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Quarterly Individual & Small Business Newsletter

4th Quarter 2003

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Holiday Greetings from 4-Serenity, Inc.

The month of December, and the first quarter of the year are the busiest times of the year for the tax professional. First there is last minute tax planning to make any necessary adjustments in order to minimize next years tax bill. Secondly, it's time to review and finalize all of the prior year's data, make journal entries, calculate asset depreciation, file W-2's & 1099's, and file 4th Quarter 941's & Annual 940's. Thirdly, it's a time to prepare annual Corporate and Individual Income Tax Returns.

While all of this is going on it's important to maintain monthly and quarterly accounting for the new-year, calculate monthly and quarterly payroll tax deposits, file monthly sales & use tax returns, prepare business personal property tax returns, calculate bi-weekly and semi-monthly payrolls, file quarterly payroll tax returns, and begin implementing savings strategies for the new year.

In light of all of the upcoming tax deadlines, rather than add five extra pages to this newsletter, I have published the 2004 Tax Calendar on our website www.4-serenity.com. You will find this on the left navigation bar under the section entitled, "Tips & Tools", by clicking on the link entitled, "2004 Tax Calendar". Please visit the website not only to view the calendar, but if you missed our last newsletter on "Tax Planning", you will find it as well as all of our previously published letters in the same section by clicking on the link entitled, "Quarterly Newsletters".

In this issue, we will discuss what some of our clients are practicing this year in order to reduce their tax liabilities. Tax planning and consulting are the key to finding a strategy that's right for you. If you feel that you need an appointment before the year ends, please don't hesitate to call or better yet use e-mail.

SUV Tax Break. Many of our small business clients have taken advantage of the SUV Tax break. Although this is not the official name for it and it is not new (available since 1996), if you use a vehicle for business that has a gross vehicle weight (GVWR) of 6,000 pounds or more, you can write off up to \$100,000 of the cost in the first year placed into service. In addition you can write off the cost of gasoline, repairs, and insurance. For a vehicle to be considered, it must be used more than 50% for business purposes. This means that a mileage log should be maintained to support the amount of business, personal, and total miles driven for the year.

The deduction is available whether the vehicle is new or used and whether or not you pay for it in full or use financing. Your deduction may be limited based upon the actual cost of the vehicle, the amount of net profit from your business, and the percentage of business versus personal

use. It may also be limited by the amount of additional equipment for which you are claiming the Section 179 Expense (limited to \$100,000 per year in 2003).

Following is a non-comprehensive list of vehicles that qualify:

BMW X5, Cadillac Escalade, Chevy Astro, Chevy Avalanche, Chevy Express, Chevy Silverado, Chevy Suburban, Chevy Tahoe, Dodge Durango, Dodge Ram van, Dodge Ram maxi-van, Dodge Ram wagon, Dodge Ram 1500, Dodge Ram 2500, Dodge Ram 3500, Ford Excursion, Ford Expedition, Ford Econoline E-150, Ford Econoline E-250, Ford Econoline E-350, Ford F-150, Ford F-250, Ford F-350, GMC Yukon, GMC Safari, GMC Savana, GMC Sierra, GMC Sierra Denali, Land Rover Discovery, Land Rover Range Rover, Lincoln Blackwood, Lincoln Navigator, Mercedes ML 320, Mercedes ML 500, Mercedes ML55 AMG, Toyota Land Cruiser, Toyota Sequoia and the Toyota Tundra.

SEP's, SIMPLE's, and IRA's. Many of our small business clients are establishing SEP IRA's. SEP stands for Simplified Employee Pension. Through a SEP, a company can contribute up to 25% of its owners or employees gross pay into an individual retirement account established for such purpose. The business gets to write this off as a tax deduction, while the employee receives the benefit of the account tax-free. Employees are immediately vested in the account, and can withdraw the money at any time, although early withdrawal penalties will apply. Certain employees may be excluded from the plan. The plan can generally be established up until the due date of the tax return, however some exceptions do apply.

SIMPLE stands for Savings Incentive Match Plan for Employees. Under a SIMPLE, a company's employees may contribute (pre-tax) up to \$8,000 (\$9,000 in 2004) per year into an individual retirement account established by the business, through payroll tax deductions. The employer also contributes a match of 3% of gross pay for each qualifying employee to the same account. Both the employee contribution and the employer match are excluded from income taxes. A SIMPLE had to be established by October 1, 2003 in order to count for 2003 taxes, however, it may be smart to consider this option for next year.

Many individual taxpayer's are contributing to tax deductible IRA's when qualified, and Roth IRA's when their contributions would not be tax deductible. When tax savings are involved, a portion of the money contributed to the IRA generally comes from the additional tax refund received because of the IRA. Although contributions to a Roth IRA are not tax deductible, withdrawals of those contributions are tax free, and the earnings are also tax free if withdrawn after the age of 59 1/2.

More Ideas

Maximizing retirement plan contributions. Make sure that you are contributing the maximum allowable amount to your retirement plans (e.g., 401(k)s, 403(b)s, IRAs, or SEPs). If you are age 50 and over, additional catch-up contributions to a traditional or Roth IRA are permitted beginning in 2002. For 2002 through 2005, the amount of catch-up contribution is \$500.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a "like-kind", you will be able to defer recognition of gain or loss. While your gain will eventually be subject to income tax, you may be able to defer taxation for a number of years. If you are planning an exchange, please don't try to do it on your own, there are a few tricks involved.

Installment Sales. If you must sell property (other than stock or securities) this year, delay receipt of part of the proceeds by having the payments made to you in installments over the next few years. The installment method may allow you to reduce your total tax on the sale by preventing your taxable gain from pushing you into a higher tax bracket in the year of sale. Make sure, though, that the payments are secured and that the buyer pays interest on the unpaid balance.

