

TAX & BUSINESS STRATEGIES

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Bookkeeping Tips to Keep the IRS Away

With such complex tax laws, it is commonplace for many small businesses to make mistakes with bookkeeping and filing. One way to avoid making errors is to be aware of the most commonly encountered pitfalls.

Receipts – Even though the IRS does not require receipts for meal and entertainment expenses of less than \$75, it would be wise to hang onto them. There is no better documentation than a credit card receipt since it has all the expense information required. All you need to do is write on the slip the purpose of the event, the individual you were with, and your business relationship with that person.

Auto Deductions – Since there are so many ways to compute deductions for the business use of a car, it is very easy to overlook the most beneficial options. However, regardless of the method used, make sure you keep track of the total and business use miles for the year since it is required for all options.

Reimbursable Expenses – Keep track of reimbursable expenses. Many business owners have a tendency to pay business expenses with out-of-pocket cash or with a personal credit card. Avoid having a non-reimbursed business expense by tracking those costs and substantiating the expenses.

Gifts – Do not overspend on gifts to clients and business associates. The IRS will allow a deduction of only up to \$25 worth of gifts to any individual per year. Being too generous will cost you. With only that first \$25 per recipient considered a deductible business expense, the rest will be nondeductible.

Business Equipment – Since equipment is considered a capital expenditure, it has to be depreciated. That is why lumping equipment together with supplies is not a good idea. This is true even when you elect to expense equipment purchases under Sec. 179. If the purchases are not reported properly, the IRS could rule that the expense was improperly characterized. If that is the case, you would not be entitled to the deduction claimed on your return. There could be other repercussions, leaving you with no current deduction at all.

For further clarification on any of the topics discussed, please call this office.

Dear Client:

Now that tax season is behind you, it is time to prepare for the 2005 tax year. This newsletter provides many useful tips to help you maximize your deductions and lower your tax liability. It is also designed to help you identify issues that may be relevant to your specific situation.

What sets off a red flag and how can you avoid being audited? The IRS uses computer matching programs to pick up unreported income and discrepancies on tax returns. This edition discusses the items that could set off an IRS inquiry to give you a better understanding of what is being monitored by these programs.

Another growing concern among taxpayers is the Alternative Minimum Tax (AMT), which is also covered in this issue. Many have felt the effects of the AMT and careful planning is needed to minimize its impact. Since this is an extremely complicated topic, we strongly encourage you to contact our office for assistance.

For those taxpayers that owe Uncle Sam a significant amount of money this year, check your withholding amount to make sure that you did not claim too many exemptions. If that does not correct the problem, then estimated tax payments might be necessary. Avoid getting stuck with a tax underpayment next year and call our office to discuss the best course of action.

If you would like a complete tax planning analysis, our services are available throughout the year.

We look forward to hearing from you!

IRS Has Your Numbers!

Correspondence from the IRS has a tendency to escalate a taxpayer's pulse rate. However, most of the communication received is not the feared "come on down" letter that requests an appearance for a face-to-face audit, but instead may only require a written explanation.

Generally, all types of income (wages, interest, dividends, etc.) are reported by the payer to the IRS, who in turn, matches the reported income to the recipient's tax return based on Social Security number (SSN). Over the past few years, the IRS has become very proficient in using their computer matching programs to pick up unreported income and other discrepancies on tax returns. Discrepancies will generate an IRS inquiry, so take note of the following items which are frequently monitored by the computer matching programs:

Dependent SSN – The IRS allows only one taxpayer to claim the exemption for a dependent. Frequently, a dependent will claim the exemption themselves, or in other cases, separated or divorced individuals will both attempt to claim the dependent. Expect correspondence when the exemption for any SSN has been claimed twice.

Gross Proceeds of Sale – All brokerage firms are required to report security sales to the IRS as "gross proceeds of sale" on Form 1099-B. The 1099-B copy provided to the account owner is generally combined with interest and dividend reporting requirements and included in a consolidated 1099 statement. These statements can be confusing, and the "gross proceeds of sale" is frequently buried in the multi-page statements. If a taxpayer fails to report these security sales, the IRS will treat the gross proceeds as all profit, recompute the tax owed, and send a bill.

Pension and IRA Rollovers – Unless it is a direct (trustee-to-trustee) rollover, the plan administrator is required to issue a Form 1099-R whenever a taxpayer withdraws funds from an IRA or other type of qualified plan. If the 1099-R income is not properly accounted for on the tax return, the IRS may treat it as unreported pension income and issue a revised tax bill. Even if it is directly rolled over, ALWAYS bring rollovers to our attention.

Alimony – The person paying alimony must include the recipient's name, address and SSN with the deduction claimed for alimony payments. The IRS will match the payments to income reported by the recipient. If the two amounts are not the same, the IRS will initiate correspondence to both parties.

