

# Tax News: Summer 2008

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## **Calendar**

- July 31 – Due date for 2nd Quarter Payroll Tax Returns. [Accounting information must be received by July 15<sup>th</sup>]
- August 15 – Extended due date for Non-Profit Tax Returns.
- September 15 – Extended due date for Corporation Tax Returns.
- October 15 – Extended due date for Personal, Estate & Trust, and Partnership Tax Returns. Last day to qualify for Economic Stimulus Payment.
- October 31 – Due date for 3rd Quarter Payroll Tax Returns. [Accounting information must be received by October 15<sup>th</sup>]
- Monthly Tax Deposits – Due on the 15<sup>th</sup> of each month. Must be transmitted one business day before the due date.

## Personal Taxes

### **Take Advantage of Tax Savings in a Down Market**

*Know when you have a deductible loss*

Just because the stock market lost money, doesn't mean you have a deductible loss. As long as you hold on to an investment, you only have a loss on paper. It's only when you actually sell the investment that you have a transaction to report on your tax return.

Fortunately, the tax law allows you to offset your capital gains by your capital losses. You can avoid or minimize taxable gain by selling two investments, one at a gain and the other at a loss.

However, an investment sold at a loss is not gone forever. If you believe it was a good long-term investment, you can buy it back. This strategy works very well if the price of the investment either stays the same or goes down even further. For example, let's say you sold 100 shares of ACME stock, which you purchased for \$3,000, and receive \$2,500 in cash proceeds from the sale. You can use the \$500 capital loss to offset capital gains or other income. Now, let's assume you want to buy back the ACME stock because it's a good long-term investment. If the price of 100 shares of ACME is \$2,500 or less, you can use the proceeds from the first sale to buy the stock back without having to provide any additional money. Caution: You must wait at least 31 days after the sale to repurchase the stock, otherwise the loss is not allowed.

If you are an IRA owner over age 59½, you can take advantage of the down market by taking distributions (either voluntary or required) of actual investments from your IRA, instead of the cash. You'll also escape the additional ten-percent premature distribution penalty. If there are investments within your IRA account that you want to hold long-term, but the value is currently down, you may want to consider having them distributed to you. Be aware that

this is a taxable event and the fair market value of the investment must be reported on your tax return. However, any appreciation earned after the distribution will not be taxable until you sell the investment. This provides several advantages:

- If you sell the investment, it will be taxed at the lower capital gains rate, which may be less than the rate for your IRA distribution;
- It reduces your IRA account so your required minimum distributions may be smaller in future years; and
- You can gift that investment to a person or a charity at a later date.

As always, consult your investment and tax advisor prior to taking any actions.

### **Refinancing Your Home Mortgage**

*What's deductible and what's not?*

While there are benefits to refinancing your home mortgage, most refinancing costs are not deductible on your tax return. There is one exception, however. The amount you pay for points, or prepaid interest, may be amortized over the life of your new loan. Although this might not amount to much when you spread it out over 15, 20, or 30 years, don't file away your closing papers quite yet.

When the note is paid off, you may deduct the remaining interest attributed to the points you paid the first time you refinanced. However, according to the IRS, refinancing must be done at a different lender. In addition, the closing costs may reduce the taxable gain when you sell your home.

### **Do You Have Debt Forgiveness?**

*You may not have to include it in income*

When you are liable for a loan but can't repay it, some lenders will forgive the debt. What many borrowers don't realize is that this cancellation of debt results in taxable income in the year of forgiveness. The lender usually will

issue a Form 1099-C to report the cancelled debt. If you receive one, don't ignore it. Be sure to give it to your tax preparer and discuss the circumstances surrounding the loan.

If you have cancelled debt but are bankrupt or insolvent, you may exclude the income on your tax return. To prove insolvency, your liabilities must exceed the fair market value of your assets immediately before the debt discharge. The amount of forgiven debt that can be excluded cannot be more than the amount your liabilities exceed the value of your assets.

In light of the current mortgage crisis, Congress has provided more relief for borrowers who couldn't pay their mortgages. If you have forgiveness of debt on the mortgage of your qualified principal residence (usually due to foreclosure), you don't have to recognize cancelled debt. The maximum amount of debt forgiveness eligible for exclusion is \$2 million. This relief is available for tax years 2007 through 2009.

