

The FORUM

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UNLUCKY 7: THE TOP TAXPAYER MISTAKES

According to Jeff Schnepfer, author and a former professor of taxation, accounting and finance, these are the top 7 mistakes made by taxpayers.

1. Bad math

According to the Internal Revenue Service, errors in addition and subtraction are the No. 1 mistake taxpayers make. All returns are examined for mathematical errors. Mistakes in arithmetic or in transferring figures from one schedule to another result in an immediate correction notice. If the error leads to deficiency, you automatically receive a bill for that amount. If you have overpaid, the excess is applied to future taxes, credited or refunded at your request. You can't appeal such corrections, but you can ask in writing that they be reviewed if you think the IRS made a mistake.

Check the figures on the IRS correction notice. They have been known to make their own mistakes. Arithmetic mistakes alone rarely lead to audit.

2. Forgetting about interest and dividends

Interest and dividend payments are reported to the IRS by banks, brokerage houses and other financial institutions, and are cross-checked in about 96% of the cases. The IRS attempts to match about 100% of the returns that they receive electronically or on computer tape and more than 50% of those that are on paper. As a result of this cross-checking the IRS sends out notices for taxes and interest on overdue taxes, income, and other payments that were not reported. Unfortunately according to the General Accounting Office, the government agency which audits the IRS, about half the 10 million correction notices the IRS sends each year are "incorrect, unresponsive, unclear, or incomplete."

If you get an incorrect notice, follow the appropriate procedures to correct it, or contact your local problem resolution office.

3. Not properly tracking investment basis

A basis is the original value of your investments. If you have mutual funds, for example, each year those funds will report to you the dividends and capital gains you earned. These dividends and gains will be taxed to you in the year reported.

When you sell these funds, your gain will be the difference between what you receive on the sale and your basis. If you have reinvested taxable gains from these funds, those gains (all of the dividends and capital gains reported) are added to your basis to reduce your gain (or increase your loss). For example, if I bought a fund for \$1,000 and reinvested \$200 in dividends and \$50 in capital gains, basis is now \$1,250. If I sell the fund for \$1,500, I only have to recognize \$250 in gain on that sale. That's much better than reporting a \$500 gain for tax purposes. To make sure you have the right basis, check with your fund company or broker. If you can't get the data by the April 15 filing deadline, you can either file for an extension or file an amended return later.

4. Getting married

I'm not saying don't get married. What I am suggesting is that you postpone a Christmas wedding until after the first of the year. The savings could pay for a sizeable chunk of the honeymoon.

Although the new 2003 tax law attacked some problems of married couples and their taxes, there remains a marriage penalty if both of the partners work. For example, in 2003, two individuals who each earned \$68,800 in taxable income would pay \$14,010 each in taxes for an outlay of

\$28,020, according to the 2003 IRS tax tables. As a married couple their income would be \$137,600. They would have to file either a joint return or a return as married filing separately. Either way they would be required to pay \$28,708.50 in taxes --\$688.50 more than what they would have paid had they remained single. This is because we have a progressive tax system where incremental dollars are taxed at higher marginal rates. The second \$68,800, therefore, would be taxed at a higher marginal rate than the first \$68,800.

This tax penalty on marriage is no longer compounded by the standard deduction, thanks to the 2003 tax law. A married couple is allowed \$9,500 in nontaxable income in 2003. Two single workers get \$4,750 each for a total of \$9,500.

However, high-income earners who marry will lose write-offs for personal exemptions faster than their single counterparts. Marriage may also phase out potential IRA deductions. Of course, if only one partner is employed, marriage would provide a tax savings. They could file jointly, at rates lower than for single taxpayers.

5. Losing track of receipts

In the real world, you either have proof of your deductions or you lose them. Always keep your receipts and checks if you want to deduct. Deductible receipts and checks should always be kept for at least three years from the due date of the year filed, or the actual date filed. Unless the IRS can prove fraud, the statute of limitations to disallow deductions is three years. Once this three-year period has elapsed the IRS is prohibited from even questioning these deductions. Receipts of expenses that may be deducted in later years, such as improvements to your house, should be kept for three years after the return on which they are claimed.

