

4th Quarter 2007 Tax News

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Calendar

- January 15 – Monthly Tax Deposits Due for December Payroll.
- January 31 – Due date for 4th Quarter Payroll Tax Returns, Form W-2's, and Form 1099's.
- March 15 – Due date for Corporation and S-Corporation Tax Returns, or Extensions to September 15th.
- April 15 – Due date for Personal, Estate & Trust, and Partnership Tax Returns, or Extensions to October 15th.
- April 30 – Due date for 1st Quarter Payroll Tax Returns.
- May 15 – Due date for Non-Profit Tax Returns, or Extensions to September 15th.

Electronic Filing Services

The IRS is scheduled to begin accepting e-filed personal tax returns on January 12, 2008 (however, expect some delays due to Congress' waiting until the week of December 23rd to pass the AMT Patch.) The State's do not begin accepting until after January 20th. You may file your Federal return first, and have the State return sent later, although the State's encourage simultaneous filing.

[If you would like to have your return filed prior to the electronic filing date, we can prepare a paper copy for mailing.]

Last year, we began filing Corporation returns electronically and were successful in spite of some delays by the State. We do incur some additional fees for e-filing, but this is absorbed by cost savings in paper, printing, and postage. Filing electronically also enables us to receive your signature by fax or mail which saves you from making a trip to our office. We e-mail a copy of your return for review prior to signature, and it is strongly suggested that you review your return before signing.

[As we initiated last year, PDF copies of your returns which are sent by e-mail will be password protected.]

Following are your refund and payment options:

Direct Deposit – Refund's in 10-16 days with no additional fees. You will be allowed to have your refund direct deposited in up to three accounts such as checking, savings, or certain types of IRA's. We do not charge additional fees for this option.

Refund Anticipation Loans (RAL) – We do not promote or encourage refund loans, but we offer them to remain competitive with other tax preparation companies. You will find our rates to be lower than those of H.R Block, Jackson Hewitt, and other large companies. Refunds are issued in as little as 12 to 48 hours with additional fees

ranging from \$34 to \$125 depending on the amount of the Loan. Loans of up to \$8,000 are available in 2008. Certified Bank Checks are printed in our office. Loans are not available on State refunds or after April 15th. Tax preparation fees are subtracted from your refund loan.

[Note: Beginning this season, our Certified Bank Checks will be issued by Bank of America, which should make them easier to cash. Bank of America will charge a \$5.00 fee for those without a Bank of America account. Wal-Mart will also cash checks up to \$2,999 for a 1% or \$3 fee.]

Electronic Refund Deposit (ERD) – Have your tax preparation fees deducted from your refund (up to \$600) and the balance direct deposited to up to three different accounts (checking, savings, certain types of IRA's). Bank processing fees are \$33 for Federal and \$10 for State refunds. Refunds are issued in 8-15 days.

[Note: If your tax preparation fees exceed \$600, we will require the balance to be paid in advance. This can occur when small business owners desire to pay the fees for their corporate accounting and tax out of their personal tax refunds. We will no longer accept promises to pay the balance when the refund is received, so be sure your corporate accounts are caught up this year.]

Electronic Refund Check (ERC) – Have your tax preparation fees deducted from your refund (up to \$600) and a check for the balance printed in our office. Bank processing fees are \$33 for Federal and \$10 for State refunds. Refunds are issued in 7-14 days. This option is only ideal for those who do not have bank accounts or who simply insist on receiving a physical check.

Paying taxes owed - If you owe Federal Taxes we can set it up so that your payment is debited from your checking account by April 15th, or you may make payments by credit card. The companies that handle credit card processing for the government do charge fees of up to 2.49% for this service. The lowest fee that we know of is a flat fee of \$2.95 per transaction charged by www.incometaxpayments.com for Debit and Check Cards only. Setting up a direct debit from your checking account at the time the return is filed is the best method because it is free of charge.

Copies of Tax Returns – As we initiated last year, you have the option of receiving copies of your tax returns either the traditional way (a hardcopy on paper); or in PDF format (on either 3.5 floppy diskette, by secured e-mail, or on CD). We strongly encourage you to accept a PDF copy.

Last year we began storing our files electronically to save paper, printing, and storage costs. We have to maintain copies of all returns prepared for at least 3

years after filing so electronic copies have become the safest and most environmentally friendly method.

This year we will also begin scanning your other tax related documents to PDF files including W-2's, notes, completed tax organizers, and other related documentation. If you would like to receive a paper copy of your return, please let us know at the time of service.

