2008

Small Business advisor

TIMELY TALK ABOUT BUSINESS, TAXES AND TRENDS

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Disposing of Business Assets Without the Tax Bite

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Many taxpayers fail to understand the tax ramifications of disposing of personal property such as equipment, furniture and autos used in business and end up with unpleasant surprises at tax time. The tax consequences of disposing of business assets depends upon how the property was used, how long it was owned, and the method of disposition. There are numerous ways of disposing of an asset, so we can give only an overview.

The key to knowing the tax ramifications of dispositions is to understand the tax term "adjusted basis." Any gain or loss from the disposition of a business asset is measured from adjusted basis. Adjusted basis is generally the cost of the item reduced by any business deductions taken for the item. Let's say you purchase computer equipment for $1,000 and it is in a class of business property that must be depreciated over five years. You can elect to write off any portion of the item the first year (within the Sec. 179 expense limitations) and depreciate the balance over five years. If you elected to depreciate the item instead of taking the Sec. 179 expense election, your depreciation deduction would be $200, and your adjusted basis after the first year would be $800 ($1,000 - $200). If you then sold the equipment for $900, you would have a $100 ($900 - $800) taxable gain. Why? Because $100 of your cost was recovered as the depreciation you had previously taken as a deduction. On the other hand, if it was sold for $500, you would have a $300 deductible loss. So, as you can see, you must take into account how much of the cost of the asset has already been written off to determine any subsequent gain or loss.

Favorite and frequently-encountered deductions for taxpayers are non-cash contributions to charity. Although there are some special rules, taxpayers can generally deduct the lesser of cost or fair market value (FMV) of personal items contributed to a charitable organization. For business assets, adjusted basis is substituted for cost. For example, if a taxpayer contributes to charity a desk that was used only for personal purposes and never for business, that had cost $150 and has a FMV of $50, the taxpayer can take a $50 charitable deduction. However, if the desk had been a business asset and its cost had been fully deducted (depreciated), the taxpayer's charitable deduction would be zero, since the adjusted basis would have been zero and was less than the FMV.

When a business asset is exchanged (traded-in) for a like-kind item, generally any gain or loss that would have resulted from the sale of the asset increases or decreases the adjusted basis of the replacement property. Thus, where a sale would result in a gain, the gain can be avoided by exchanging the item, such as trading in one business vehicle for another. On the other hand, if a sale would result in a loss, it is probably to the taxpayer's advantage to actually sell the business asset so a loss can be taken.

Gains and losses from the sale of business assets are not included on the business schedule in the tax return where net profit or loss from operating the business is figured, and generally do not affect the taxpayer's self-employment tax. Generally, losses from selling business assets are fully deductible in the year of sale. Gains, to the extent they are attributable to depreciation, are generally treated as

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The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

If you have any questions, please feel free to contact us at:

