



## 4-Serenity, Inc.

2775 Trotters Walk Trail  
Snellville, GA 30078  
Office: (770) 978-9565  
Fax: (404) 795-0467

Larry M. Walker, Jr., EA, CFS  
Enrolled Agent  
Certified Fund Specialist

## 3<sup>rd</sup> Quarter 2007 Tax News

Date: 09/21/2007

### Calendar

- September 15 – Final Deadline for 2006 Corporation Tax Returns
- September 23-25 – NATP Annual Meeting at Dillard (Larry)
- October 15 – Final Deadline for 2006 Individual and Partnership Tax Returns; Monthly Tax Deposits
- October 17 – HD Vest Compliance Meeting at Columbia (Larry)
- October 18 to December 20 – Tax Planning Season
- October 31 – Deadline for 3<sup>rd</sup> Quarter Payroll Tax Returns; Quarterly payroll tax payments due
- November 5-6 – NATP 1040 & 1040Xtra Workshops in Atlanta (Larry)

### Inside News

- New Assistant – Jennifer Sabol was hired in August to assist with accounting, tax preparation, financial services and administration. Her background includes experience with dental offices, construction, criminology, and insurance. She is currently studying for her licenses in insurance and securities.
- CFS – I recently completed a one-year graduate level course and exam to obtain the CFS designation. CFS stands for Certified Fund Specialist. Only one percent of the financial services community has this designation. The course, exam, and case study were all very challenging. The course was taken through the Institute of Business and Finance.

## Individual Tax Issues

### **Hurricane Victims Get Extension for Residence Sale Exclusion**

The IRS has granted the victims of Hurricanes Katrina, Rita and Wilma an additional year in which to use the primary residence gain exclusion for gain from the sale of vacant land that had been used as a principal residence. Victims of these

hurricanes will now have three years from the date of the destruction of their principal residence in which to sell the vacant land and exclude the gain.

### **Special Web Section Unveiled for Homeowners Who Lose Homes; Foreclosure Tax Relief Available to Many**

The IRS has set up a special section on [www.irs.gov](http://www.irs.gov) for people who have lost their homes due to foreclosure. Mortgage workouts and foreclosures can have tax consequences, however, special provisions have been established to reduce or eliminate the effect. The IRS is also urging struggling homeowners to consider their options carefully before giving up their homes through foreclosure.

Generally, if the debt wiped out through foreclosure exceeds the value of the property, the difference is taxable income. A special rule however allows insolvent borrowers to offset that income to the extent their liabilities exceed their assets.

Any time taxes are involved you should seek advice before making a decision. The worst case scenario, and I have seen it before, is to lose a home through foreclosure, and then wind up owing taxes on the transaction.

### **Alternative Motor Vehicle Credit**

The IRS has announced that purchasers of qualified Ford and Mercury hybrid vehicles may continue to claim the full alternative motor vehicle credit since the manufacturer has not sold its 60,000th qualifying vehicle, as of June 30, 2007. The credit for Toyota and Lexus vehicles, on the other hand, while still available, is being phased out in 2007.

Ford Hybrids. The Ford and Mercury vehicles and their credit amounts are:

- 2008 Ford Escape 2WD Hybrid: \$3,000;
- 2005, 2006 and 2007 Ford Escape 2WD: \$2,600;
- 2008 Ford Escape 4WD Hybrid: \$2,200;
- 2005, 2006 and 2007 Ford Escape 4WD: \$1,950;
- 2008 Mercury Mariner 2WD Hybrid: \$2,200
- 2006 and 2007 Mercury Mariner 4WD: \$1,950; and
- 2008 Mercury Mariner 2WD Hybrid: \$3,000.