Engagement Letters

We generally prepare engagement letters for our services. An engagement letter is a contract which you sign that spells out the services we will perform, our confidentiality and privacy policies, the estimated costs, your responsibilities, our limited liability, and other services which we offer. Following are excerpts from our standard tax engagements for this season. These policies apply whether or not you receive or sign a letter.

[Scope:] We will prepare your 200X individual federal and state of residence income tax returns based on information you provide. We also will prepare other state returns as needed to properly report income originating in those states. We will file your return electronically (if eligible) unless you specifically decline. We also will prepare estimated tax returns for 200X (if needed) unless you decline. If we find inconsistencies in any information you provide, we will check with you; however, we do not audit or verify from source documents the information you provide.

Our work will be completed in accordance with appropriate income tax laws and regulations. We will use our judgment in resolving questions when the law is unclear or where there are conflicts between tax authorities' interpretations of the law and other supportable positions. Please inform us if you prefer that we not make such judgments in your favor.

Tax returns are subject to audit by the taxing authorities. If your returns are audited, you may be required to furnish source documents to the tax authorities to substantiate information you provided and that we reported on your return. If your returns are selected for audit, we would be pleased to represent you; however, representation services are not included in our fee for tax preparation and require a separate letter of engagement. In this regard, remember to retain backup documents for your tax return for at least four years after the returns were filed.

We also will help you answer correspondence from the taxing authorities. This may require you to designate us as your agent by a Limited Power of Attorney to permit quicker, more direct resolution of the problem. If these services are extensive, we may charge an hourly fee of \$125 but only after consultation with you.

[Confidentiality:] Under the law, some communications between a client and an Enrolled Agent are privileged and not subject to disclosure to the IRS. However, any information you furnish to us for preparing your tax returns is not protected by this privilege and consequently may be discovered by the IRS.

[Privacy:] We do not disclose any non-public personal information about our customers or former customers to anyone except as instructed to do so by such customers or as required by law. We restrict access to non-public personal information to those professionals necessary to comply with state and federal laws and we maintain physical, electronic, and procedural safeguards to guard your non-public personal information from unauthorized access, alteration, or premature destruction.

[Fees:] Our fees for tax preparation are based on the forms required to complete your return. A copy of our fee schedule is available on request. You can expect a fee of \$____. Dividend and/or interest income from numerous sources and numerous capital gain/loss transactions can increase these estimates. Also, if we must make repeated requests for information, we may charge additional fees.

Fees are due and payable when we present the returns to you or upon electronic filing. In some cases you may choose to have your fees deducted from your income tax refund, or you may pay by e-check, credit or debit card. Invoices not paid within 30 days will receive a rebilling charge of \$10.00 per month.

[Client's Responsibilities:] It is your responsibility to provide us with all the information needed to prepare complete and accurate returns and to review completed returns before signature for accuracy and completeness.

[Limited Liability:] Our liability to you for the services described in this letter is limited to the fees you pay for those services; however, in the unlikely event we make an error in preparing your return (when you have provided us with complete information and timely reviewed your return before signature), we will reimburse you for interest and penalties charged to you which were clearly due to our error.

Although we are available at any time to provide you with tax planning advice, we are not obligated to do so unless you specifically request it. Our policy is to put in writing all official tax advice. Therefore, we will not charge you for, nor should you rely upon, any unwritten advice since it may be tentative and not yet fully reviewed.

[Other Services:] We also are available to you for personal financial planning and other business advisory services; however, such services are not included in the scope of this engagement. Please feel free to discuss with us ways we may be of further service to you.

Inside News

- Office Hours – Our office hours will remain Monday through Friday, 9:00 AM to 6:00 PM. A limited number of Saturday appointments will be available on an as needed basis. Meetings are by appointment only, but you are welcome to drop off documents at anytime during office hours. You may also send your documents by fax, email, overnight or regular mail.
- Appointments - We know that it is not practical for every client to visit our office each year. We service clients throughout the state of Georgia as well as clients in other states including South Carolina, Florida, Texas, New York, California, Illinois, and many others. 80% or more of our services are performed solely by fax, e-mail, and mail.
- Pricing – We have increased some of our prices moderately to keep pace with inflation. Most of our tax clients will not notice any increase in prices. Our costs rise each year due to increases in software, technology, supplies, education, subscriptions, insurance and licensing. We make an effort to keep your costs down, by keeping ours down. For example, providing an electronic copy of your tax return is one way of lowering costs.
- Newsletters – Beginning in 2008, this newsletter will only be published twice a year rather than quarterly.