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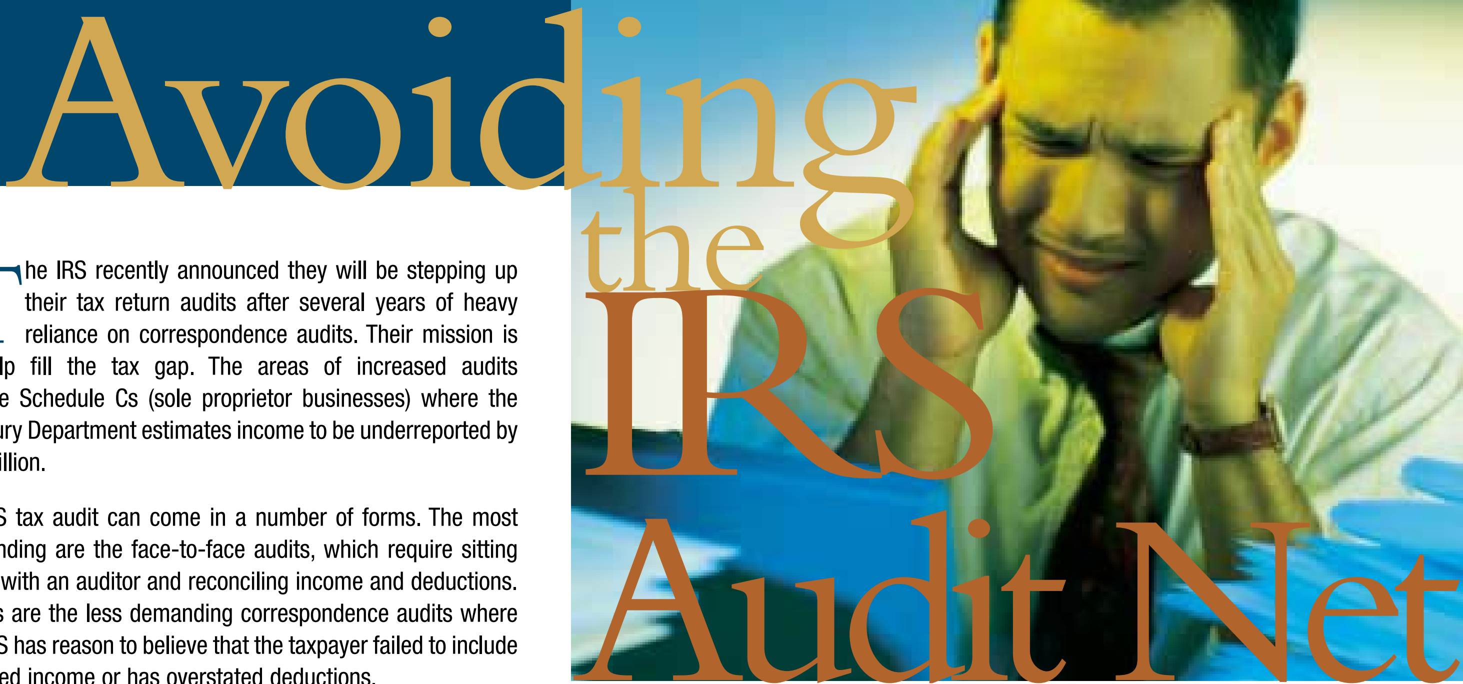
Avoiding the IRS Audit Net



The IRS recently announced they will be stepping up their tax return audits after several years of heavy reliance on correspondence audits. Their mission is to help fill the tax gap. The areas of increased audits include Schedule Cs (sole proprietor businesses) where the Treasury Department estimates income to be underreported by $68 billion.

An IRS tax audit can come in a number of forms. The most demanding are the face-to-face audits, which require sitting down with an auditor and reconciling income and deductions. Others are the less demanding correspondence audits where the IRS has reason to believe that the taxpayer failed to include reported income or has overstated deductions.

Face-to-Face Audits – Self-employed, high-income taxpayers, those who have omitted substantial income, or those who repeatedly fail to show income to support their lifestyle are more likely to be subject to these types of audits. Some are simply random to provide the IRS with statistics for targeting the most fruitful audit results.

You can appear for the audit yourself, but that is probably a bad idea since you are not trained in the rules and regulations regarding audit procedures and what limits the IRS's incursion into your private life. You can authorize your tax professional to handle it without you. Often, this is the best way to prevent the audit from escalating beyond the original areas that attracted the interest of the IRS in the first place. Practitioners experienced with IRS audits are less likely to become emotional or to make statements that would lead to additional IRS questioning.

Correspondence Audits – Employers, banks, lending institutions, schools, brokerage firms, escrow companies and others all feed data to the IRS, which the IRS, in turn, matches by computer to the information reported on your tax return. If there is a significant discrepancy, the IRS will correspond with the taxpayer. Here are some examples of typically-encountered discrepancies:

- **Unreported Retirement Income –** Whenever a taxpayer takes money out of one IRA account and rolls it over within the 60-day statutory limit into another IRA or qualified plan, the income is not taxable. The IRS will know about the withdrawal but not the subsequent rollover, and unless the rollover is reported on the tax return, the IRS will believe it to be a taxable distribution.

- **Gross Proceeds of Sale –** Generally, when real estate, stock or marketable securities are sold, the IRS knows what you sold and for what price. Thus, you must account for the sale on the tax return and compute the gain or loss. If you omit reporting the transaction, the IRS will treat the entire sales price as profit, adjust your tax, and notify you via a correspondence audit.

- **Alimony Paid or Received –** A taxpayer who pays alimony is able to deduct the amount he or she paid. On the other hand, the recipient of that alimony must report that amount as taxable income. The IRS checks to make sure the amounts match. If they don't, expect a notice in the mail.

- **Home Mortgage Interest –** Each of your mortgage lenders will report to the IRS the interest paid on your mortgage for the year and issue you a Form 1098 for the same amount. If these amounts don't reconcile, expect a notice or a request for an explanation.