Toyota and Lexus Hybrids. Purchasers of Toyota and Lexus hybrid vehicles may claim the alternative motor vehicle credit at a reduced amount. The phase-out period for the credit for Toyota/Lexus vehicles began on October 1, 2006. The Toyota and Lexus qualifying vehicles and their credit amounts for sales April 1 through September 30, 2007, are:

- 2005, 2006 and 2007 Toyota Prius: \$787.50;
- 2006 and 2007 Toyota Highlander 2WD and 4WD: \$650;

- 2007 Toyota Camry Hybrid: \$650;
- 2006 and 2007 Lexus RX 400h 2WD and 4WD: \$550; and
- 2007 Lexus GS 450h: \$387.50

Toyota and Lexus vehicles purchased after September 30, 2007, are not entitled to any amount of the credit.

Phase-out. Taxpayers may claim the full amount of the allowable credit (which is based on vehicle weight and fuel consumption) up to the end of the first calendar quarter after the quarter in which the manufacturer records its sale of the 60,000th vehicle. For the second and third calendar quarters after the quarter in which the 60,000th vehicle is sold, taxpayers may claim 50 percent of the credit. For the fourth and fifth calendar quarters, taxpayers may claim 25 percent of the credit.

Other credits are available through September 30<sup>th</sup> and beyond on GMC's and Honda's. You can search [www.irs.gov](http://www.irs.gov) for the most recent information.

### **Final Regulations Clarify Child and Dependent Care Credit**

The IRS has issued final regulations for the child and dependent care tax credit (Treasury Decision 9354). The final regulations generally track proposed regulations issued in 2006, with some modifications, including clarifications of educational programs that do not qualify as employment-related expenses.

Comment: If an individual's employer does not offer any type of dependent-care assistance, the tax credit for child and dependent care may be his or her only chance to recover some tax benefits for dependent-care expenses.

Comment: Because the child and dependent care credit is nonrefundable, only individuals who owe federal income taxes can take advantage of the credit. Approximately 6.3 million taxpayers claimed the credit in 2004.

Background. The child and dependent care tax credit is calculated as a percentage, which can reach as high as 35 percent of qualified employment-related expenses for qualifying dependents. Expenses are employment-related only if the expenses are primarily for household services or for the care of a qualifying individual. Actual expenses are capped at \$3,000 for one dependent and \$6,000 for two or more dependents. Income restrictions also apply.

Three categories of individuals may be qualifying persons for purposes of the child or dependent care credit. They are (1) any child under the age of 13 for whom the tax payer can claim a dependency exemption; (2) any dependent, regardless of age, who is disabled; and (3) a disabled spouse, regardless of age, amount of support or place of abode.

Educational Programs. The IRS received a number of requests to allow some apportionment of the expenses for all-day kindergarten. However, the IRS determined that expenses for a child in kindergarten or a higher grade are not for care and are not employment-related expenses. Additionally, summer school and tutoring programs are not for care. Similarly, the cost of an overnight camp does not qualify.

Comment: Expenses for before-school or after-school care of a child in kindergarten or a higher grade may be for care.

Gainful employment. Expenses are employment-related only if they enable the individual to be gainfully employed. The expenses must be for periods when the individual is employed or is seeking employment. Determining if an expense is for gainful employment depends on the facts and circumstances, the IRS reiterated.

### **Tax Planning**

Are you rolling the dice or do you have a tax plan? In order to prepare a tax projection, or plan, what we need to see are your most recent pay stubs, mortgage interest statement; and to know about any additional income or expenses you expect for the year. Projections always start with last years tax data so for new clients we always ask for a copy of their prior year return (we already have this on file for all existing clients).

### **Business Tax Issues**

#### **Corporate Records Insufficient to Estimate Deductions**

The tax court has refused to allow a corporation to rely on the "Cohan rule" (G.M. Cohan, CA-2, 2 USTC 489) to claim depreciation deductions with respect to \$2 million in inadequately documented expenditures (Tyson Foods, Inc., TC Memo. 2007-188, Dec. 57,005(M)). While the Cohan doctrine permits a court to estimate allowable deductions where it is clear that deductible expenses have been incurred, there must be sufficient evidence in the record to provide the court with a basis for making an estimate of the deductions.

