



DYER & ASSOCIATES, P.C.

Certified Public Accountants

10415 Armory Avenue

Kensington, MD 20895

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

September 2006

Client Information Bulletin

INSIDE

**Four Retirement Plans for
Small-business Owners**

**Helping Your
Child Buy a Home**

**IRS Disconnects the
Telephone Tax**

**What to Do About
Employee Blogs**

Facts and Figures

Perfectly Legal: When You Can Deduct Legal Expenses

Tax treatment based on type of fees

Can you deduct the legal expenses you pay during the year? There's no definitive answer to that question. While certain types of legal fees are currently deductible, others must be capitalized and still others provide no tax benefit whatsoever. With that thought in mind, let's take a closer look at the tax treatment for different types of expenses.

Basic rules: As a general rule, legal fees incurred by a business are currently deductible (assuming they are not capital expenditures). According to the relevant section of the tax law, you may deduct a legal expense that is "ordinary and necessary" to the conduct of your trade or

business. However, the rules are considerably more complicated for nonbusiness expenses.

To be deductible, a nonbusiness legal expense must be incurred due to one of the following circumstances:

- ❖ The collection or production of taxable income;
- ❖ The management, conservation or maintenance of income-producing property; and
- ❖ The determination, collection or refund of any tax.

While nonbusiness legal expenses incurred in connection with a rental property may be deducted from your annual gross income, other costs generally are deducted as miscellaneous expenses. **Key point:** Miscellaneous expenses are deductible only to the extent the total for the year exceeds 2% of your adjusted gross income (AGI). In other words, you may not get the full tax benefit of these legal expenses.

Example: Ms. White has an annual AGI of \$100,000. In 2006 she incurs \$2,200 in miscellaneous expenses, including \$1,000 for legal expenses related to personal stock investments. As a result, White can deduct only \$200 (\$2,200 less 2% of AGI) on her tax return.

As a general rule, legal expenses incurred to acquire property or to defend or protect its ownership must be capitalized and added to the “basis” of the property. This may allow you to claim depreciation deductions over a period of time or cut your taxable gain when the property is sold. Similarly, legal fees that are incurred in connection with buying a

personal residence are added to its basis. When the home is sold, legal expenses may reduce the taxable gain.

On the other hand, legal costs related to personal or family matters generally do not provide any tax benefit. This includes fees paid in connection with a divorce or separation. **Exception:** The portion of the cost associated with determining the tax ramifications of alimony or other tax aspects may be deductible.

You should ask your attorney for an itemized bill spelling out the cost for various services rendered. At the very least, make sure your attorney specifies the amount of the fee (if any) that is tax deductible. This is particularly important in the estate-planning area, where taxes can be a significant factor.

Note that similar principles apply to the accounting profession. For example, many accounting fees incurred in connection with a business can be deducted currently. Further guidance can be provided upon request.

Four Retirement Plans for Small-business Owners

Choices abound for operations of all sizes

Until recently, the retirement plan options available to small-business owners and self-employed individuals were limited. But now you can choose one of these four types of plans.

1. Simplified Employee Pensions (SEPs): A SEP is generally exempt from the reporting requirements for other qualified plans. With a SEP, you must make contributions on behalf of all employees age 21 or older who have worked for a company during three out of the last five years (absent any union agreement).

For 2006, you can make a deductible contribution up to the lesser of 25% of compensation or \$44,000 (the defined contribution plan limit). The maximum amount of compensation taken into account for this purpose is \$220,000. Contributions are discretionary, so you are not locked into a figure for the year.

As with other qualified plans, distributions must begin by April 1 of the year following the year in which you turn age 70-1/2. If you take an early distribution, you will trigger a 10% tax penalty, unless an exception applies.

2. Savings Incentive Match Plans for Employees (SIMPLEs): A SIMPLE is only available to employers with 100 or fewer employees. Like SEPs, SIMPLEs are exempt from most reporting rules. **Key difference:** A company cannot contribute to a SIMPLE in a year in which it maintains another qualified plan.

For 2006, an employee may elect to contribute up to \$10,000 to the plan. If you

are age 50 or older, you can add a “catch-up contribution” of \$2,500. As a general rule, the employer may provide matching elective contributions subject to nondiscrimination rules. The rules for mandatory distributions after turning age 70-1/2 also apply to SIMPLEs (but the 10% penalty tax is increased to 25% for early withdrawals in the first two years).

3. Keogh plans: To set up a Keogh plan, you must be a self-employed individual. It does not matter if you have any other employees or not.

The amount you can contribute annually depends on whether the plan is a defined contribution or defined benefit plan. For 2006, the maximum amount you may contribute and deduct for a defined contribution Keogh is the lesser of 20% of earned income or \$44,000.

With a defined benefit Keogh, contributions are actuarially computed. You can provide an annual retirement benefit of the lesser of 100% of earned income for the three highest-paid years or a specific dollar amount adjusted for inflation (\$175,000 for 2006). The rules for distributions from qualified retirement also apply.

4. Solo 401(k) plans: A 401(k) plan generally combines elective deferrals with matching contributions by the employer. The contributions are made on a pretax basis. The rules for contributions and distributions from qualified plans generally apply to solo 401(k) plans.

Assuming you are the only employee, you don't have to worry about nondiscrimination rules. There is an annual

dollar cap on the elective deferrals that can be made to a solo 401(k) plan. For 2006, the limit is \$15,000 (plus a catch-up contribution of \$5,000). Employer contributions may be made up to the limits for defined contribution plans.

Which type of plan is best for you? Everyone's situation is different. Discuss the options with your professional advisers.