- **Tuition Paid –** Because of the education tax credits that can be claimed for paying tuition to a qualified higher education institution, the IRS requires those institutions to report the tuition received to the IRS and a Form 1098-T issued to the student. Thus, the IRS has the ability to verify the tuition paid during the year, and any mismatch could result in a correspondence audit.

- **Interest and Dividends –** The IRS allows many financial institutions to issue substitute 1099s, i.e., forms that are not in the standard 1099 format. These substitute forms – with various types of interest and dividends reported separately and spread throughout lengthy annual account statements – can often be misinterpreted by an untrained eye. To make matters worse, many brokerage firms have issued amended 1099 statements late in the tax filing season because of errors in allocating the investment income by the proper type. Incorrectly reported, erroneously reported, or omitted investment earnings can trigger correspondence from the IRS.

- **Non-Taxable Interest –** Interest from municipal obligations are tax-free for purposes of computing federal tax. However, tax-free municipal interest income is added to income for purposes of computing taxable social security income and determining whether a taxpayer qualifies for earned income credit (EIC). Thus, all tax-free municipal interest must be reported on the tax return or risk a subsequent inquiry from the IRS.

- **Cash Contributions Beginning in 2007 –** Beginning in the 2007 tax year, regardless of the amount of cash contributed, the contribution must be backed up by either a bank record or written communication from the donee organization showing the: (1) name of the donee organization, (2) date of the contribution, and (3) amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records.

Just because you received a notice, don't assume that the IRS is correct. They are frequently wrong. Contact this office immediately upon receipt of any inquiry from the IRS or state tax agency. Procrastination only leads to further action on the part of the IRS or state agency.

(Disposing of Business Assets Without the Tax Bite Continued…)

ordinary income (but still not taxable for self-employment tax purposes), and any additional gain is treated as capital gain. If the asset was held for more than a year, the long-term capital gains rates will apply.

At times, you may simply scrap an item because it has no further use in your business and has no resale value. When this happens, treat the disposition as a sale for no money, which will produce a loss equal to the balance of the adjusted basis at that time. If an item ceases to be used for business purposes and is converted to personal use, your personal basis becomes the adjusted basis at the time of conversion, with no additional deduction for the business. If the item is subsequently disposed of, any amount received in excess of the adjusted basis would be taxable, but any loss would not be deductible.

If you simply give the item away to an individual, neither the business nor you, as an individual taxpayer, is allowed a deduction. The general rule is that the recipient's basis will be the asset's adjusted basis at the time of the gift. However, where a sale in the hands of the recipient would result in a loss, the loss would be based on the lower of the item's adjusted basis or FMV at the time of the gift. If the value of the asset, plus other gifts given to the same individual during the year, exceeds $12,000 (2008), a Gift Tax return generally will be required.

Disposing of personal property business assets can be complicated, so please call us for additional information.

Employers Beware!

New Form Available to Misclassified Workers

The Internal Revenue Service has developed a new form for employees who have been misclassified as independent contractors by their employers. Form 8919, Uncollected Social Security and Medicare Tax on Wages, will now be used to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation.

Generally, a worker who receives a Form 1099 for services provided as an independent contractor must report the income on Schedule C, and pay self-employment tax on the net profit using Schedule SE. However, sometimes the worker is incorrectly treated as an independent contractor by an employer when he or she is actually an employee. When this happens, beginning with tax year 2007, Form 8919 will be used by workers who performed services for an employer but the employer did not withhold the worker's share of Social Security and Medicare taxes.

In addition, the worker must meet one of several criteria indicating he or she was an employee while performing the services. The criteria include the following:

- The worker was previously treated as an employee by the firm and is performing services in a similar capacity and under similar direction and control.
- The worker's co-workers are performing similar services under similar direction and control and are treated as employees.
- The worker's co-workers are performing similar services under similar direction and control and filed Form SS-8 for the firm and received a determination that they were employees.
- The worker has been designated as a Section 530 employee by his or her employer or by the IRS prior to January 1, 1997.
- The worker has filed Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, and received a determination letter from the IRS stating that he or she is an employee of the firm.
- The worker has received other correspondence from the IRS that states he or she is an employee.
- The worker has filed Form SS-8 with the IRS and has not yet received a reply.

By using Form 8919, the worker's Social Security and Medicare taxes will be credited to his or her Social Security record. To facilitate this process, the IRS will electronically share Form 8919 data with the Social Security Administration.

