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# Client Information Bulletin

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## What You Should Know About Annuities

### *Key points for investors to consider*

Are you confused about tax-deferred annuities? You are not alone. This type of investment, which has its fair share of detractors as well as proponents, has mystified people from all walks of life. Let's take a brief look at how annuities work and the different types that are available to investors.

**Basic premise:** Briefly stated, an annuity is simply a contract between you and an insurance company or some other financial institution that provides regular payments on scheduled dates and continues for the rest of your life or a period of years. You can pay the entire amount up-front or make a series of payments to

the issuer. No tax is due until payments are received.

Is that all there is to investing in annuities? Not quite. There are numerous variations on this basic theme. In a general sense, however, tax-deferred annuities may be divided into two categories: fixed and variable.

**Fixed annuities:** This type of annuity pays a fixed amount at regular intervals for a set amount of time. It is tied to the performance of government-backed securities, and the payments are guaranteed by the issuer.

**Variable annuities:** As the name implies, this type of annuity invests in a wide variety of investment products. Therefore, the amount of your payments depends on the performance of the investments. It generally offers the opportunity for a greater return than a fixed annuity, but at a higher risk.

Although many conservative investors may feel more comfortable with fixed annuities, sales of variable annuities have **grown dramatically** in recent years. As with every investment, it is important to know all the implications of annuities. For instance, you may find that the terms differ from one annuity to another. Also, consider any fees, commissions and surrender charges you may have to pay.

Finally, be aware that withdrawals prior to age 59½ may be subject to a **10% tax penalty**. This may be an important consideration.

The Securities and Exchange Commission requires that financial institutions issuing the annuities spell out all the expenses in a standardized table near the front of the prospectus. This will enable you to uncover any unexpected fees.

***Reminder:** Although you should only consider issuers of annuities with a proven track record, be aware that past investment performance is no guarantee of future results. Ask questions first and invest second.*

## Estate Planning: It Can Make a Difference

### *Astute decisions can save estate taxes*

If you have not yet devised an estate plan, do not procrastinate any longer. This can have a significant impact on your family's future. In fact, with the assistance of a professional adviser, your family can save hundreds—perhaps even thousands—of dollars in federal estate tax. You may also appoint a professional to act as the executor of the estate.

Here are some areas where advance planning can make a big difference.

**Credit shelter trusts:** A **credit shelter trust** (or “bypass trust”) is designed to maximize use of the federal estate-tax exemption. Currently, the exemption may effectively shelter assets worth up to \$2 million from estate tax. This is in addition to the unlimited marital deduction covering transfers to a spouse.

For example, say that your estate is worth a total of \$2.5 million. According to your wishes, the estate planner arranges for you to leave half to your spouse and the other half in trust for your children. When you die, your family owes no federal estate tax. Upon your spouse's death, the remaining funds may be sheltered by his or her estate-tax exemption. **Result:** No federal estate-tax complications.

**Caveat:** The federal estate tax is scheduled to be repealed in 2010, but revived the following year with a less-generous exemption. The rules in this area may change, but we will keep you posted.

**QTIP trusts:** In general, no marital deduction is permitted for property that passes to a spouse for his or her lifetime

and then to someone other than the surviving spouse. However, there is an exception for “qualified terminable interest property” (QTIP). If a special election is made, the value of the property may qualify for the marital deduction. The property generally is included in the taxable estate of the surviving spouse.

**Power of attorney:** This legal document authorizes another person to act on your behalf in the event you are incapacitated. In many cases, the estate-planning professional is named the attorney in fact. A “durable” power of attorney remains in effect until you die.

**Tax year:** It is possible to choose a fiscal year for the estate. As a result, certain taxes that are due on the estate’s income may be deferred to a later year.

**Administrative expenses:** These expenses may be deducted either on the estate-tax return or the estate’s income tax return. The executor can choose the

method that will produce the biggest tax savings for the beneficiaries.

**Disclaimers:** Your family may save taxes overall if one or more family members “disclaims” his or her interest in the estate. This strategy may be used to retain the tax benefits of the estate- and gift-tax exemptions or to properly utilize the marital deduction.

**Business interests:** The full amount of estate tax is generally due nine months after an individual’s death. However, there is special estate-tax relief available for a family that inherits an interest in a small business. If the estate qualifies, the tax on the business interest may be postponed for up to five years. After that, the payments can be stretched out over a period as long as ten years.

*These are just a few of the ways a professional estate planner can provide assistance. It helps to establish a strong relationship with someone you trust.*

# Non-compete Agreements: Terms of Endearment

## *Ensuring that non-compete agreements are enforceable*

What's the worst thing that could happen to your business? For some employers, it is losing a fast-rising star or trusted staff member to the competition. But you do not have to stay awake at night. **Practical solution:** Try to ward off potential problems by having key employees sign non-compete agreements.

Typically, such an agreement is signed either as a pre-condition of employment or upon termination (e.g., to enable the employee to receive severance pay). **Ca-veat:** Do not overdo things. In general, your company cannot prohibit a former employee from making a living in the same field or industry.