Remember, the IRS is a paper-based bureaucracy. Separate your receipts and checks by deductible category and make any audit easier for the auditor. The easier you make it for them, the more they believe and accept that you know what you are doing, and the easier they will be on you.

6. Failing to bunch deductions

There are a number of deductions that are allowed only after you reach a minimum amount. For example, only those medical expenses that exceed 7.5% of your adjusted gross income are allowed. Alternative miscellaneous deductions are allowed only to the extent that they exceed 2% of your adjusted gross income.

Your best planning strategy here is to bunch your deductions into the same year to exceed these minimum requirements. For example, if you have an adjusted gross income of \$100,000, only those medical expenses in excess of \$7,500 can be deducted. In order to exceed this "floor", you might prepay your orthodontia bill or pay your Jan. 1 medical insurance on Dec. 31. With miscellaneous itemized deductions, and the same adjusted gross income, you need to exceed \$2,000 in expenses. Prepay your tax preparer on Dec. 31 for that year's taxes or bunch your investment subscriptions and expenses to exceed that amount.

7. Forgetting to donate unwanted items to charity before December 31.

Give your old clothes, furniture, appliances and other items away to your favorite charity. The wholesale value of those contributions is allowed as a charitable deduction. Make sure that you get a receipt. No receipt, no deduction. The receipt doesn't have to list what you gave or what the items were worth, but it must be dated. You can fill in the details yourself. Remember, too, that you can deduct 14 cents a mile for any charity work, including the trips to bring the old clothes to the charity.

How to Get Fast Depreciation Deductions

Naturally, it is important for a business to claim every possible deduction it is entitled to. But owners should pay particular attention to the biggest deduction on the block: depreciation. In effect, the tax law allows a business to recoup the entire cost of qualified property it uses in the regular course of business. The only problem is it takes time. Fortunately, however, the cost of depreciable property can be written off faster than ever before, thanks to several recent tax-law changes. Here is a closer look:

MACRS: As a general rule, depreciation deductions are computed under the Modified Accelerated Cost Recovery System (MACRS). Depending on the "class" of property, the property is written off under the 200 percent declining-balance method, the 150 percent declining-balance method or the straight-line method. (In certain cases, an alternate depreciation method may be available.) Alternatively, a business may elect to use the straight-line method for all property within a recovery class placed in service during the tax year.

Generally, property placed in service in 2003 is entitled to the equivalent of a half-year's deduction regardless of the actual date it occurs. This is called the mid-year convention. Note: A less favorable mid-quarter convention applies if the cost of property (other than real estate) placed in service in the last quarter of the year exceeds 40 percent of the cost of all property placed in service during the year.

Bonus depreciation deductions: The 2002 tax act created a new "bonus" depreciation deduction equal to 30 percent of qualified property (e.g., MACRS property with a recovery period of 20 years or less). Under the 2003 tax act, the deduction was increased to 50 percent of the cost. The 30 percent deduction applies to property acquired after September 10,

2001 and before May 6, 2003; the 50 percent deduction applies to property acquired after May 5, 2003 and placed in service before January 1, 2005.

Section 179 expensing: Under Section 179 of the tax code, a business may "expense" (i.e., currently deduct) the cost of qualified property placed in service during the year. The maximum expensing allowance for 2003 was quadrupled from \$25,000 to \$100,000 by the 2003 tax act. However, the allowance claimed by a taxpayer in any tax year is limited to the amount of taxable income from business activities. Furthermore, the maximum allowance is reduced dollar-for-dollar for asset purchases in 2003 above \$400,000 (up from \$200,000).

When these three tax breaks are combined, it may be possible to write off most or all of the cost of business assets purchased in 2003.