A completed Form SS-8 may be filed with the IRS by either the employer or an employee – with or without the knowledge or consent of the other party – to request a determination of the worker's status as an employee. The IRS will rule with regard only to prior employment status, not on the individual's prospective employment status as an employee or independent contractor. During the review of the information provided with Form SS-8, enough questions may be raised to result in an employment tax audit of the employer.

If it is determined in audit that the worker should have been treated as an employee and not as an independent contractor, the employer may face some serious, and potentially expensive, consequences. In addition to having to pay the payroll taxes that should have been withheld, the employer must issue the employee a W-2 and revised Form 1099 for the years that are reclassified. The employer will also need to review any of its benefit plans to determine the consequences of the reclassification.

While it may be tempting to classify a worker as an independent contractor to avoid paying the employer's share of employment taxes, or having to deal with the extra tax filings and paperwork that comes with employees, the consequences of having that person reclassified as an employee can be severe. Now that the IRS has provided employees with a convenient method to pay their share of the Social Security and Medicare taxes, and thus raise the "red flag" as to the classification, it is likely that the IRS will be more aggressive in following through with audits of employers.

For more information, please give this office a call.

FOR SMALL BUSINESSES

QUESTION: My business is organized as an S Corporation, and I've heard that there is a new rule related to the above-the-line health insurance deduction for sole owner-employees of an S Corporation. Can you explain?

ANSWER: In 2006, IRS guidance had concluded that an S corporation's sole shareholder, who was also its sole employee, couldn't buy health insurance in his or her own name and deduct the premiums above-the-line in arriving at adjusted gross income under a special provision that applies for self-employed persons, partners, and more-than-2% shareholder-employees of S corporations. The IRS has since changed its tune, and now allows the deduction if the sole shareholder makes the premium payments and furnishes proof of payment to the corporation, and it then reimburses him or her. The S corporation reports the amount of the premium reimbursements as wages on the shareholder-employee's Form W-2, and the shareholder-employee reports that amount as gross income on his or her Form 1040. The changed position may make it possible to file an amended return, claiming a refund for someone who was denied a deduction under the old rule.

QUESTION: I am self-employed, and occasionally solicitors for charitable organizations will come into the office looking for a contribution. Can I deduct those contributions as a business expense?

ANSWER: Generally, for self-employed individuals, charitable contributions are not deductible on Schedule C as a business expense, and can be deducted only as an itemized deduction on Schedule A. However, tax regulations state that transfers to a charity that are directly related to a taxpayer's business and made with a "reasonable expectation of financial return commensurate with the amount transferred" may be deductible as a business expense. You should contact this office if you have questionable contributions.

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Tax Calendar
March – July 2008

March 17, 2008:
- 2007 calendar year Corporation and S Corporation returns are due, including any taxes owed. This is also the due date for providing Schedule K-1 to the S Corporation shareholders. If you cannot complete and file the Corporation return by the March due date, file for the automatic six-month extension to give yourself until September 15 to file the return.

March 31, 2008:
- This is the due date for electronically filing (not by magnetic media) 1099 forms, W-2 forms, W-2G forms and tip reporting. File these forms electronically if you did not previously file by other means on February 28.
- This is the last day to withdraw funds from your Traditional IRA if you turned age 70½ in 2007 and haven't taken your 2007 distribution yet. In addition, this is the last day to withdraw funds from your SEP or Keogh plan if you are retired and turned age 70½ in 2007. Failure to take the required distributions could result in substantial penalties.

April 15, 2008:
- First quarter estimated tax installment payment for the 2008 tax year is due.
- Filing due date for your 2007 income tax return and to pay any taxes that are due. If you expect to owe, estimate how much and include your payment with the extension. If you owe taxes when you do file your extended tax return, you will be liable for both the late payment penalty and interest from the due date.
- Filing due date for the 2007 calendar year Partnership return(s) and to provide Partnership Distribution Forms (Form K-1) to the partners. If you cannot file a Partnership return by the April due date, file for the automatic six-month extension to give yourself until October 15.

June 16, 2008[1]:
- The second installment of your 2008 individual estimated taxes is due. If your income or deductions have changed significantly, you should call this office to determine if any adjustment in estimates is appropriate.
- U.S. citizens living abroad on April 15, 2008 must file a 2007 income tax return (if not already filed) or file for an extension.

June – July 2008:
- Time to review your 2008 year-to-date income and expenses to ensure your estimated tax payments and withholding are adequate to avoid underpayment penalties.

[1] *Normally this date falls on the 15th of the month. However, when falling on a Saturday, Sunday or holiday, it becomes the next business day.*