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Quarterly Individual & Small

Business Newsletter

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Re: Pending Due Dates

- April 8th – Monthly & Quarterly Clients submit bank statements, canceled checks, credit card statements, and other records for 1st quarter accounting and financial statements.
- April 15th
 - Monthly Payroll Tax Deposits due.
 - 1st Quarter Estimated Tax Payments due for Individuals.
 - Personal Income taxes or extension due date.
 - 2004 IRA Contributions due.
- April 20th – Sales & Use Tax Returns.
- April 30th – Quarterly Payroll Tax Returns.

Re: Check 21 -- Proving Tax Deductions Without Cancelled Checks

The *Check Clearing for the 21st Century Act* (Check 21) became effective on October 28, 2004. The bottom line on what this means for most consumers is that in time you won't be seeing any of your checks ever again after you send them off as payment with a bill or other statement. Instead, Check 21 allows your bank to truncate each of your checks and create a new electronic negotiable instrument called a substitute check. After doing this, your bank destroys your original check.

How does Check 21 change the way I am able to prove an expense to the IRS in order to be entitled to a tax deduction or credit?

The short answer is that, for most taxpayers, Check 21 means you will need to keep your past bank statements in good order -- IRS says that it will accept bank statements that contain images of cancelled checks and/or substitute checks. To be used as proof, an account statement must show check number, amount, payee's name, and the date the check was posted.

In order to keep track of your payments more easily for tax purposes, you should also maintain a careful check register. That way, you'll know on which bank statement to look if you are ever audited.

Some details

Banks are not being forced to jump on board to the new electronic Check 21 system. However, most have already done so and the rest are predicted to follow soon. If you receive canceled checks with your account statement, Check 21 for the time being will mean that you might begin to receive a mixture of canceled original and substitute checks. If you receive image statements (pictures of several checks on a single page), you also may notice that some of the pictures are of substitute checks.

The Check 21 law says you can use a substitute check as proof of payment because it is legally the same as the original check. The IRS, therefore, must accept your substitute check as proof of payment.

The IRS also has said that it generally will accept image statements of substitute checks as proof of payment. However, as has been IRS policy for image statements of canceled original checks, if an IRS auditor is suspicious that the image statement is not genuine, you may be requested to order the actual substitute check from your bank. This will be a rare instance, however, and only if you are audited. Your recordkeeping obligations under the tax law are satisfied in the meantime by keeping your bank statements.

Banking online

What if you do all your banking and bill paying online? The same rules apply. As a precaution, however, we suggest that you download and print out your bank statements at the end of the year. That way, even if you are audited several years from now, you'll have a record that's easy to access.

Please do not hesitate to call this office if you have any further concerns about Check 21.

Re: Home Office Deduction

The home office deduction enables taxpayers that operate a trade or business from their home to deduct certain expenses associated with maintaining the home office. The expenses related to the business use of your home include both direct and indirect expenses. Direct expenses include those expenses directly related to your home office, such as the costs of repairs, paint, or additional insurance for your office. Indirect expenses include those costs to operate your home. Indirect expenses include expenses such as the following:

- Real estate taxes
- Mortgage interest
- Casualty losses
- Rent
- Repairs
- Security systems
- Telephone

- Utilities
- Waste removal services
- Cleaning Services
- Insurance
- Depreciation

In the last few years, the rules for the home office deduction have undergone a number of changes. For instance, the statutes have become more stringent in regards to an "exclusive use rule," which states that business deductions are only allowed with respect to a portion of a home that is used exclusively and regularly for business purposes. In order to comply with the tax law, it is essential to stay current with these changes.

Re: Standard Mileage Rates

The standard mileage rates are based on an annual study of the fixed and variable costs of operating an automobile. Beginning January 1, 2005, the standard mileage rates for the use of a car (including vans, pickups, or panel trucks) are:

- 40.5 cents per mile (up from 37.5 cents per mile in 2004) for all business miles driven;
- 14 cents per mile for all miles driven for medical or moving purposes; and
- 15 cents per mile (up from 14 cents per mile in 2004) for all miles driven for charitable purposes.

You may also be able to deduct parking fees, tolls, interest, and state and local taxes (other than gasoline taxes). Even though you are not required to substantiate expense amounts, you must substantiate other elements of time, place, and business purpose of the travel.

Re: Flexible Spending Accounts (FSA's)

New flexibility for Flexible Spending Accounts. Many medications, like those for allergies or back pain, are increasingly becoming available over-the-counter

without a prescription. Consumers, however, are hit with sticker shock when their health insurance no longer covers their medications because they can be bought off-the-shelf. The IRS took note of the problem. Now, individuals can use their FSA or HRA dollars to pay for over-the-counter drugs, as well as prescription meds and other healthcare costs.

Not just cough syrup

Flexible Spending Accounts (FSAs), Health Reimbursement Arrangements (HRAs) and other employer arrangements allow employees to be reimbursed for health care, dependent care or other expenses that are excludable from gross income if paid by an employer. Medical care includes amounts paid for the diagnosis, cure mitigation, treatment, or prevention of disease. Medicines and drugs are expenditures for medical care. FSAs, HRAs, and other arrangements may also reimburse employees for out-of-pocket expenses for over-the-counter drugs as well.