### **Summer Day Care**

*What expenses qualify for the childcare credit?*

Parents who have children under the age of 13 are allowed a tax credit for childcare expenses paid so they can work. In the summer, many parents send their children to a structured day camp or an overnight camp for a week or two at a time. In most cases, the cost of sending your child to a camp of this nature does not qualify as a childcare expense, even if one of the reasons for sending the child is for care. In order for the cost of a day camp to qualify for a tax credit, the organization that conducts the camp must adhere to the same rules as a dependent care center.

If you need childcare in the summer months and hire someone to come and watch your children in your home, the amount you pay for care qualifies for the credit. However, if you wish to take the credit, you must get the caregiver's social security number and

address. Plus, you must issue that person a W-2 if you pay him or her more than \$1,600.

### **Interest on Summer Recreation May Be Deductible**

*Your motor home or boat could yield a deduction*

If you own a boat or motor home that is fully equipped with kitchen and sanitary facilities and you use it as a "second" home, the interest you pay on it is probably deductible on your tax return. Although a fishing boat without facilities won't qualify, most motor homes and campers do. If you're looking to buy a boat that doesn't qualify as a second home, you may want to consider paying for it with a home equity loan. That way, the interest is generally deductible. As with most tax rules, there are exceptions and limits so check with a tax expert before you sign on the dotted line.

### **Converting a Traditional IRA to a Roth?**

*You may want to wait*

At some point, taxpayers who have a traditional IRA may wish to convert it to a Roth. Roth IRAs are more flexible in that there are no required minimum distributions when the owner reaches age 70½. In addition, qualified distributions from a Roth IRA are not taxable.

Under current tax law, in the year you convert a traditional IRA to a Roth IRA, you must recognize the amount converted as income on your tax return, with the exception of any basis that may be in the traditional IRA. Depending on the amount, this can significantly impact your tax return. It can even bump you up into a higher tax bracket!

New legislation may make it worthwhile to hold off converting your IRA. For conversions made in 2010 only, the income from these conversions will only be includible in income ratably over the two-year period beginning in 2011. For example, let's say you convert a traditional IRA worth \$40,000 to a Roth during 2010. You won't need to report the conversion on your 2010 return, unless you elect to. Your

2011 and 2012 returns will each include \$20,000 of income from the conversion.

Generally, if your income is more than \$100,000, you currently are not eligible to make a conversion. However, beginning in 2010, this restriction will be eliminated and you'll be able to make conversions regardless of your income or filing status.

### **Charitable Remainder Trusts**

*Reduce your estate by gifting property*

There are many ways to contribute to a charitable organization. You can write a check, donate property, or give of your time. If you're planning for retirement, you might want to consider making a gift of a future interest in your property by establishing a charitable remainder unitrust or annuity trust. These trusts allow you to contribute the property and retain an income stream. You have an income interest in the property while the charity receives the actual property at some future date. At the time you contribute the property to the charitable remainder trust, you'll receive a charitable contribution deduction. This is a win-win situation for all. The charity can continue its work and you receive income and a charitable deduction while reducing your taxable estate.

### **HSA Funding Options**

*For a limited time only, there are more options*

Health Savings Accounts (HSAs) are a great tax vehicle for making the most of your medical expenses. However, it's not always easy to come up with the money to fund an HSA. Well, now there are more options available to HSA owners. At any time before 2012, you can make a one-time only tax-free rollover from an IRA to an HSA. This rollover amount may not be more than your HSA maximum contribution for your type of coverage, whether individual or family. The transfer must be made via a direct trustee-to-trustee rollover. Because the rollover is tax-free, you won't receive a deduction for funding the HSA in this manner. Also, if you have a flex spending account (FSA) or a health reimbursement arrangement (HRA), you can

make a one-time rollover into an HSA from one of these accounts. This tax-free rollover may not exceed the lesser of the balance in such an account on September 21, 2006, or on the date of the rollover distribution. Like the IRA rollover option, this rollover must also be completed via a trustee-to-trustee transfer. Talk to your tax preparer in deciding if one of these options is right for you.