Comment: In this case, sloppy bookkeeping could only prove that certain payments were made and recorded. It could not also prove sufficiently the specific deductible expense or depreciable asset to which the payments were attributable or the tax year to which they should be applied. Those specific characteristics of a deductible expense were required to be proved and could not be inferred.

Background. The expenditures in this case allegedly related to the costs of purchasing, moving and installing food-processing equipment. However, the taxpayer failed to produce any invoices, purchase orders, or journal-entry explanations that reflected the nature of the items purchased or the dates of purchase. It provided only a list of vendors, amounts recorded as moving expenses and the testimony of a lawyer familiar

with certain of the vendors, but not the taxpayer's accounting practices.

**Insufficient Proof.** The Tax Court held that the taxpayer's evidence was not adequate or reliable. The available records did not identify the nature of the item or the dates that the credited amounts were expended. Therefore, the court found the taxpayers evidence inadequate to establish that the particular items paid for were either currently deductible or depreciable.

**Comment:** The lesson to be learned here is that, while it may be apparent that some expenditure was made in a business setting, no deduction will be allowed under the Cohan rule unless recordkeeping also shows the nature of that expense and the tax year in which it was incurred. For this reason, we always ask you to provide a copy of the receipt, invoice, bill of sale, or closing statement when it relates to the purchase of company assets. You need to make sure you are maintaining all of your bills, receipts, and statements for at least 4 years after the year to which they relate. Records for fixed assets should be maintained for up to 4 years after the asset is sold or otherwise disposed.

#### **Final Regulations Issued Regarding Submission of Forms W-4**

**Questionable forms.** For many years, employers were required to notify the IRS when an employee claimed excessive withholding or a complete exemption from withholding. In 2005, however, the IRS announced in temporary regulations that employers would no longer be required to routinely submit so-called "questionable" Forms W-4. Forms W-4 will not be required unless the IRS requests them in writing from the employer.

**Lock-in letter.** When the IRS identifies serious underreporting, it may issue a lock-in letter to the employer. The IRS will send the lock-in letter to the employer with a copy for the employee. The IRS will also mail a similar notice to the employees last known address.

The lock-in letter specifies the maximum number of withholding allowances permitted for the employee. The employer must impose the new withholding rate as of the date specified in the lock-in letter. The final regulations clarify that the notice will specify the marital status of the employee for purposes of calculating the required withholding under the notice.

Employees have time before the lock-in rate is effective to submit a new Form W-4. The employee must include a statement supporting the claims on the Form W-4 that would decrease withholding. If the IRS approves the employee's request, it will notify the employer in a modification notice. The employer must implement the change as of the date in the notice.

#### **Hand Delivery to Postal Worker Met Timely-Mailing /Timely-Filing Rule**

A deficiency petition that did not meet the timely filing requirements of Code Sec. 6213(a) was nevertheless, timely filed under the timely-mailing/timely-filing provision of Code Sec. 7502(a), the tax court has held (W.D. Blake, TC Memo. 2007-184, Dec. 57,001(M)). Although the petition lacked a post mark indicating its time of mailing, the taxpayer provided sufficient credible evidence to prove the date of mailing. The taxpayers attorney had hand-delivered the petition to a U.S. Postal Service employee before the deadline for filing.

**Hand-Delivered.** The court held an evidentiary hearing at which the taxpayers attorney testified that he hand-delivered the petition to a postal worker on the deadline date for filing, January 16, 2007, and the worker had said that the petition would be postmarked with that date. The court found the testimony to be credible. Under the timely-mailing/timely-filing rule, the petition was timely filed on January 16, 2007.

**Comment:** Be aware that the post office does not automatically post mark all mail. If you are sending out letters or returns on the due date, you must stand in line and ask the postal employee to post mark your letters. We do this on every deadline, and have just recently squared off with the IRS on this very issue.

#### **Rental Income and Expenses and the Tax Gap**

**Rental income.** Rental income is any payment received for the use or occupation of property. Since most landlords operate on a cash basis, they count payments in the tax year they are received and deduct expenses in the tax year they are paid. Other payments that may need to be reported as rental income are:

- (1) advance rent payments;
- (2) early lease termination fees;
- (3) property or services received in lieu of money;
- (4) expenses paid by the tenant for the landlord; and
- (5) lease payments with option to buy.