Tax benefit

Generally, employer reimbursements for medical care are excluded from an employee's income, including reimbursements through FSAs. Pre-tax dollars in an FSA, HRA, or other arrangement can be used to purchase nonprescription drugs so long as the transactions are adequately substantiated. The exclusion from income for employer-provided benefits can be as much as \$5,000. It is important to note, however, non-prescription drugs are not deductible as an itemized medical expense.

FSA mechanics

The FSA may be funded by employer contributions or by a salary reduction agreement with each employee as that employee so elects at the start of each year. The employer must take the initiative to establish the FSAs, the employee cannot start one on his or her own. The employer as the plan sponsor also shoulders the

incidental administrative costs of running the FSAs.

Once the period of coverage begins, the amount elected by the employee to be deducted from each paycheck generally cannot be changed. In addition, employer sponsors will need to amend existing plans if they want them to permit reimbursement of over-the-counter costs.

Child care also may be covered

Independent of a medical FSA, employers may set up child care FSAs to cover child-care expenses to enable the parent to work. Employees may contribute up to \$5,000 of their salary, pre-tax, each year to be placed into the FSA to cover such expenses. As an alternative, an employee may be eligible for a dependent care credit. The credit for dependent care expenses is based on annual dollar limits of \$2,400 for one person and \$4,800 for two or more persons. As a third alternative, the employer may decide to run a child-care facility in the office for employees. Employees may receive those benefits tax free while the employer is allowed a tax credit for providing them.

Re: Pros and Cons of S-Corporations

Here is a checklist highlighting advantages and disadvantages of the S corporation form. As you take a look please keep in mind that Congress may pass S corporation reform that would eliminate or lessen some of the current disadvantages.

Some of the advantages are:

Your personal assets will not be at risk because of the activities or liabilities of the S corporation (unless, of course, you pledge assets or personally guarantee the corporation's debt).

- Your S corporation generally will not have to pay corporate level income tax. Instead, the corporation's gains, losses, deductions, and credits are passed through to you and any

other shareholders, and are claimed on your individual returns. The fact that losses can be claimed on the shareholders' individual returns (subject to what are known as the passive loss limits) can be a big advantage over regular corporations. Liquidating distributions generally also are subject to only one level of tax.

- The S corporation also has no corporate alternative minimum tax (AMT) liability (however, corporate items passed through to you may affect your individual AMT liability).
- FICA tax is not owed on the regular business earnings of the corporation, only on salaries paid to employees. This is a potential advantage over sole proprietorships, partnerships, and limited liability companies.
- The S corporation is not subject to the so-called accumulated earnings tax that applies to regular corporations that do not distribute their earnings and have no plan for their use by the corporation.

Some of the disadvantages are:

S corporations cannot have more than 75 shareholders (but with husband and wife being considered as only one shareholder). Further, no shareholder may be a nonresident alien.

- Corporations, nonresident aliens, and most estates and trusts cannot be S corporation shareholders. Electing small business trusts, however, can be shareholders, a distinct estate planning advantage.
- S corporations may not own subsidiaries, which can make expansion difficult, unless the subsidiary is a Qualified Subchapter S Subsidiary (a 100% owned S corporation).
- S corporations can have only one class of stock (although differences

in voting rights are permitted). This severely limits how income and losses of the corporation can be allocated to shareholders.

- A shareholder's basis in the corporation does not include any of the corporation's debt, even if the shareholder has personally guaranteed it. This has the effect of limiting the amount of losses that can be passed through. It is a disadvantage compared to partnerships and limited liability companies, and is one of the main reasons that those forms are usually used for real estate ventures and other highly-leveraged enterprises.
- S corporation shareholder-employees with more than a 2-percent ownership interest are not entitled to most tax-favored fringe benefits that are available to employees or regular corporations.
- S corporations generally must operate on a calendar year.

Re: Business Trips That Mix Business with Pleasure

Many taxpayers are beginning to plan trips that combine elements of both business and pleasure. Business trips, conventions, and continuing education seminars are frequently planned to incorporate exotic locations and leisure time. With proper planning, these trips can yield great personal pleasure while at the same time generate legitimate deductions. Although the basic rules are relatively simple, there are a number of angles in this area that you might be interested in knowing.

Business Travel - The Rules.

Taxpayers who travel away from their tax home on business are permitted to deduct travel expenses, including fares, meals, lodging, and incidental expenses, if they are not otherwise lavish or extravagant. A business trip is "away from home" if it takes enough time that the taxpayer may be

reasonably expected to need sleep or rest. A taxpayer's tax home is his regular or principal place of business, or his regular abode if he has no regular or principal place of business. Naturally, you are not prohibited from enjoying nonbusiness or personal activities while on a business trip, but the primary reason for the trip must be related to your trade or business.

Foreign Travel.