### **Is an Inheritance Taxable?**

*In most cases, an inheritance is not taxable to you, but there are exceptions*

At some point, you may inherit money or property that, in most cases, is not taxable to you. Life insurance proceeds are included in the deceased person's estate, but are not taxable to the beneficiaries. Bank accounts and other income-producing assets such as stocks are not taxable to you when received, but the income these assets generate is taxable to you. If you are not sure if something was included in the decedent's taxable income, you should check with the administrator or attorney handling the estate to advise you what portion of the income earned on these assets should be included on your personal return. You may get a Schedule K-1 for items that are allocated to you from the estate. Be sure to inform your tax preparer of any income you receive from an inheritance because, although in most cases there is no income tax liability, there are some exceptions. If you inherit a pension or IRA, you must pay tax on the amounts you receive just as the decedent would have been required to do during his life. Only the spouse of a decedent can roll over these types of funds tax free into a plan in her name and treat it as her own. If you inherit a pension plan or IRA, contact your tax professional as soon as possible to discuss your options regarding the withdrawal of the money. Savings bonds can also be treated in several different ways, so be sure to provide any information from the estate to your tax preparer.

Have you ever heard of the term "stepped-up basis"? This means that your investment in inherited property is considered to be the value

as of the date of death. When you sell property that you inherit, you only pay tax on the difference between the amount you sold it for and the value of the property as of the date of death (or six months thereafter, as determined by the administrator of the estate). There can also be a loss if you sell the property for less than this date-of-death value. Your tax professional will need to know the date-of-death value to determine the gain or loss. The administrator or the attorney should be able to provide you with the value of the property so that you can correctly report the sale.

### Quik Tips

1. Beginning January 1, 2008, the standard mileage rates for the use of a car (including vans, pickups, or panel trucks) are:
  - 50.5 cents per mile for business miles driven;
  - 19 cents per mile for all miles driven for medical or moving purposes; and
  - 14 cents per mile for all miles driven for charitable purposes.
2. If your tax refund was too high or too low, adjust your withholding so it doesn't happen again next year. You can file a revised Form W-4 with your employer at any time to increase or decrease the number of exemptions you claim. The more exemptions you claim, the less tax your employer withholds from your wages, resulting in a smaller refund. Decreasing the number of exemptions results in more withholding and a larger refund.
3. It doesn't appear that a college education will get cheaper any time soon. Look into establishing a qualified tuition plan for your children. The earnings in the account grow tax-free. As long as the funds are spent on qualified education expenses, there are no tax consequences. Plus, there may be an added tax benefit at your state level.
4. Are you planning on making any substantial gifts? Talk to your tax preparer first. Gifts with values exceeding \$12,000 must be reported to the IRS.
5. Not only will you save money at the pump if you buy a hybrid vehicle, you may be eligible for a credit on your income tax return.
6. If your child has earned income from a summer job, you may want to consider opening an IRA

for him or her. There is no minimum age for contributing to an IRA. The only requirement is that the person making the contribution has earned income and has not reached age 70½.

### Tax Developments

- The Mortgage Insurance Deduction can still be deducted as interest on new loans from 2007 through 2010
- There is no more Residential Energy Tax Credit after 12/31/2007, with the exception of Solar, and Fuel Cells.
- AMT – The alternative minimum tax issue is still up in the air. Will it change or will there be another patch?
- *Go Zone* – You can take a 1<sup>st</sup> year write-off up to 50% of the purchase price of residential or non-residential rental property within the areas damaged by hurricanes Katrina, Rita, or Wilma through 2008. This is extended through 2010 for specified counties and parishes in which 60% or more of the homes were destroyed.
- The Capital Gains Tax is now 0% for taxpayers in the 15% tax bracket. This is good through 2010 so it may be a good time to sell appreciated capital assets such as stock.
- Economic Stimulus Payments – You can calculate your refund and check the status at [www.irs.gov](http://www.irs.gov).
- The maximum IRA limit is now \$5,000 (\$6,000 if over age 50).
- The maximum 401K limit is \$15,500 (\$20,500 if over age 50).
- Health Savings Accounts – If you currently pay for your own private health insurance, are not able to deduct your medical expenses, and don't have a Health Savings Account, you are missing out on a great tax savings option.

### Small Business Taxes

#### **Determining Qualified Business Expenses**

*Be sure to deduct every legitimate expense*

Amounts you spend in the course of conducting business are generally deductible from the gross income of that business. This includes any start-up expenses. You can claim amounts spent for items ordinary and necessary in your trade or business as a deduction against your income. Otherwise, the amounts are amortized, depreciated, or

expensed depending on the nature of the purchases.