Helping Your Child Buy a Home

Equity sharing is a possible solution

With today's housing prices, it is often difficult for a young couple to scrape together enough money for a down payment. If you can simply give your child the money needed to buy a home -- that's great. But you may not be able to be so generous.

One possible solution is to enter into an “**equity sharing**” arrangement with your child. As the name implies, you share the ownership rights in the home, but you get to keep most of the tax breaks. After a specified period of time, you sell your interest in the home to your child.

With this type of arrangement, your children can gain a foothold in the housing market without dire consequences. At the same time, you may be able to claim tax deductions that can benefit people in your high income tax bracket.

Hypothetical example: Let's say your daughter is getting married in June and would like to move into a single-family house. Unfortunately, the newlyweds cannot afford the home they have their hearts set on. Instead of letting the couple pass up their dream house, you agree to buy 50% of the home through an equity sharing arrangement.

For starters, you pay half of the down payment for the home and the young

couple pays the other half. They move into the house and pay you a fair rental value in return. Then you use the rent money to pay expenses such as homeowner's insurance, repairs, property taxes and mortgage interest. The newlyweds are required to pay any remaining amounts. Both parties agree to split the cost of any capital improvements to the home.

Finally, the agreement includes a provision that the home is to be sold after five years (or some other period of time). The occupants are given the right of first refusal. After five years on their own, they should be able to come up with the money needed to buy you out.

Now let's see what you have accomplished. The rental income is offset by the available deductions for insurance, repairs, property taxes and mortgage interest plus depreciation based on 50% ownership of the home. You must legally own 50% of the home to claim a deduction for that percentage of the interest. **Caution:** Make sure you charge a fair rental value to the occupants or the IRS may challenge the deal.

If you show a loss for a given year, it is treated as a **passive activity loss (PAL)**. You can generally use the PAL to offset up to \$25,000 of ordinary income such as salary. If your other annual income

exceeds \$150,000, the PAL is carried forward to future years. And, when you finally sell your interest in the home, any gain is taxed at favorable capital gain rates.

Of course, the newlyweds will be short-changed on their share of the usual tax deductions. But the tax breaks are worth a lot more to you in your high tax

bracket than they are to the young couple in their lower bracket. Plus, they are able to live in -- and eventually own completely -- the house of their dreams.

***Reminder:** Equity sharing usually involves family members, but it can also work with nonrelated parties. In any event, be sure to consult with your professional advisers.*

IRS Disconnects the Telephone Tax

After suffering several losses in court cases, the IRS has finally conceded that long-distance phone services are not subject to federal excise tax. As a result, both individual and business taxpayers may qualify for refunds or credits on their 2006 tax returns.

Background: The excise tax on long-distance services was first imposed in the late 1800s to help finance United States efforts in the Spanish-American War. In a new ruling, the IRS has said it will issue credits or refunds of excise taxes paid on long-distance services billed between February 28, 2003, and August 1, 2006.

The IRS has stated that it will stop collecting the current 3% tax after July 31, 2006. In addition, it clarified that the tax would not apply to “bundled” services (i.e., local and long-distance service provided under the same charge). However, the tax will continue to be collected for local-only services.

Furthermore, the IRS also noted that the federal excise tax should not apply to wireless telephone services and prepaid calling cards.

Hold the line: We will have more to report on the process for receiving refunds and credits in the coming months.

What to Do About Employee Blogs

Increased blogging at work causes concern

A new threat to the workplace is coming from a surprising source: the computers that your employees are using to do their work. Specifically, we are referring to “blogs” and the practice of “blogging.” It may seem harmless at first, but employers are now waking up to the potential dangers.

What is a blog? Essentially, it is a Web site journal displaying a running commentary by the author (i.e., the blogger). It may also include links to comments on certain postings. According to a recent report, an estimated 30 million Americans are readers of blogs, while about 8 million take credit for being a blogger.

In a blog, the commentary can cover virtually anything and everything, ranging from personal information to politics and sports to random observations. It requires only basic computer skills, and the necessary software is readily available.

What’s the harm if an employee is a blogger? The employee may use the blog for issues relating to his or her employment. He or she could include discussions about the employee’s supervisor or co-workers, human resource issues, details of the employee’s job and other proprietary information -- just to name a few examples. As you might imagine, the repercussions from such disclosures can be significant -- in some cases, it could even lead to the downfall of a company.

Increasingly, employers are taking proactive steps to reduce their risks. In several highly publicized cases, employers have even terminated employees for the comments they have posted on their blogs. Other employers are in the process of developing company-wide policies concerning blogging.

Some of the common features of such policies require employees to:

- Identify themselves on the blogs;
- Establish that they speak for themselves, not the company;
- State their connection to the company if they discuss employment matters;
- Preserve the confidentiality of sensitive materials; and
- Avoid discussions of any customers, clients, vendors, suppliers, etc. without written approval.

These precautions may be especially important to employers in industries that deal with sensitive business information. You may want to consult with legal counsel concerning the application of a formal policy.

Practical advice: *Don’t simply ignore or “pretend not to see” blogging in the workplace. This seemingly innocuous practice could have dire repercussions for your business.*

Facts and Figures

Timely points of particular interest

- Direct Deposit Options -- Starting with 2006 tax returns, you will have more options when you are entitled to a federal income tax refund. The IRS will allow you to directly deposit the funds into a checking, savings or retirement account. According to a new IRS release, you can use one, two or all three of these accounts. To accommodate your refund choices, the IRS is devising a new election form.
- Computer Fixes -- If you are experiencing a minor computer problem, one of the simplest solutions is to simply reboot your computer. This can work for certain types of software, word processing programs and Internet connections. Then wait at least 10 to 15 seconds before you start the computer up again. If this “quick fix” works, you may have saved yourself a lot of time and aggravation.