Personal Tax Issues

IRS Abused Discretion in OIC Rejection

An appeals officer abused his discretion when he rejected a taxpayer's offer in compromise (OIC) on the grounds that the taxpayer had sufficient future income to pay his 2002 tax liability in full.

Al Sampson was age 43 at the time of the trial. He was sporadically employed throughout his adulthood, but he had no wages from 1998-2003. He had been a student at City College for the past several years, and he was a senior at the time of the trial, but unsure when he would graduate. In 2002, he won a car valued at \$38,540, which he reported on his 2002 tax return. However, he made no payments toward his tax liability. In 2004, the IRS made assessments for 2002 totaling \$5,942. Sampson submitted an offer in compromise for \$2,000 based on doubt as to collectability. The appeals officer rejected his OIC based on future income.

Future income may be taken into consideration when determining whether an OIC is adequate and should be

accepted. However, if a taxpayer has a sporadic employment history, earnings over several periods should be averaged. In this case, the taxpayer's average income of the several years prior to 2002 was close to zero. The appeals officer used the taxpayer's 2002 gross income and then projected that amount over a 48-month period, which was inaccurate.

In addition, future income does not include wages a student could have earned but chose to forego in order to pursue his studies. The appeals officer erred again when he argued that the taxpayer's foregone earnings were sufficient to pay his 2002 tax liability in full.

Al Sampson v. Commissioner, T.C. Summary Opinion 2006-75

[Comment: Settling IRS back taxes is not as easy as it sounds on those TV commercials. One has to practically be destitute or have some circumstance that would make paying over time practically impossible or uncertain. The IRS has 10 years to collect on a debt and is willing to wait that long. Generally, the best method for resolving past due taxes is to enter into an installment agreement. I have won a couple of OIC cases, and lost a few. In the current environment, I won't file an offer for a client unless they have a good chance of winning. I currently have one case pending.]

Alternative Minimum Tax - Patch

Congress passed a patch for the Alternative Minimum Tax (AMT) during the week ending December 23rd, but it won't help the vast majority of people who are already affected.

Without the patch, approximately 23 million 2007 tax returns would have been affected by the AMT. With the patch, the AMT will strike about 4.2 million tax returns - roughly the same as last year.

Bottom line: If you paid AMT for tax year 2006, you probably will pay it for 2007 unless your income or family circumstances have changed.

The AMT was created in 1969 to make sure the superrich didn't avoid income tax altogether by taking a lot of deductions. Most of the exotic tax shelters people were using back then have disappeared. But the AMT remains, hitting people with more basic deductions such as state and local income and property taxes.

About two-thirds of the cause of the AMT comes from state and local taxes. That's why people in high-tax states pay a disproportionately large share of the AMT. In 2005, the states with the largest percentage of taxpayers owing AMT were New Jersey (6.8 percent), New York (6 percent), Connecticut (5.9 percent), Maryland (5 percent) and California (4.9 percent), according to Citizens for Tax Justice.

The AMT is a separate way of calculating your income tax. Everyone is supposed to calculate their taxes under both systems and pay the higher of the two. The AMT tosses out some deductions, exemptions and credits that reduce your tax under the ordinary system, such as the deduction for state and local taxes and the hybrid-car credit. It taxes your bottom line at 26 or 28 percent.

Large families can fall under AMT because it throws out the personal exemption you normally get for each member of the household.

In 2006, almost 12 percent of married couples with children earning \$100,000 to \$200,000 owed AMT, compared with roughly 5 percent of married couples in that income bracket without children. For couples earning \$200,000 to \$500,000, almost 83 percent with children owed AMT, versus 64 percent without kids.

Before 2000, the AMT never hit more than 1 percent of taxpayers. As the tax cuts championed by President Bush started phasing in, the AMT began affecting more people. That's because their tax under the regular system was dropping but the AMT, which had never been indexed for inflation, was not.

To prevent hordes of additional people from falling into the AMT, Congress has been enacting a series of temporary measures. The patch increases the AMT exemption amount, which is similar to a standard deduction. A higher exemption lowers your AMT, bringing it closer to the regular tax.

The exemption amount for married couples filing jointly was increased from \$45,000 for tax year 2000 to \$49,000 for 2001, \$58,000 for 2003 through 2005, and to \$62,550 for 2006. Without a patch, the exemption for 2007 would have reverted all the way back to the 2000 level - \$45,000.

Had lawmakers not acted, about 13.8 percent of all taxpayers would have been affected by the AMT in 2007, up astronomically from 2.5 percent in 2006, according to the congressional Joint Committee on Taxation. Congress once again staved off pandemonium by increasing the exemption amount for married couples by about 6 percent to \$66,250 and by 4.4 percent for singles to \$44,350.