Home Sales – Technically, escrow companies are not required to issue 1099-S forms to taxpayers who sell their primary residence for less than the home sale gain exclusion amount and certify that they meet the exclusion qualifications (\$250,000 for a single taxpayer and \$500,000 for married taxpayers). Despite this, many escrow companies choose to issue them, making it necessary to report the home sale and avoid IRS correspondence.

Home Mortgage Interest – Since all lenders who are in the business of lending money are required to report home mortgage interest, the IRS can verify the amount claimed as deductible mortgage interest on the Schedule A of a tax return, and any significant discrepancy can lead to IRS correspondence. If a private party holds the loan (not the course of business), Form 1098 is not required to be filed, but the taxpayer claiming the mortgage interest as a deduction is required to include that party's name, contact information and SSN on Schedule A. The IRS can then match the claimed interest deduction to the amount reported by the private party as interest income.

Education Benefits – Schools are now required to report the tuition payments qualifying for the Hope or Lifetime Learning tax credit or the tuition and fees deduction that were made during the year on Form 1098-T. Educational lenders report the amount of student loan interest paid on Form 1098-E. Both are used to match against claimed deductions and credits on the tax return.

Should you receive a notice, it is generally best to contact this office. Don't just pay the revised tax the IRS proposes. Frequently, the IRS notice is in error and attempting to respond to the notice without professional advice may create additional problems.

Refund vs. Underpayment: It's All About Your Withholding!

What did Uncle Sam surprise you with this year – a big tax refund or a huge debt to pay? The ideal situation is to owe a small amount at tax time. If you have a large refund coming your way, you just gave the government an interest-free loan. That money could have definitely been put to better use!

Instead of celebrating your good fortune, find a way to avoid giving the government free use of your money this year. Increasing the number of exemptions claimed on your W-4 or reducing your estimated tax payments should do the trick. You may even consider doing both! Just be careful not to go overboard and find yourself stuck with a tax underpayment. Your payments for the 2005 tax year should generally be enough to cover whichever of the following is the lower amount:

- 90% of your 2005 tax liability, or
- 100% of your 2004 tax if your 2005 income (adjusted gross income) is \$150,000 or less (110% if your AGI was over \$150,000).

For those taxpayers that end up owing more than 10% of their total tax bill, an interest-charge penalty could be imposed for not paying enough before filing. This scenario is the exact opposite of those receiving a refund. To avoid falling into this category, examine your paycheck to see how many exemptions you claimed. If too many exemptions were claimed, correct your withholding amount to ensure that it will cover this year's tax bill. File a new W-4 with your employer and claim fewer exemptions to withhold more from each paycheck.

Are you also receiving income from self-employment or through investments? This could be another reason for your tax underpayment. To fix this problem, start making estimated tax payments for this year or increase the amount of your payments if you already plan to make them. Keep in mind that estimated payments for the 2005 tax year are due on April 15, June 15, September 15, 2005 and January 16, 2006. Form 1040-ES must be filed with each payment.

By taking the appropriate course of action, you can avoid any unexpected blows next tax season. Please call our office to assist you with your 2005 tax projections, W-4 adjustments and safe harbor estimates.

Avoiding or Mitigating the Effects of the AMT

AMT is the acronym for Alternative Minimum Tax. It is a different (alternative), and generally punitive, method of computing income tax when either certain types of income receive preferential tax treatment or there are excessive deductions in certain categories. The AMT was originally designed to impose a minimum tax on higher income taxpayers who were avoiding taxes. However, years of inflation without corresponding adjustment to the AMT components have caused an increasing number of taxpayers to be subject to the AMT. The following six items routinely affect the average taxpayer:

Medical Deductions – These are allowed for the AMT computation, but only to the extent that they exceed 10% of a taxpayer's income. In contrast, the regular tax computation limit is a lesser 7.5%. Sometimes it is possible to defer or accelerate medical expenses from one year to another, such as paying the orthodontist in installments or all at once. If your employer offers one, consider participating in a flexible spending plan. It allows you to pay medical expenses with pre-tax dollars and avoid both the regular tax and AMT deduction limitations.

Tax Deductions – When itemizing deductions, a taxpayer is allowed to deduct a variety of taxes, including real property, personal property and state income tax. But for AMT purposes, none of the itemized taxes are deductible. For most taxpayers, this represents one of their largest tax deductions and frequently triggers the AMT. If you are affected by the AMT, conventional wisdom would dictate deferring tax payments to a subsequent year when the AMT may not apply. When deferring, care should be exercised in regards to late payment penalties and interest on underpayments for certain taxes. In addition, taxpayers can annually elect to capitalize taxes on unimproved and unproductive real estate. This means foregoing the deduction currently and adding the tax paid to the cost basis of the real property.

Home Mortgage Interest – For both the regular tax and AMT computations, interest paid on a debt to acquire or substantially improve a home or second home is deductible as long as the debt limit (generally \$1 million) isn't exceeded. This is true of refinanced debt, except that any increase in debt is treated as

equity debt. For regular tax purposes, the interest on up to \$100,000 of equity debt on the two homes can also be deducted. However, equity debt is not deductible against the AMT; neither is the acquisition or equity debt interest on a motor home or boat that qualifies as a second home. Therefore, taxpayers should exercise caution when incurring home equity debt. Generally, loan brokers are not aware of these limitations, and there are numerous pitfalls.

