flat

Most C corporations benefit from a graduated tax rate structure. But certain companies, known as personal services corporations, are taxed at a flat 35% rate.

Traditionally, the list of personal services includes services performed in the fields of health, law, engineering, accounting, actuarial science, performing arts and consulting.

New case: An Ohio firm split its accounting business from its financial services business. Nevertheless, the parent company continued to furnish the paychecks to the employees who worked in the financial services end. It also continued to provide their employee benefits and to pay the employer's share of Social Security tax on the wages. The financial services company reimbursed the parent company for the wages and claimed the resulting deduction.

The IRS argued that the parent company, left only with the accounting business, should be treated as a personal services corporation. However, the Tax Court said that simply allocating costs of employees to the financial services company does not make them employees of the new company. The employees in the financial services business still functioned as employees for the parent company. **Result:** The company is not a personal services corporation.

Note: The flat tax is imposed on personal services corporations only if employees performing the personal services own at least 95% of the stock.

How to Defuse Workplace Violence

Resolving employee disputes peacefully

The threat of violence remains a concern in the workplace. A dispute at work can involve anything from a shoving match between two colleagues to a hostage crisis involving a disgruntled ex-employee. In its most extreme form, it can result in fatalities.

What are the potential legal consequences of workplace violence? There are several. For one thing, employees who are injured in a fight at work may file workers' compensation claims.

Furthermore, if an employee injures an outsider, the company may be sued for negligent hiring. And if an employee shows signs of increasing desperation,

the employer may be liable for keeping him or her on the job.

On the other hand, employers are vulnerable to discrimination lawsuits initiated by protected minorities. For instance, the guidelines established by the **Equal Employment Opportunity Commission (EEOC)** and the **Americans with Disabilities Act (ADA)** prevent employees with mental problems from being removed because of a "speculative" or "remote" risk they will become violent.

Keeping all that in mind, the best approach to minimizing workplace violence may be to address the problems

before they escalate. Here are five suggestions to consider:

1. During job interviews, identify those applicants who are likely to lose their temper and become violent. While you can't question a job candidate about arrest records, you can ask about criminal convictions. Or you can simply ask the applicant if he or she has had any prior personality conflicts with supervisors. If you get a heated response, it may be a tipoff.

2. Check references carefully. At that time, try to find out how the applicant has handled stressful situations with previous employers (but keep your questions work-related). If there were problems in the past, it can send up a red flag.

3. Watch out for employees who might lose control. And it's not just the vocal employees you have to worry about (although they are also capable of violence). It is often the quietest employees or the "loners" who cause the most damage. Some of the typical danger signs are:

- ❖ Sudden changes in behavior;
- ❖ Shortness of temper;
- ❖ Marked decline in work productivity;
- ❖ Carelessness on the job; and
- ❖ Chronic complaints of illness.

4. Try to alleviate tensions at work before they explode. For example, you might speak in private to an employee who seems to be experiencing difficulties with coworkers. Similarly, you can alert a supervisor who might be sitting on a powder keg and not know it. If the problem is severe, you might recommend counseling or a similar type of program.

5. Step up security measures. It may be necessary to control access to the workplace by electronic means. If a worker is fired, make sure you get back any keys and identification materials. You might also ask to be notified if the ex-employee appears on the premises.

There is no foolproof way to eliminate violence from the workplace. Yet management should not stand by idly. You should take reasonable precautions for your circumstances.

When to Say “No” to an Inheritance

Qualified disclaimer can reduce estate tax

Does it ever make sense to turn down an inheritance? In a word -- yes. **Reason:** In some cases, your family might be able to reduce its federal estate-tax bill with a qualified disclaimer. Furthermore, it may be possible to use a disclaimer to correct an earlier estate-planning error.

What is a disclaimer? Generally, it is a written, irrevocable decision on the part of an estate’s beneficiary to refuse all or part of a bequest. To be effective, a beneficiary must make the disclaimer within nine months of the decedent’s death and before the property has been received.

It is also possible to disclaim part of an inheritance. An experienced professional adviser can provide you with details as to how this can be done.

Why would you need a disclaimer? Typically, a disclaimer may be used to allow a family to take full advantage of the breaks in the federal estate-tax law. It could come into play if a married couple has overlooked estate-tax complications. For instance, this often occurs if one spouse leaves all of his or her assets to the other spouse. When the surviving spouse dies, the federal estate-tax exemption is insufficient to cover the estate-tax liability for assets passing to the children.

Currently, the exemption can be used to shelter up to \$2 million from estate tax.

This figure will increase to \$3.5 million by 2009 before the estate tax is eliminated in 2010. However, under a “sunset” provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the tax is scheduled to be revived in 2011 with a tax exemption shelter of only \$1 million (based on the exemption prior to enactment of EGTRRA).

In other words, unless Congress takes subsequent action, the law reverts to the pre-2001 law after 2010. Note: A disclaimer may also be used to pass assets directly from a grandparent to a grandchild. Usually, assets that are passed down to a grandchild are subject to a double estate-tax bite: once in the grandparent’s estate and then again in the parent’s estate.

One potential way around this problem may be to have the parent disclaim the bequest. As a result, the property can then go directly from the grandparent to the grandchild while being taxed in only one estate. Note that amounts above a specified amount passed through a generational “skip” may be subject to a special generation-skipping tax.

Disclaimers can help reduce your family’s federal estate-tax liability in certain situations, but they can also cause confusion. Make sure you understand all of the repercussions before you take action.

Facts and Figures

Timely points of particular interest

- **Money Talks** -- The IRS recently joined forces with 33 states and Puerto Rico to combat money laundering in the business sector. The agreements allow the participants to share Bank Secrecy Act (BSA) information and other resources for ensuring compliance. Note: Although BSA information does not include tax information, the IRS and the individual states have long-standing arrangements for sharing that information.
- **Living Wills** -- A living will can provide health care instructions in the event of a life-threatening circumstance. Frequently, living wills are kept in safe deposit boxes or other secure locations. However, it is important that the document is easily accessible. For instance, you might give a copy to your primary care provider or include a copy of the living will in your medical records.