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Client Information Bulletin

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Beware of Rising IRS Audit Rates

New data pinpoint areas of concern

The latest data released by the IRS indicates that audits are on the rise. The new IRS Data Book for the 2006 fiscal year shows the number of examinations increased for virtually every category of taxpayer based on type (individual or business entity) and income level.

Furthermore, the IRS intends to keep the pressure on as it attempts to close a perceived \$300 billion "tax gap" in revenue. The Data Book shows the following:

* The IRS audited about 1.3 million individual tax returns, 41,646 employment tax returns and 28,799 corporate tax returns.

* Audit rates for individuals with an adjusted gross income between \$50,000

and \$100,000 increased from .57% in 2005 to .60% in 2006.

* Audit rates for self-employed filers with gross receipts above \$100,000 jumped from 3.65% in 2005 to 3.90% in 2006.

* Examinations of S corporation returns increased from 0.30% in 2005 to 0.40% in 2006.

But audit rates of non-S corporations remained at 1.20%.

Although the exact process for selecting taxpayer returns for audits is not known to outsiders, be aware of the following areas that could lead to inquiries:

Charitable donations: The IRS recently tightened the rules for substantiating chari-

table donations. In particular, the IRS is concerned that taxpayers are overinflating the value of donations of property. Giving large gifts could attract the attention of the IRS, especially if the amount of your donations is disproportionate to your annual income.

Self-employed individuals: The IRS realizes there is a temptation to blur the distinction between business and personal expenses. Thus, it may examine returns of self-employed individuals more closely than most other taxpayers, especially for those with a six-figure income. Be sure you can substantiate sizeable deductions for business automobiles and home offices.

Hobby losses: Similarly, the IRS may be suspicious of taxpayers who regularly claim losses from sideline business activities. It may claim the “business” is really a “hobby” in disguise. In that case, deductions are generally limited to the amount of hobby income.

Note: An activity is presumed not to be a hobby if profits result in three out of five consecutive years.

Matching capital gains and dividends: Understandably, IRS computers may zero in on tax returns where capital gains and dividends reported on Forms 1099 do not match up with the income reported on a taxpayer’s return. This same principle applies to Schedules K-1 reported by S corporations and partnerships. Such omissions could lead to a subsequent audit.

Travel and entertainment (T&E) expenses: This area has long been a hot button for audits. The IRS imposes strict record-keeping requirements for T&E, especially with regard to actual expenses deducted for the business use of vehicles. However, if you maintain the necessary proof, there is no reason to shy away from claiming legitimate deductions.

Other items considered by the IRS to be abusive, such as certain offshore tax shelters and other tax avoidance schemes, are definite red flags to avoid. It is more important than ever to ensure that all income is properly reported and that deductions and credits can be substantiated. This is the best way to meet any challenges to your return.

Keeping Top Employees in the Fold

It is hard enough to find top-quality workers for your company. But enticing “rising stars” to stay long-term may be even more difficult. Although there are no absolute guarantees, consider these four ideas for retaining top employees.

1. Hold “stay” interviews. As opposed to an exit interview, this allows you to address issues before they become the cause of an employee’s departure.
2. Grant employees more flexibility. By giving your top workers room to spread their wings, they will be more productive and challenged in their jobs.
3. Let them try something new. Practically every worker will become bored if he or she stays stuck in the same routine. Your best workers will probably enjoy diversions.
4. Open your eyes. Consider what is best for your employees’ careers rather than just what is best for the company. This may instill greater loyalty.

Of course, there are no guarantees that your best employees will not walk away for a better offer. But some top performers may return in the future if you treat them right now.

Monitoring Outside Conduct of Employees

Right-to-privacy issues may surface

Suppose you find out that one of your company's top salespeople is secretly dating an executive who works for your main competitor. Could it be grounds for disciplinary action or discharge?

Federal law is not entirely clear in this area. Such an action could trigger a lawsuit based on discrimination or invasion of privacy. As a rule of thumb, employers have more leeway to regulate off-duty conduct of workers when the activities are illegal, especially if it specifically relates to the job. Otherwise, it is a slippery slope to navigate.

In addition, many states have enacted laws that prevent employers from discriminating against employees who participate in legal activities when they are outside the workplace -- despite the fact that those actions may prove to be detrimental to the company.

Even in states that do not provide a statutory right to privacy, it is generally illegal for an employer to unreasonably intrude on an employee's "seclusion." This refers to the physical areas where an employee has a reasonable expectation of privacy. Significantly, an employer cannot physically enter an employee's home without consent.

The following are several key instances involving off-duty conduct:

Drug testing: As a general rule, drug testing is permitted in the course of a job application if the employee performs work that is security-sensitive or if the employee has given the employer cause to believe that he or she is impaired by drugs at work.

Religious beliefs: An employee's religious beliefs (and activities relating to those beliefs) are generally protected by both federal and state laws. However, if an employee exhibits unreasonable behavior in the workplace -- for example, attempting to convert other employees -- he or she may be subject to discipline.

Outside employment: There is no strict legal prohibition against moonlighting. However, an employer is able to restrict after-hours work that is in conflict with its business. As a result, if an employee begins working for a direct competitor, it may be just cause for discipline or discharge.

Marital status: Generally, employers cannot discriminate on the basis of marital status or monitor such status, except for its need to regulate employee benefits such as health insurance. But the legal boundaries can become blurry when one spouse applies for a job where his or her spouse is a supervisor or, even more tenuous, if the spouse works for the competition.