The IRS scrutinizes entertainment and meal expenses more than others because of the potential for abuse. You'll need to keep track of the business that was discussed during these events. Other expenses such as cellular phones, computers, and cars are specially classified as listed property because they can be used for both personal use and business use. The IRS requires you to keep written documentation of the business use of your car and computer, plus meals and entertainment expenses, so be sure to keep accurate records.

Expenses must be directly related to your trade or business to qualify as a deduction; amounts spent on items that may help you indirectly do not necessarily qualify. However, to increase your profit, be sure to deduct every legitimate expense that you can reasonably prove. Take advantage of your tax preparer's expertise throughout the year to assist you with tax planning opportunities as they arise.

### **Automobile Expenses**

*Which is better—deducting the standard mileage rate or actual expenses?*

With the increasing cost of gas, it might be a good idea to revisit which tax deduction is the most beneficial—claiming 50.5 cents per business mile or your actual vehicle expenses. Claiming the standard mileage rate is easier. All you have to do is keep track of your business miles and multiply them by the current rate. In addition to the standard mileage rate, you may also deduct the costs for parking and tolls. Plus, if you are self-employed, you can deduct the interest paid on your car loan.

Claiming actual expenses may result in a larger deduction, but requires a bit more diligence in your record keeping. First, keep all receipts for gasoline, oil, repairs, and tires. Also, track any amounts paid for licensing and registration, insurance, garage rental, leasing,

parking, tolls, and rentals. Sales tax and luxury tax are not deductible, although the amounts you pay can be added to the cost of your car and recovered through depreciation.

Regardless of what method you choose, the expenses are limited to your business use. Therefore, you must document the total miles and the business miles for the year to calculate the business-use percentage.

### **Reimbursing Your Employees for Business Expenses**

*What method should you choose?*

Attracting and keeping good employees is a goal in any business. One way to make life easier for your employees is to have an easy to use reimbursement plan. Travel, transportation, moving, and educational expenses are common reimbursable expenses. As the employer, you have the option to set up an accountable or nonaccountable reimbursement plan. Under either plan, you can deduct many of the business expenses paid to or for employees. However, the plan you choose can make a big difference to your employees.

Qualified items that are reported under an accountable plan are not included in the employee's wages. Under this plan, you issue a check to the employee, who accounts to you for the expenses and returns the excess advance, if any. You take the deduction for the business expense, but the expense never shows up on the employee's W-2. For a meal expense, the employee must provide you with the time, place, and business purpose. You are allowed to give and deduct the meal per diem amount given to the employee. If the meal per diem is within the federal guidelines, no income is reported on the employee's W-2, even if he or she doesn't spend the entire amount. Keep in mind that you and your relatives are not allowed to use the per diem method.

Under a nonaccountable plan, you grant a certain amount of money to the employee to cover business expenses. The employee's W-2

income includes the expense money. You deduct the expense money as wages paid to the employee. The employee can deduct the allowable business expenses on his or her personal return, subject to a limit. Tax wise, the accountable plan is generally easier and more advantageous for the employee.

### **Turning Interest Payments Into Tax Deductions**

*Make interest payments work for you, not against you*

You can deduct business-related interest on your business return if you used the borrowed funds to purchase business supplies, equipment, services, etc. Co-mingling business and personal expenses makes it difficult to determine what amount of the interest is business versus personal. If this happens, the IRS may consider the entire amount as nondeductible personal interest and disallow the deduction. Therefore, keep all business purchases made with loans and credit cards clearly separate from your personal expenses. Use a separate credit card for your business to make it easier.

Also, make sure to tell your tax professional if you use home equity debt for business expenses. He or she will be able to determine how much of the interest you can elect to deduct directly against self-employment income.

### **Thinking of Selling Your Corporation?**

*Carefully review your options before making a decision*

When it comes time to sell your corporation, you have two options. You can either sell the corporation stock or have the corporation sell the assets and distribute the proceeds. The tax implications of the two sales are very different. If you choose to sell the stock, you are the seller. The corporation is not affected by the transaction. The new owner steps into your shoes as the shareholder and takes over the existing corporation. If your share of the proceeds exceeds your basis in the stock,

you'll have a capital gain to report on Schedule D.