Payments for renting a portion of ones home may or may not be taxable income, depending on certain thresholds.

Generally, security deposits are not counted as income because they are refunded at the end of a lease period, as provided in an agreement between the lesser and lessee. However, any funds withheld from a deposit are counted as income in the year they are retained. Deposits used as final lease payments are considered advance rents and counted as income in the period they are received.

**Rental expenses.** Landlords can deduct ordinary and necessary expenses for managing, conserving and maintaining their rental property. Necessary expenses include interest, taxes, advertising, repairs and maintenance, utilities and insurance. In addition, all or a portion of the original investment in rental

property and subsequent improvements may be recovered through depreciation. The expenses must be incurred from the time a property is made available for rent and is actually rented.

The personal-use portion of rental-property expenses may not be deductible. Landlords are permitted to use any reasonable method for allocating expenses to the rental portion of property, such as using the square footage of the rented portion of the property or days of use.

Expenses with respect to property that is rented out at times and used for personal use at other times, such as a beach house, must be calculated based on the number of days the property is used for each purpose. The rental expenses cannot exceed the gross rental income for such property.

### **Hobby vs. Trade or Business**

Brenda Konchar reported net losses on Schedule C for her Mary Kay activity in 1996, 1997, and 1998. The IRS disallowed the business losses, since the activity was not a trade or a business entered into for profit. It was a hobby. Furthermore, even if the activity had been conducted with a profit motive, most of her business expenses could not be substantiated.

Under Sec. 183(b), if an activity is not engaged in for profit, expenses are generally only deductible to the extent of the gross income from the activity. The deductions that exceed gross income cannot create a business loss.

An activity is conducted for profit if deductions are allowable under: (1) Sec. 162 as ordinary and necessary trade or business expenses; or (2) Sec. 212 as expenses for the production or collection of income. Under either section, the taxpayer must intend to make a profit. Whether an activity is conducted with a profit motive is based upon all relevant facts and circumstances.

Under Sec. 1.183-2(b), the Courts considered nine nonexclusive factors to determine whether an activity is engaged in for profit:

1. The manner in which the taxpayer carried on the activity.
2. The expertise of the taxpayer and his advisors.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the assets used in the activity may appreciate in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.

6. The taxpayer's history of income or loss with respect to the activity.
7. The amount of occasional profits that are earned.
8. The financial status of the taxpayer.
9. Whether elements of personal pleasure or recreation are involved.

The Court determined that Brenda Konchar did not intend to make a profit in her Mary Kay activity based upon the following factors:

1. She did not conduct the activity as a business. She did not maintain a separate checking account or any business records.
2. In general, her returns and allowances plus cost of goods sold (COGS) exceeded her gross receipts, which indicates that she was selling her products at or near cost.
3. She had an element of personal pleasure in the activity, since most of her customers were family and friends. She took huge business mileage deductions for long distance travel to visit these customers for business and personal reasons.
4. She had no experience in operating her own business, and she did not seek any professional advice.
5. She had large losses each year and no possibility of ever recovering those losses. She never developed a plan to improve her profitability.

In conclusion, the Court ruled that Brenda Konchar did not have an honest objective to make a profit. She conducted her Mary Kay activity as a hobby. As a result, her business deductions were limited to the gross income from the activity. No business losses were allowed.

### **Tax Planning**

We prepare financial statements on a monthly or quarterly basis. Our financial statements are accompanied by personal tax projections for the shareholders. The proverbial shoe box full of bank statements, receipts, cancelled checks and other records dumped on the tax guy during tax season does not constitute tax planning. Proactive tax planning has the added benefits of (1) meeting key deadlines and avoiding penalties, (2) keeping your books and records in order for compliance purposes, and (3) allowing your income tax forms to be prepared in a timely manner.

It's not too late to get back on track, but if you're books are behind, I would suggest you contact us immediately.