Some people who bought a hybrid car this year thinking they would get a tax credit might be surprised to find out they're not eligible. The hybrid credit cannot be applied against AMT, so anyone who owes AMT won't get it at all. Some people who are just below the level at which they would owe AMT might not get the full credit either. That's because the hybrid credit is limited to the amount by which your regular tax liability (minus certain credits) exceeds your AMT. For example, if your regular tax is \$20,001 and your AMT is \$20,000, you won't owe AMT but your hybrid credit will be limited to \$1.

[Comments: (1) You generally need to be concerned about AMT if your income is over \$100,000 and you are claiming a large amount of deductions. (2) The patch is only good for a year, so this issue will be debated again in 2008. (3) Unrelated to the patch, beginning with 2007 tax returns, there is now a refundable credit available for AMT paid in a prior year. The AMT may be refunded in a subsequent year if it was due to your income being larger than normal due to some temporary event such as the sale of an asset.]

Deductions Disallowed

Throughout the 1999 and 2000 tax years, Terri and Austin made trips to Atlantic City, NJ, and played the slot machines at various casino locations. They did not keep records of their gambling activities during these trips.

Terri and Austin filed timely 1999 and 2000 Form 1040 tax returns. The couple reported \$230,825 of gambling winnings in 1999 and a deduction for the same amount on Schedule A as a gambling loss. In 2000 they reported \$293,750 of gambling winnings and a deduction for the same on Schedule A as a gambling loss.

The IRS disallowed the gambling loss deductions, claiming that they were allowed only \$76,314 losses in 1999 and \$55,750 in 2000. Terri and Austin could not provide adequate records to substantiate the amount of gambling losses they claimed. They offered only self-prepared worksheets and self-serving testimony about a suspicious loss computation method that was uncorroborated and insufficient.

An example of the unreliability of his work papers shows Austin claiming a \$22,800 loss in just a 29-minute period on a \$25 slot machine. When later questioned during the court proceedings, Austin testified that he would have lost about \$8,700 in a \$25 slot machine over 29 minutes. Terri and Austin failed to carry the burden of proof needed to claim a gambling loss in excess of the allowed IRS deduction.

Terri L. Hartssock vs. Commissioner, TC Memo 2006-205

[Comment: When maintaining a log, journal or worksheet to substantiate your expenses, whether it's for mileage, gambling, meals, or entertainment expenses, be sure your estimates are reasonable. If you claim mileage, meals and entertainment, or gambling expenses, you should maintain a log or journal.]

Business Tax Issues

Business Expenses for Beginners

According to the IRS, taxpayers with small businesses may take deductions for any expenses that are both ordinary and necessary. Ordinary expenses are common and accepted in a given industry. Necessary expenses are helpful and appropriate for a line of work but do not have to be indispensable to be deductible.

A simple test in determining which expenses are deductible can be found by answering the following question. *“Would you have incurred the expense if you were not in business?”* This should help a new business owner draw the line between a business and personal expense.

For example, many people go out to lunch during the work week. A lot of new business owners seem to think that because they are in business, they can deduct their meals everyday. *“Would you have incurred the expense if you were not in business?”*

“So when are business meals deductible? Here are a few examples: you take a client out to lunch to discuss business, you travel out of town on business, or you are an over-the-road truck driver subject to DOT rules. Going out to lunch everyday with a colleague does not necessarily constitute a business expense. You should keep a log or journal to substantiate any questionable (those that could be construed to be personal in nature) deductions.

Client Recordkeeping

A taxpayer was employed doing auto repair work as well as being self-employed doing the same type of work. On Schedule A the taxpayer claimed \$22,138 of unreimbursed employee business expenses. Breaking that down, the taxpayer had the following expenses:

- \$12,213 vehicle expenses;
- \$725 parking and tolls;
- \$4,250 travel expenses away from home;
- \$2,240 business expenses; and
- \$2,710 meals and entertainment.

IRS Code Section 274(d) imposes strict substantiation requirements to corroborate expenses for travel, entertainment, gifts, and passenger vehicles.

Section 274(d) indicates that no deduction will be allowed for such expenses unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement. That evidence must show: 1) The amount of such expense; 2) The time and place of the travel, entertainment, amusement, or the date and description

of the gift; 3) The business purpose of the expense; and finally, 4) The business relationship to the taxpayer of the person(s) entertained, using the facility or receiving the gift.