Miscellaneous Itemized Deductions – The category of miscellaneous deductions that includes employee business expenses and investment expenses is not deductible for AMT purposes. For certain taxpayers with deductible employee business expenses, this can create a significant AMT. Employees with significant employee business expenses should attempt to negotiate an "accountable" reimbursement plan with their employer. Under this type of plan, the reimbursement for qualified expenses is tax-free. Because the employee has been reimbursed, he or she no longer claims a deduction for the expenses, thus eliminating the miscellaneous deduction. Another strategy would be to defer the expenses to a year not affected by the AMT.

Personal Exemptions – Personal exemptions for dependents provide no benefit when taxed by the AMT method. Therefore, divorced or separated parents should carefully consider which party should claim the exemption for a dependent child.

Standard Deduction – Since the regular tax standard deduction is not allowed as an AMT deduction, taxpayers affected by the AMT should always itemize. Granted that the benefit of some deductions will be lost, there is still a partial advantage. Even the smallest of charitable deductions will benefit at a minimum of 26% (the lowest bracket for the AMT).

The AMT is an extremely complicated area of tax law that requires careful planning to minimize its effects. Please contact our office for further assistance.

Caution: *Although not frequently encountered, incentive stock options (ISO) can have a profound impact on the AMT, and clients are strongly encouraged to seek our advice prior to exercising incentive stock options*

Technology & Equipment: A Big Write-Off?

Small businesses are entitled to take a big deduction for all or part of their office equipment, furniture, computers and other "personal property" items purchased through the end of 2005. Business owners may deduct up to \$105,000 worth of purchases in 2005 on their federal returns.

This deduction does not work for land or buildings, or for improvements to buildings. In addition, the deduction amount is reduced if more than \$420,000 in equipment is purchased in 2005. Keep in mind that this tax break cannot be used to generate a loss on an individual return.

Under legislation passed by Congress in October 2004, this six-figure Section 179 write-off is scheduled to continue through at least 2007.

June 15, 2005:

- U.S. citizens living abroad on April 15, 2005 must file a 2004 Income Tax Return (if not already filed) or file for an extension.
- Second installment of 2005 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

June – July 2005:

- Time to review 2005 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

August 1, 2005:

- Due date for self-employed individuals and employers to file 5500 Series Returns for 2004 calendar year benefit plans (including Keogh/HR-10 plans). This due date is extended to August 1, 2005, since the normal July 31 due date falls on a Sunday.

August 15, 2005:

- Extended 2004 Individual Returns due (if four-month automatic extension was filed).
- Last day to file for an additional extension of time to file the extended 2004 Return. The additional extension, if granted by the IRS, can extend the filing date to October 17, 2005.

September 15, 2005:

- Third installment of 2005 Individual Estimated Taxes due.

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SINCE YOU ASKED...

YOU ASKED: I am self-employed and have a Keogh pension plan. Do I need to file a return for the plan?

ANSWER: Filing the annual return for pension plans, due on July 31, is a task generally handled by the plan administrator or the employer. Employers who fail to file on time, or obtain an extension to file, face a \$25 per day penalty. Plans that require an annual return to be filed are: (1) those with one or more plans with aggregate assets of \$100,000 or more, (2) those that were previously required to file a return for any year, and (3) those in their final year. Generally, for self-employed plans, the 5500EZ return can be used to file.

Now that the Simplified Employee Pension (SEP) plan limits have been increased to the same contribution levels as the Keogh plans, you may wish to consider rolling your Keogh account into a SEP plan. This will eliminate the filing requirement (except the final year requirement), since one-participant SEP plans are not required to file the annual return. Please call for assistance with the annual return.

YOU ASKED: My husband and I are planning to sell our home in the near future. This home was purchased for us by my parents a few years back, and its current value is significantly more than what they paid for it. Even though they held the title, we have been paying the mortgage and property taxes for the last several years. In addition, there was a verbal agreement between us that we could sell at any time. Is it true that we will be heavily taxed if we go through with the sale? Will this still apply if we purchase a home in our new neighborhood?

ANSWER: Since verbal agreements are insignificant in real estate (or to Uncle Sam), it was a big mistake not to hold the home's title in your names. The fact that you made the mortgage and property tax payments does not entitle you to claim the tax deductions for the payments you made all those years. Only individuals who have an ownership interest in the property can deduct the interest and taxes on their tax return. Your parents are not entitled to the interest and taxes deductions either. They may have held the title, but the payments came from your pocket.

Selling the home has another major drawback. If, after the sale, your parents honor the verbal agreement and give the proceeds to you, they will not only be responsible for the huge capital gains tax but may be faced with gift tax consequences. You should seek professional advice since the tax implications are quite complicated.