Simplified example: XYZ Corp. buys new five-year business equipment costing \$150,000. After claiming the \$100,000 expense allowance, XYZ is entitled to deduct an extra 50 percent of the remaining \$50,000 cost under the bonus depreciation tax break. Finally, the MACRS depreciation of \$5,000 is claimed on the \$25,000 balance. Result: XYZ can write off a total of \$130,000 (\$100,000 + \$25,000 + \$5,000) in the first year of ownership.

Be aware that other special rules apply to depreciation deductions. For instance deductions for luxury passenger vehicles are strictly limited despite the availability of the usual depreciation methods. See your professional advisor for more details concerning your specific situation.

You should also consider the impact the new depreciation rules have on future years. If you have a large purchase in the current year and depreciate it entirely, and have little or no purchases in subsequent years, your current deduction may cost you in those following years

Making Tax-free Gifts of Family Business Interests and Investments

Family limited liability companies (FLLCs) and family limited partnerships (FLPs) have become popular financial-planning vehicles in recent years. They permit parents to give their children a share of their business or investments without giving up control. In the case of FLLCs, children are given a minority share of the company's units, while the company's day-to-day activities are controlled by a manager selected by the majority owners (the parents). With an FLP, the children are limited partners, while control of the partnership remains in the hands of the general partners (the parents).

FLLCs and FLPs offer several benefits from a tax standpoint. For example, income generated by an FLLC or FLP is taxed directly to the FLLC members and FLP partners. So when parents make gifts of FLLC and FLP units to their children, they are effectively shifting a portion of the income from the underlying assets to the children. Because the children are, presumably, in a lower tax bracket than the parents, this income shifting reduces the overall tax bite.

What makes FLLCs and FLPs particularly attractive is the ability to minimize estate and gift taxes. A gift of an interest in an FLLC and FLP is a taxable gift, but the interest is removed from the parents' gross estate. Thus, appreciation in the value of the interest accruing after the gift is made is not subject to gift or estate tax.

In addition, the potential gift tax is reduced because of the use of minority discounts in valuing the gifted interests. Due to the lack of control and marketability, the units are valued below the pro rata value of the underlying assets.

Annual gift-tax exemption: In the past, most people thought that outright FLLC or FLP gifts qualified for the annual gift-tax exemption (currently \$11,000 per recipient), which would further reduce any gift-tax liability. But a recent decision by a federal appeals court has raised some doubts about the use of the gift-tax exemption (Hackl, CA-7, 7/11/03).

By law, the gift-tax exemption is available only for a gift of a "present interest"—where the recipient has an immediate right to the use,

possession or enjoyment of the gift. The appeals court ruled that the gifts in question were not present-interest gifts.

The case involved an FLLC in which the owners transferred units to their children and grandchildren. Under the operating agreement, members of the FLLC could withdraw property or sell their units back to the FLLC only with the manager's approval. If a member transferred his or her units without consent, the person receiving the units would not have membership or voting rights.

The appeals court said that the operating agreement clearly foreclosed the children and grandchildren's ability to realize any substantial present economic benefit. Although the units that the owners gave away had the same legal rights as those that they retained, the restrictions on the transferability of the units meant that they were essentially without immediate value to the recipients.

There may be ways to structure FLLC or FLP gifts to retain the gift-tax exemption. For example, when the present-interest issue has arisen with trusts, parents have been able to qualify for the gift-tax exemption by giving their children a right to withdraw funds from the trust for a very limited period of time. (This is commonly referred to as a "Crummey" power.) It's possible that a similar arrangement with an FLLC or FLP may withstand an IRS challenge.

Be aware that gifts of interests in a FLP or FLLC must be properly valued. This generally requires an appraisal by a qualified appraiser. The appraisal is of the value of the FLP or FLLC interest including discounts for lack of marketability and/or minority interests. These appraisals are expensive and should be done with each gift. Therefore, we recommend these arrangements for high value property only. Otherwise, the cost of operation may exceed the tax benefits.

Please contact us if you would like to learn more about the benefits of an FLLC or FLP.