Foreign travel expenses are subject to some limitations that are not applicable if the business trip is within the United States. Some of an individual's foreign travel expenses may not be deductible if he or she takes part in substantial nonbusiness activity during the trip. Taxpayers who travel outside the U.S. for longer than one week or spend less than 75 percent of their time on business are subject to allocation rules, which operate to partially disallow their expenses, unless they had no control over the trip arrangements or the vacation portion was not a major consideration of making the trip. The general rule is to allocate expenses, including meals and lodging, between business and nonbusiness on a day-to-day basis. Each day is either entirely for business, or it is considered to be a nonbusiness day. A day counts as entirely for business if the taxpayer's principal activity on such day was the pursuit of a trade or business. In addition, a day is counted as a business day if any of the following factors are present:

- The individual was traveling to or from an overseas destination in pursuit of a trade or business.
- The individual's presence outside the U.S. on that day was required at a particular place for a specific and bona fide business purpose.
- The individual was prevented on that day from engaging in the conduct of his or her principal business activity due to circumstances beyond his control.

- The day was a Saturday, Sunday, legal holiday or other reasonably necessary stand-by day, which intervened during the course of the taxpayer's trade or business.

Educational Travel.

The tax law expressly prohibits deducting expenses for travel as a form of education. Nevertheless, a recent Tax Court case allowed a school teacher to deduct her travel and tuition costs related to two university courses overseas. There, the court found that the educational activities engaged in by the taxpayer went beyond mere travel and helped her maintain and improve skills necessary to her employment. The courses were well organized and conducted with regular lectures, extensive assignments, and left her with little free time for personal pleasure. The taxpayer was able to show that the knowledge she gained helped her to develop curriculum materials for the courses she taught. Whether this "business need" may be extended to other professions or businesses remains to be seen as this case law develops.

Conventions and Seminars.

Expenses for both self-employed persons and employees to attend a convention in the U.S. may be deductible if there is a sufficient relationship to the taxpayer's trade or business. However, a special rule prohibits the deduction of any costs of attending conventions or seminars for investment purposes.

Cruise ships. A limited deduction (to a maximum of \$2,000 annually) is permitted for conventions on cruise ships if the ship is of U.S. registry, all ports of call are in the U.S. or its possessions, and the meeting is directly related to the taxpayer's trade or business. Rigorous reporting requirements must be satisfied, including written statements by both the attendee and an officer of the sponsoring organization.

Foreign conventions. A foreign convention under the tax law is considered one held

outside the U.S., its possessions, the Trust Territory of the Pacific Islands, Canada, or Mexico. The deductibility of expenses for foreign conventions is subject to a higher standard than for conventions held in the U.S. The taxpayer must establish that the meeting is directly related to the active conduct of his trade or business and that it is as reasonable to be held outside the North American area as within it.

For a stateside convention, the taxpayer merely has to show that his business duties and responsibilities are related to the agenda of the meeting even though it may not deal with the specific duties of the taxpayer's work.

Staying Over.

Due to airline pricing policies, it is sometimes economical for a business traveler to stay over Saturday night although business was concluded on Friday. The additional lodging expense is frequently more than offset by the lower airfare as a result of the Friday and/or Saturday night stayover. In such situations, the additional meals and lodging expenses for the Friday/Saturday mini-vacation may be written off entirely as part of the deductible as ordinary and necessary expenses of the trip.

If, on a business trip during the week, a certain day is devoted primarily for pleasure, that day's expenses are not deductible. Although this may be a nondeductible expense that the business traveler is willing to pay, you should be careful not to devote over half of the time you spend away from home on pleasure. In such a case, none of the transportation expenses getting to and from the location are deductible. On the other hand, if more than half of the trip is devoted to business, all of the transportation expenses may be written off as a business expense.

Re: Bankruptcy Rules Get Tougher

The bankruptcy reform bill approved by the Senate recently has been branded a

consumer foe by bankruptcy attorneys and consumer advocates alike. The bill, which is expected to be approved by the House of Representatives in the first week of April, would go into effect six months after President Bush signs it into law.

Here are the most important changes, along with details on how they will affect those filing for bankruptcy protection.

More people forced into Chapter 13

Currently, more than twice as many people file for Chapter 7 bankruptcy than for Chapter 13. Under Chapter 7, most of the filer's unsecured debts are written off, whereas Chapter 13 requires the consumer to repay all or part of their debts within three or five years.

Once the law is in place, however, most people will be forced into Chapter 13 even if they can't afford it. That's because of the new Means test, which will require a filer's income to be lower than the median for the state (as determined by the IRS) in order to qualify for Chapter 7 filing. This will affect many middle-income individuals or families who earn above their state's median, but are forced into bankruptcy after accruing large debts, often because of divorce or medical emergencies.

Chapter 13 repayment schedules become unaffordable for many

Under the new law — and by applying the Means test — the courts will determine the amount to be repaid to creditors based on the basic living expenses in your state or county as determined by the IRS. The catch here is that your actual expenses are often higher than what the IRS says they should be in its Collection Financial Standards (the same standards currently applied to Offers in Compromise).

Remember: Tax Planning & Financial Services Appointments are available on a year-round basis.