Illegal activities: It is questionable whether an employer may discipline or discharge employees who have been arrested for driving while intoxicated or for the commission of a crime. State law often offers legal protection to the employee. Generally, employers may investigate further only if the conduct will have a direct impact on the business.

Clearly, each case must be analyzed on its own merits. You can rely on your business adviser for guidance.

Joint Ownership: Is It Right for You?

Consider all estate-planning ramifications

Although joint ownership is often the best way to own property, it is not the only way. It is important to consider other estate-planning aspects.

Key point: There are several forms of joint ownership. For example, suppose you and a sibling each own an undivided one-half interest in a home. You are considered to be “tenants in common” with each party owning a one-half interest. If you die first, the property is bequeathed to whomever you choose. In contrast, property owned by joint tenants with a right of survivorship automatically passes to the survivor when the other owner dies.

The pros and cons: Joint tenancies have both advantages and disadvantages. On the plus side, property held in joint tenancy may be transferred smoothly to the survivor. The probate process is avoided, and the survivor generally receives the property without delay. In addition, estate administration expenses may be reduced. For instance, an elderly person may decide to place funds in a joint account with an adult child. Result: The child can make withdrawals for the parent when sickness or other conditions affect the parent’s ability to function. However, joint ownership may also have adverse effects. For instance, if you own property jointly with a relative, it may be subject to your relative’s creditors.

Federal estate-tax consequences: If you own property with your spouse as joint tenants with rights of survivorship, one half of its value is presumed to be included in the estate of the first to die -- no matter who paid for it. Initially, the property is

exempt from federal estate tax under the unlimited marital deduction. When the survivor dies, however, the entire value of the property is included in his or her estate.

Example 1: Clyde buys a \$400,000 residence and names himself and his spouse, Bonnie, as joint tenants. When Clyde dies, the house is worth \$600,000. Although the \$300,000 is included in his gross estate, it is sheltered by the marital deduction. Bonnie dies three years later when the home is worth \$650,000. Result: The full \$650,000 is included in her gross estate (but all or part may be sheltered from federal tax by the federal estate-tax exemption).

For non-spousal joint tenancies, the full value of the property is included in the taxable estate of the first one to die. If the survivor contributed toward the purchase of the property, that amount is reduced proportionately. In any event, the full value not included in the estate of the first tenant to die is included in the survivor’s estate.

Example 2: Thelma buys a home and names her granddaughter, Louise, as a joint owner. Assuming Thelma dies before Louise when the home is worth \$500,000, the entire \$500,000 is included in Thelma’s estate. But if Louise had paid half of the purchase price, only \$250,000 would be included in Thelma’s estate. Similarly, if joint tenants receive property as a gift or inheritance, only a proportionate interest is included in the estate of the first tenant to die.

Of course, estate planning must also take state law into account, particularly in those states where community property laws apply.

Four Options for Retirement Plan Payouts

Weigh choices when leaving a company

Are you in line to receive benefits from a qualified retirement plan at work? For instance, you might be switching jobs or retiring completely. What should you do with the money?

There are four basic options to consider:

1. Take the money and run.

Remember that a lump-sum payout is taxed at ordinary income rates (reaching as high as 35%). Also, you generally are required to pay a 10% penalty tax -- on top of the regular income tax -- for distributions made before age 59½.

However, if you were born before 1936, you may qualify for special income averaging. In effect, the distribution is taxed as if it were spread out over ten years (plus favorable capital gain treatment may be available).

2. Receive annuity-type payments.

By choosing to receive a series of payments, you effectively spread out the tax liability over time. Typically, the payments are based on your life expectancy or the joint life expectancy of you and your spouse. The payments end upon the death of the surviving spouse.

3. Leave the money in the plan.

If it is permitted, you can leave the money right where it is -- in the plan of your former employer. The funds in your account may still provide earnings with-

out any current tax erosion. However, it may be difficult to manage the funds or gain access to them, especially if you are leaving on bad terms.

4. Roll over to another plan or IRA.

Instead of taking out cash, you can elect to roll over all or part of your account balance to another qualified plan (say, the plan at a new employer) or an IRA. If the rollover is completed within 60 days, there is no current tax liability on the transfer. Then you can take withdrawals of cash as needed, subject to regular income tax.

But there's a catch: The IRS requires your former employer to automatically withhold 20% of a lump-sum distribution to offset your potential tax liability. To roll over your entire account balance, you must come up with 20% of the amount out of your own pocket. Then you can recoup this amount when you file your tax return.

This result can be avoided by arranging a trustee-to-trustee transfer where the cash never touches your hands. In that case, you avoid the 20% withholding rule.

As you can see, you will be facing some difficult choices on retirement plan payouts. Consult with your trusted adviser for your situation.

Facts and Figures

Timely points of particular interest

- Keep on Trucking -- In a new case, an Ohio trucking firm contracted with drivers to operate as independent contractors. But the firm still had significant control over their activities. For instance, it made all the assignments, supervised all the work and confirmed deliveries. It also took full responsibility for repairs and maintenance. Result: Despite the existence of written contracts, the Tax Court determined that the drivers should be treated as employees, not independent contractors.
- What's in a Name? -- According to a new survey, almost 50% of the employees surveyed believe they are underpaid in their current jobs. Yet only 22% of the participants are actually underpaid, based on the fair-market value for their positions. Why the discrepancy? One potential reason is over-titling. In other words, when someone is given a bigger or fancier title, that person may feel he or she deserves to be paid more. Suggestion: When possible, keep job titles realistic.