How Small Businesses can Protect Themselves Against Business-to-business Fraud

The Federal Trade Commission (FTC) and the Better Business Bureau (BBB) receive thousands of complaints each year from small-business owners who were victims of fraud. Some of the more common "scams" include:

* Web site cramming--Charges for web site design services or features that were never ordered.

* Yellow Pages scam--Deceptive sales tactics that induce business owners to buy advertisements in small directories that have a limited audience.

* Not-for-profit scam--Ads sold for phony publications under the premise of helping a civic or public-safety cause.

Office-supply scams, however, are one of the most widespread. An estimated \$200 million per year is stolen from businesses, schools, government agencies and nonprofit institutions in the form of products such as paper, toner, light bulbs and cleaning material. Often the supplies were never ordered, are of inferior quality or are invoiced at artificially inflated prices.

The FTC has seen this as a huge problem and developed a special educational program known as Banish Office Supply Scams (Project BOSS) to help business owners. And they recommend that business owners implement several procedures within their companies to avoid these scams.

The agency suggests that a specific person or department be named to approve and document all purchases. Other employees could then be trained to redirect telemarketers to the designated purchasing agent. In addition, a policy should be established that invoices would not be paid until they are matched with goods or services actually ordered and received.

Furthermore, it is a good idea for business owners to buy from suppliers they know and trust. This philosophy ought to be shared with employees who are authorized to make purchases. They should also be instructed to be skeptical of unsolicited phone calls and that it is okay to say "no" to high-pressure sales tactics. Before placing orders with new vendors, designated employees must get their offer in writing.

When considering placing ads in phone books, business owners can weed out bogus telephone directories by contacting the Yellow Pages Publishers Association at (800) 841-0639 or visiting the web site at www.yppa.org.

Business owners can also avoid swindles by reviewing their phone bills as soon as they arrive. Charges for goods or services that they haven't ordered should be brought to the phone company's attention and a dispute filed.

Any business can be a victim of fraud. And even the best preventive procedures will not stop a determined scam artist who may send bills for goods or services that were never ordered. The law, however, allows recipients of such products and services to treat them as gifts and therefore ignore the invoice; they do not have to return the unordered merchandise.

Business owners who feel that they have been a victim of a scam can contact their state Attorney General's office or local BBB. Complaints may also be filed directly with the FTC by calling (877) FTC-HELP or at the FTC at the FTC web site at [https://rn.ftc.gov/pls/dod/wsolcq\\$.startup](https://rn.ftc.gov/pls/dod/wsolcq$.startup).

Seven Steps Toward a Succession Plan

After years of building up a business operation, the next step for many business owners is to think about an exit strategy. At this time, a succession plan may be the first order of business. Here are seven steps that a business owner can follow towards that goal.

1. Assemble a succession-plan team. Owners should not try to do this on their own. They should seek input from an attorney, accountant, and other key business advisors.

2. Appoint successors. It's important to groom the person who will be taking over primary control of the business. This may be a difficult decision, especially if there are several family members participating in the business, but postponing it can have a detrimental affect.

3. Put the plans in writing. In particular, a buy-sell agreement should be established that provides a blueprint for the sale of the business upon the death or disability of a business owner. The buy-sell agreement can be set up as a cross-purchase agreement between co-owners or partners, an entity agreement where the corporation redeems stock, or a combination of the two. A financial professional can help tailor the agreement.

4. Take out extra insurance. Typically, an insurance policy on the life of the business owner is used to provide the funds necessary to

accommodate a buy-sell agreement. The insurance proceeds will also be critical at a time when liquidity is needed. Similarly, a disability income insurance policy can cover the possibility of a severe disability.

5. Coordinate the succession with estate-planning efforts. Succession planning and estate planning usually go hand-in-hand. For instance, an owner might transfer ownership of the business interest to family members, including the groomed successor, to reduce potential estate-tax liability. With advance planning, the interest can be transferred without any dire gift-tax consequences. Note: This may involve the owner reducing his or her control of the business.