Tax Court Cases

S-Corp shareholders should be aware that the IRS is actively looking at abuses in the area of reasonable compensation. The case that follows clearly supports the reason why we advise that you make sure you pay yourself a reasonable salary.

Royalty Payments...Recharacterized as Wages

Charlotte's Office Boutique, Inc. paid Ms. Charlotte Odell "royalties" from 1995 through 1998. Ms. Odell and her husband are each 50 percent shareholders and the corporation's primary employees. When the Odells filed their tax returns, the IRS recharacterized the royalty payments as wages subject to federal employment taxes.

Ms. Odell incorporated her sole proprietorship, which sold office supplies and equipment, into Charlotte's Office Boutique on January 3, 1995. Her former office supply sales business transferred ownership of bank accounts and inventory to the new corporation. Ms. Odell purportedly did not transfer a customer list used in her former business, nor any ownership interest in existing contracts (those executed prior to January 1, 1995). Consequently, she executed a licensing and sales agreement in August 1996, which allowed the corporation the right to receive Ms. Odell's knowledge (customer list) and the right to assume the income and liabilities from the existing contracts in exchange for royalty payments beginning January 4, 1995.

In August 1996, Ms. Odell also executed an employment agreement with an effective date of January 1, 1995. Ms. Odell would not be compensated for services she performed from January 1, 1995 through July 31, 1996, since it was a "start-up company with limited cash flow." Beginning August 1, 1996, she would earn \$400 per month for her services. Ms. Odell and her husband perform substantially all of the services for the corporation. Mr. Odell does not receive any compensation for his services.

The court held that the royalty payments from 1996 through 1998 were really wages for the following reasons:

- Ms. Odell performed substantial services for the corporation.
- A corporation cannot avoid federal employment taxes by classifying payments to its principal employee for services performed as something other than wages or compensation.
- The disputed amounts were not royalties. Ms. Odell could not sell the right to use income-generating intangible property subject to self-employment tax in her sole proprietorship to a corporation she controls and avoid federal employment taxes by paying herself royalties for the use of that property.

The court gave little weight to Ms. Odell's employment agreement. Her employment agreement underwent scrutiny for the following reasons:

- The employment contract was executed solely by Ms. Odell, between Ms. Odell as an individual and Ms. Odell as an officer of her controlled corporation.
- The corporation was not a start-up company, since Ms. Odell had been operating the business since 1989.
- The corporation did not have a limited cash flow, since it reported taxable income in 1995 and 1996 and had enough money during those years to pay Ms. Odell's rent and royalties totaling \$49,248 and \$36,700, respectively.
- Compensation of \$400 per month was unreasonable. Her royalty payments represented reasonable compensation.

Charlotte's Office Boutique, Inc. 121 T.C. No. 6

If you have more than one job, your mileage between the first and second job is generally fully tax deductible. There are other times that travel expenses to and from a temporary job are also deductible. The following case gives food for thought in this area.

Deductible Business Mileage . . . Travel Between Residence and Temporary Job Sites

Teresita T. Daiz incurred automobile expenses traveling between her residence and various temporary job sites during 1997. The United States Tax Court addressed whether the expenses were deductible business mileage or nondeductible personal commuting expenses.

Teresita regularly worked and lived in Stockton, CA for several years before accepting some temporary assignments at various job sites outside of Stockton from 1996 through 2001. It was necessary to spend the night at some job sites, whereas other job sites were merely outside the Stockton vicinity and didn't require her to stay overnight. Throughout the years, she was assured that she would be permanently reassigned to Stockton. When that didn't happen, she accepted a permanent position in Vista, CA in 2001.

IRC §162(a)(2) allows a deduction for travel expenses incurred while away from home in the pursuit of a trade or business. A taxpayer is "away from home," if the trip requires sleep or rest. "Home" generally refers to the taxpayer's principal place of employment. However, if the taxpayer's place of employment is temporary, then the taxpayer's residence may become his/her tax home. If the employment is expected to last for one year or less, then the employment will be treated as temporary under Rev. Rul. 93-86. In other words, travel from a taxpayer's residence to a temporary work location that requires the taxpayer to spend the night is deductible, since the taxpayer is considered to be away from home.

Generally, transportation expenses from daily commuting are not deductible, since they constitute personal expenses under §262. However, under Rev. Rul. 94-47, commuting expenses are deductible if they are incurred going to a temporary job site that is distant from the taxpayer's residence. "Distant" is defined as outside the metropolitan area where the taxpayer lives and normally works. Therefore, a taxpayer may deduct travel expenses incurred between his/her residence and a distant temporary work location, even if it isn't necessary to spend the night.

The Court concluded that Teresita properly treated Stockton as the metropolitan area where she lived and normally worked. She was allowed to deduct her automobile expenses between her residence (tax home) and her temporary job sites, which were all outside the vicinity of her tax home. The transportation expenses were deductible whether she was required to spend the night or not, since the job sites were distant and temporary.

Teresita T. Daiz, T.C. Summary Opinion 2002-192

4-Serenity News

After a year and a half battle with the IRS's Fresno Examination Branch, we finally got our case moved to the Atlanta Appeals office where we won over \$12,000 for a client in a case involving the IRS's disallowance of the earned income credit for a three-year period. Although the client nearly lost all faith and patience in the process, he was well pleased with the outcome. We're still undefeated in the claims arena and have several more cases in the hopper presently.

Larry passed both the series 6 and 63 licensing examinations in March 2003, and began offering financial services to all accounting and tax clients. He will be attending 48 hours of classroom training during the first two weekends in January in order to be able to offer you more services in the future.

Wishing you a safe, joyous, and serene holiday season,

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