A valid non-compete agreement must distinguish between acts that take legitimate profits from the company and those that are essential to the employee's livelihood. For example, an employee usually will be permitted to compete with an ex-employer on some levels, but prior clients or customers may be off-limits.

Any non-compete agreement should be worded carefully. Typically, the agreement may call for a former employee to refrain from specific acts at specific places for a specific period of time. The enforceability of these terms depends on whether the restrictions are "reasonable" or not.

When judging the reasonableness of a non-compete agreement, the courts may consider the following factors, among others:

- The length of time the agreement remains in force;
- The scope of the geographic area restricting the employee;
- If the agreement restricts activities not in competition with the company;
- If the agreement prevents the employee from working in his or her chosen field; and
- The reason for termination of the employee.

A dispute over the violation of a non-compete agreement may boil down to two essential factors: (1) what the employee actually knows about your business and (2) his or her course of action. For example, an employee may claim no knowledge of trade secrets or confidential knowledge but only general knowledge of the business. In that case, the burden of proof is on the company to establish that such knowledge is confidential or contains valuable trade secrets.

If a court finds that the employee has only general knowledge or that the agreement was made simply to prevent another company from becoming a more efficient competitor, no legitimate company interest is being protected. As a result, the agreement probably will not be enforced.

In many instances, courts throughout the country have refused to classify general knowledge in the industry or trivial differences in practices as trade secrets. In fact, an employee may get the benefit of the doubt because the employer is often perceived to be more powerful. This is especially true if the employee's conduct

did not contribute to termination of employment or the agreement was signed as a pre-condition to employment.

*A non-compete agreement often accompanies the sale of a business, because*

*competition from a former owner might reduce the value transferred to the purchaser. In this case, it is more likely that an agreement including strict terms will be enforceable.*

### How to Block Cell Phone Spam

It is bad enough that you have to deal with e-mail spam, but another potential problem is growing in this high-tech world: **cell phone spam**. Typically, you might receive unwanted text messages or calls on your phone from either telemarketers or known contacts. Besides the annoyance, it costs you money.

Anti-spam programs can detect spam from telemarketers, but no system is foolproof. If you receive messages from solicitors, you can have the charges removed from your bill by contacting the cell phone provider. In addition, you can file complaints with the Federal Trade Commission (FTC). The FTC has established a **Do Not Call registry** for this purpose.

You might also receive an overabundance of “friendly fire” from people you know on a personal or business level. To combat the worst offenders, the service provider will generally allow you to block certain numbers from sending you communications. However, you must use this option with discretion: You do not want to restrict access that is vital for your business or personal life.

## Special S Corporation Election for Family Businesses

*IRS issues new guidance for treatment for shareholders*

The American Jobs Creation Act of 2004 liberalized the rules for S corporations. For instance, the act enables you to elect to treat all family members as a single shareholder. Earlier this year, the IRS released new guidance concerning this special S corporation election. The new notice applies to elections made for the 2005 tax year.

**Background:** S corporations offer several tax advantages to small-business owners. Significantly, you are protected from personal liability while you avoid the double taxation that plagues regular C corporations. The income and losses

from the S corporation are passed through to the owners and reported on their individual returns.

Under the 2004 tax act, several restrictions for choosing S corporation status were relaxed. For instance, the maximum number of shareholders permitted was increased from 75 to 100. **Even better:** Any family member may elect to treat all of the members of the family as a single shareholder for this purpose. The new IRS notice says that the election can include:

- Common ancestors;

- Lineal descendants of common ancestors;
- Spouses or former spouses of lineal descendants or common ancestors; and
- Certain beneficiaries of electing small-business trusts (ESBTs) who are members of the family.

Note that the two or more elections can be made for the same S corporation. The members of one family for which the election has been made (the “**inclusive family**”) may include the members of another family for which the election has also been made (the “**subsumed family**”). In this case, the members of the inclusive family are counted as one shareholder as long as their election remains in effect. The members of the subsumed family are not counted as a separate shareholder.

The S corporation must be notified of the election. This notification should include:

1. The name of the family member making the election;
2. The common ancestor of the family to which the election applies; and
3. The first tax year the election is effective.

The election remains in effect until it is terminated. Forthcoming regulations are expected to address this issue in greater detail.

*In summary: This special election enables more business entities to benefit from the S corporation rules. It also paves the way for future expansion without forfeiting any tax breaks. Your tax advisers can provide the necessary assistance in this area.*

## Facts and Figures

### *Timely points of particular interest*

- **Green Day**—The IRS recently issued a new fact sheet explaining some of the points in the Energy Tax Incentives Act of 2005. The new law, which went into effect January 1, 2006, provides tax breaks to owners of homes, certain “green” (i.e., environmentally friendly) vehicles and energy-efficient commercial buildings. More information on these deductions and credits is available upon request.
- **Pointed Questions**—Do not assume the poor performers in your company know who they are. The best way to be sure is to ask. For instance, you might question an underachiever about the number of his or her errors or how the employee stacks up against others. They may be surprised to learn that they are not on a par with others—the first step towards getting there.