6. Communicate. The owner should talk things over with his or her family and business advisors and keep them up to date on the latest developments.

7. Review the plan periodically. Creating a succession plan is an ongoing process. For example, a significant occurrence, such as a divorce or termination of a key employee, may create the need to alter the succession plan.

Naturally, these seven steps cannot guarantee that a smooth transition will take place, but they provide a decided advantage for a business owner who is committed to the future of his or her company.

Locking Up Charitable Deductions

It's been said that "charity begins at home." That's also true when it comes to income-tax deductions. If proper records are kept, a taxpayer is entitled to deduct charitable donations on his or her personal tax return.

For starters, written acknowledgement must be obtained from a charity for contributions of \$250 or more. Substantiation is not required if the organization files a return with the IRS reporting the same information. The acknowledgement should include the amount of cash, a description of any property donations and a description and good-faith estimate of the value of any benefits received in exchange for charitable

contributions. Disclosure by the charity is also required for "quid pro quo" contributions of more than \$75.

If a taxpayer gives a gift of appreciated property to a charity, the deduction is generally equal to the property's fair-market value. However, an independent appraisal is required for property (other than most publicly traded securities) that is valued at more than \$5,000. Silver tax lining: The cost of the appraisal itself is deductible as a miscellaneous expense (subject to the 2 percent-of-AGI floor).

Defending Computers from Attack

Earlier this year, the "Blaster Worm" infected four versions of Microsoft Windows in hundreds of thousands of computers throughout the world. The Blaster Worm isn't the first virus to invade homes and businesses. It certainly won't be the last. Fortunately, several steps can be taken to keep these bugs from crawling along the Internet and into a computer. Many of the following can be easily and inexpensively accomplished.

- * Turn off high-speed Internet access when not in use.
 - * When choosing passwords, avoid common words or personal information.
 - * For PC users, download regular updates from Microsoft.
 - * Install an antivirus program and update it regularly.
 - * A few moments backing up files on a CD, floppy disk, or online service can save countless hours of recovery work.
 - * Create a "boot" disk in case a virus crashes the system so badly that it can't be rebooted off the hard drive.
- Depending on the computer's version of Windows, the utility for "add/remove programs" can be found either in the control panel or the startup menu. From there, follow the instructions for "startup disc."
- * Do not open e-mail attachments from unknown or suspicious sources.
 - * Download files first to a floppy disk or CD, then scan for viruses before opening or saving to a hard drive or network folder.

Loose Change

Insult to Injury--In a new case, a taxpayer received a damage award in connection with a civil action for malicious prosecution. After she initiated the action, the law was amended to limit the scope of the tax exclusion for damage awards to damages received on account of personal injury or illness. Nevertheless, the Tax Court concluded that the award was taxable, since it was not based on personal injury or illness (Venable, T.C. Memo 2003-240).

Shirking Responsibility--A president and sole shareholder of a company was held liable for the company's willful failure to remit employment taxes. Despite the fact that his father, the founder of the company, effectively controlled the corporate finances, the son was the responsible person and was aware that the employment taxes should have been paid (Lyon, CA-4, 7/11/03).

Watch Those Distributions--A taxpayer could not avoid paying tax on an IRA distribution he claimed was intended to be rolled over into a qualified retirement plan, but instead was rolled into a nonqualified retirement plan, but instead was rolled into a nonqualified annuity. He claimed it was a bank error, but the IRS countered by saying there was no evidence the bank made the error or that the taxpayer took steps to correct the mistake (Crow, T.C. Memo 2002-178).

Electronic Funds Transfer Act--What rights does an individual have if his or her ATM card is lost or stolen? Generally, if the problem is reported in a timely manner to the proper authorities, the cardholder won't be charged for withdrawals made by someone else. However, if there is a delay in notifying the issuer of the card, the cardholder can be liable for up to \$500, or an unlimited amount if the problem is not reported within 60 days.

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