If the corporation sells its assets, the corporation may close its doors. The assets could be sold to one person who intends to operate a business similar to yours, but does not want your corporation. The corporation return will reflect the sale of the assets. When the corporation liquidates, your share of the cash will be reported on Form 1099-DIV as a liquidating distribution. You'll use Form 1099-DIV to report the sale of your stock on Schedule D. Selling the assets of the corporation could result in double taxation. The sale of the assets is taxable to the corporation and the liquidating distribution is taxable to the shareholder.

If you are selling the corporation stock for a loss, you may qualify for special tax treatment. It's a good idea to review the tax consequences of the sale with your tax advisor before making a move.

### **Do You Know How Much Your Business Is Worth?**

*Tips for placing a value on your business*

There are several reasons why you should know the value of your business. If you are planning to sell your business, the general rule is that you should sell it for fair market value. In many instances the term "fair market value" is somewhat ambiguous. In the simplest sense, fair market value is what a willing buyer would pay a willing seller, with each party knowing all the pertinent facts.

There are several acceptable methods for determining the fair market value of a company. The most common three methods use (1) the value of the company's assets, (2) the earning power of the company, or (3) the stock value, assuming the company is a corporation. When determining the value of the corporation's stock, you must research the sale of stock for a substantially similar business. If you have been operating the company for many years, you have built up a reputation for

providing good service. This goodwill is a valuable asset and should play an important role in determining a fair asking price for your business.

The fair market value of the business is also relevant if you plan to transfer the company to a family member. If the transfer is for less than fair market value, the IRS considers the transaction as part sale and part gift. Inter-family transfers are more closely scrutinized, making an accurate valuation even more important.

### **Starting Your Own Business?**

*Here are a few quick tips to help you reduce taxes*

Open a separate business checking account. Many small business owners don't realize the complications that can arise from using their personal checking account to pay for business expenses. If business expenses are mixed in with personal expenses, the IRS may disallow them. When you set up a business checking account at the bank, be prepared to submit either your social security number (SSN) or an employer identification number (EIN). Your SSN will do if you plan on establishing a sole proprietorship and do not have employees or a retirement plan. If you plan on operating a partnership or corporation, you'll need to submit an EIN.

Keep track of expenses you incur before you start your business. Expenses incurred once you decide to start a business, but before business operations actually begin, are deductible up to \$5,000 in the first year of business. The rest is deductible over a 180-month period after your business opens its doors.

### **Quik Tips**

1. The Stimulus Act increases the expense deduction for business equipment purchased in 2008 to \$250,000.
2. Instead of deducting the actual expenses for the business use of your vehicle, opt for the

standard mileage rate. In 2008, you can deduct 50.5 cents for each business mile you drive.

3. The Social Security wage base increases to \$102,000 in 2008, up from \$97,500 for 2007. This means that you are no longer required to withhold social security tax for employees after meeting this threshold. However, you are required to withhold Medicare taxes regardless of the amount of wages paid.
4. If you are disposing of property used in your business, you may want to consider a like-kind exchange to defer the taxable gain on the sale.
5. If your business owns a vehicle that is available for an employee's personal and business use, the vehicle is nevertheless considered used 100 percent for business on the business tax return. The personal-use percentage is included on the employee's W-2 as additional compensation.
6. Employer-provided education assistance benefits of \$5,250 provided under a written plan are excludable from wages. The education doesn't need to be job-related to qualify.
7. If you are planning to start a SIMPLE retirement plan for your employees or yourself, do it now. The deadline for setting up a SIMPLE plan is October 1, except for new employers coming into existence after October.

### **Tax Developments**

- 100% Health Insurance Deduction for S-Corp Officers – The deduction is back, but must be reported correctly to get the full write-off. We have amended a few 2007 returns where the deduction was not taken.
- New Penalty for late filing of S-Corp and Partnership Returns \$85 per month per shareholder for up to 12 month's.
- Bonus Depreciation – The recent Stimulus package includes the return of 1<sup>st</sup> year 50% bonus depreciation on business assets. This means if your business already has a loss it may be increased by the amount of bonus depreciation. This is an advantage over the full write off under Section 179 which cannot be used to add to a loss.
- LLC vs. Corporation – Recent developments have made the LLC easier to maintain than a corporation. An LLC can also elect to be taxed as a corporation and make the S-Corporation election.