The related IRS regulation gives further advice on how the taxpayer can verify expenses. By using an account book, diary, log, statement of expenses, trip sheet, or similar record. If a receipt shows any information that would normally be documented in any of these records, it does not have to be duplicated again. For example, writing the information on the back of the receipt is adequate documentation.

The taxpayer in this case presented no documentary evidence to substantiate the expenses. Therefore, the court had no choice but to disallow them. Of the \$47,282 of expenses claimed on Schedules A and C, only \$5,000 was allowed.

TC Summary Opinion 2006-99

[Comment: Document, document, document...]

Home Office Expense

To claim a home office deduction under Section 280(A), taxpayers must use a portion of their home regularly and exclusively for a “bona fide” trade or business. To satisfy the exclusive-use test, there must not be any personal use. Exclusively means solely. There is no exception for de minimis personal use. Any rent-free personal use during a taxable year will cause taxpayers to fail the exclusive use test.

In one case, the taxpayers operated a bed and breakfast out of their home. The house was 5,664 square feet in total; of which, 4,363 square feet was used exclusively for business, 695 square feet was used exclusively for personal purposes, and 606 square feet was used for both business and personal purposes. Based on this information, the business-use percentage is 77% (4,363/5,664). Taxpayers can only take into consideration the portion used exclusively for business, not common areas like the kitchen and laundry room that are dual-use.

The taxpayers argued that the dual-use portion was used 75% for business. They computed their total business use percentage of 85%. The court held that the business-use percentage is only based on areas used exclusively for business and disallowed the dual-use portion.

[Comment: Form 8829 is used to claim a portion of home office expenses for rent, mortgage interest, utilities, property taxes, insurance, repairs and maintenance, depreciation, and other related expenses. Home office expenses are limited to the net income

generated from the business with the balance being carried forward until the business has sufficient income. {Note: If the business has a limited amount, or no income, the home office expense cannot be used to create a loss.}

For businesses that are incorporated, I recommend using the self-rental method. The self-rental method is where the company pays rent to the individual for use of business space in the home. The rental expense is deductible by the company, and taxable to the individual. The individual reports the income on Schedule E as rental income and may deduct, in similar fashion, a portion of the utilities, mortgage interest, property taxes, insurance, and repairs and maintenance against the rental income. A standard lease contract should be employed to substantiate the relationship.

Had there been a contract in place with the business paying the fair market value of the dual-use portion of the home, perhaps the above situation above could have been avoided.]

Standard Mileage Rate

Beginning January 1, 2008 the standard mileage rates will increase to the following:

- 50.5 cents per mile for business miles driven;
- 19 cents per mile driven for medical or moving purposes; and
- 14 cents per mile driven in service of charitable organizations.

Keep in mind that, whether you use the standard rate, or the actual expense method; and whether you own the vehicle, or it is owned by your company, you are required to report the total miles placed on the vehicle for the year, and the number of business miles.

S-Corporation Income Subject to Self-Employment Tax

A tax preparer, Mr. Edwards, and his wife, who is a realtor, each owned S corporations in 2002 and 2003. Mr. Edwards ran his tax preparation business through one of the corporations while his wife ran her realtor activity through her corporation. The S corporations recognized the income and operating expenses of their businesses. Neither Mr. Edwards nor his wife received a salary from the S corporations. No payroll taxes were paid on moneys distributed to them. They did report income flowing through to themselves from the S corporations and paid income tax on the amounts, but no FICA or self-employment tax.

A basic principle of taxation is that anyone who earns income should pay tax on it. "The existence of a validly organized and operated corporation does not preclude

taxation of income to the service provider instead of the corporation." In this case, the court had to determine whether the S corporations or its shareholders controlled the earning of the income. A corporation earns the income if both of the following are true:

- The person providing the service is an employee of a corporation that has the right to instruct or control the employee in some meaningful sense.
- There exists a contract or similar arrangement between the corporation and the service provider that recognizes the aforementioned right to instruct and control.

Both these factors were absent in this case. Therefore, the court upheld the IRS' decision to subject the taxpayers' income from their S corporations to self-employment tax.

TC Memo 2007-168

[Comment: If you own an S corporation and are performing services for the S corporation, you should be drawing a reasonable salary, and reporting it on Form W-2. This means your business should be filing quarterly and annual payroll tax returns with the IRS, the State Department of Revenue, and the State Department of Labor. It also means that your business should be making either monthly or quarterly tax deposits.

If you own an S corporation and are not paying yourself a reasonable salary, then you are just giving the IRS (and the State) an invitation to make an assessment, with interest and penalties tacked on. The statute of limitations expires three years after your tax return is due, so you could technically be hit for three years all at once.]

**Have a
Happy New Year!**