Client advisor
CURRENT INFORMATION, NEWS AND TRENDS
SUMMER 2011 Volume XVI, Number 2

Inside This Issue:

- Taking Your Business Home
- Can You Write Off a Bad Debt?
- What Are the Chances of Being Audited?
- 100% Write-Off for Heavy SUVs Used Entirely for Business
- Tax Records Piling Up? Don't Toss Them Just Yet!
- Qualified Leasehold Improvements Eligible for 100% Write-Off
- Tax Calendar
- Since You Asked...

Taking Your Business Home

In the current economic environment, many smaller firms are looking for ways to cut costs. One such possible move would be to relocate from a rented office space to a home office. With today's modern means of communications and virtual marketplace, this may be a good option for your business.

The advantages include the ability for you to deduct from your business income some home expenses, such as utilities and certain maintenance costs that are not otherwise deductible. Those expenses will include a depreciation allowance for the part of your home that is the office. A portion of your mortgage interest and real property taxes will be deducted on your business schedule rather than as itemized deductions. You will be eliminating the costs of your non-deductible commuting travel, while business travel will now generally be measured from your front door.

There are two significant downsides to a home office. First, to the extent of the depreciation taken on the home, gain when you sell it cannot be excluded under the home sale rules. Secondly, if the home office is in a separate structure, then the separate business portion does not qualify for the home gain exclusion. You should also note that the home office deduction is limited in any year that your business operates at a loss.

Generally, a self-employed individual will qualify for a home office deduction if the office is a place where the taxpayer meets with customers, patients or clients, or is used on an exclusive and regular basis for administrative or management activities of his or her trade or business, and there is no other fixed location of the business where the taxpayer conducts substantial administrative or management activities of the business. Even if a taxpayer conducts administrative activities at a fixed location outside the home, he or she is still eligible to claim a deduction as long as the administrative activities conducted at the outside location aren't substantial. Space in the home used to store inventory for a wholesale or retail business also qualifies as business use of the home.

If you would like to learn more about how the business use of your home might affect your taxes, please give this office a call.

Can You Write Off a Bad Debt?

Most small businesses have receivables that cannot be collected. These receivables can be from the sale of products, providing services to customers, or a combination of the two.

Whether or not a bad debt deduction will apply generally depends upon which accounting method is used (either the cash or accrual method). Why does this make a difference? Let's look at what happens under both methods of accounting.

Accrual – If the accrual method is used, all of your billings must be treated as income whether or not they have been collected. This means that the taxable income already includes the income from your deadbeat customers. Therefore, these items are considered a bad debt when those receivables become uncollectible and can be deducted. If the accrual method of accounting is used, bad debts are deductible.

Cash – On the other hand, if the cash method of accounting is used, income is not reported until it is received (unlike the accrual method). Since the income was never reported in the first place, a deduction cannot be taken if payment was never made for the goods or services that were provided. However, if you made a loan to a customer or supplier and there is a business reason for the loan, you may have a business bad debt.

Proof of Worthlessness – Proving a debt (or receivable) is worthless requires the taxpayer or business to show that the debt has become worthless and that reasonable steps were taken to collect the debt.

Non-Business Bad Debts – Some bad debts may actually be personal debts, such as personal loans to individuals. In those cases, the bad debt is not deducted as a business expense but is treated as a short-term capital loss on Schedule D instead.

If you still have questions, please give this office a call for additional information.

SilkRoad
–Realty, Inc.–
The Road To Your Happiness & Prosperity Begins With Us

- Residential & Commercial
- Tax & Financial Analysis
- Investments

11620 Wilshire Boulevard
Suite 220
Los Angeles, CA 90025

Telephone 310.479.7020
Facsimile 310.479.7426

www.SilkRoadRealtyInc.com

D.R.E. License No. 01874990

What Are the Chances of Being Audited?

Each year, the IRS releases a publication entitled the "Data Book." The 2010 version of the book was released in early March, which provides statistical data on its fiscal year (FY) 2010 audit activities. The book provides valuable information that include how many tax returns the IRS examines (audits), how they examine them, and what categories of returns the IRS is focusing its resources on.

Keep in mind that audits usually occur one to two years after the return is filed. The data found in the 2010 Data Book is based upon returns filed in calendar year 2009, which will be predominantly 2008 returns, and audited in fiscal year 2010. Year-to-year changes are compared to returns filed in 2008, and audited in fiscal year 2010, which are predominantly 2007 returns.

Overall chance of being audited – Out of 142,823,105 total individual income tax returns filed in 2009, 1,581,394 were audited. This works out to roughly 1.1%, a bit higher than the 1% rate for the previous year. But the overall audit percentage can be misleading because certain types of returns are audited more frequently than others. For example, 473,999 (30%) were for returns that included an earned income tax credit (EITC) claim.

Of the total, only 21.7% of the individual audits were conducted by face-to-face meetings with IRS personnel. The bulk of the audits (about 78.3%) were conducted by mail.

The IRS, like any good business, concentrates their efforts where they produce the best results (revenue)! Thus, their audit selection process favors returns that claim the EITC (where a lot of fraud is prevalent) and higher-income taxpayers. As a result, their Data Book presents the statistics in the following format. In addition, the audit percentages shown in the next column are based on returns with the same category rather than overall returns filed.

Returns with Net Positive Income under $200,000	
• **Returns That Do Not Claim EITC**	**Percent**
– Returns without Schedules C, E, F or Form 2106	0.5
– Returns with Schedule E or 2106	1.2
– Non-Farm Business Returns with gross receipts:	
Under $25,000	1.2
$25,000 under $100,000	2.5
$100,000 under $200,000	4.7
$200,000 or more	3.3
– Farm returns	0.4
• **Business & Non-Business Returns That Claim EITC**	
– Tax Credit by size of total gross receipts	
Under $25,000	2.4
$25,000 or more	1.8
Returns with Total Positive Income of $200,000 under $1M	
• **Non-Business Returns**	2.5
• **Business Returns**	2.9
Returns with Total Positive Income of $1M or more	8.4
Small C-Corporation Returns (other than 1120-C and 1120-F):	
• **Balance Sheet Returns by size of total assets:**	
– No Balance Sheet	0.4
– Under $250,000	0.8
– $250,000 under $1,000,000	1.4
– $1,000,000 under $5,000,000	1.7
– $5,000,000 under $10,000,000	3.0
– $10,000,000 under $50,000,000	13.4
Partnership Returns	0.4
S Corporation Returns	0.4

Many returns end up being audited due to incorrect reporting on the tax return. This firm is sensitive to these issues and strives to properly report income and deductions so as to minimize audits. Clients are cautioned not to respond to IRS correspondence without first consulting this office.

100% Write-Off for Heavy SUVs Used Entirely for Business

The 2010 Tax Relief Act provides a limited-time 100% bonus depreciation allowance for qualified property, which allows taxpayers who buy a new heavy SUV and use it entirely for business to write off the entire purchase price in the placed-in-service year.

Heavy SUVs are vehicles with a gross vehicle weight (GVW) rating of more than 6,000 pounds which are exempt from the luxury auto dollar caps because they fall outside the definition of a passenger auto. To deal with this "SUV tax loophole," Congress imposed a limit on the Sec. 179 expensing of heavy SUVs several years ago. Thus, not more than $25,000 of the cost of a heavy SUV placed in service after Oct. 22, 2004 may be expensed under Sec. 179. These rules apply, with some exceptions, to SUVs rated at 14,000 pounds GVW or less.

Under the 2010 Tax Relief Act, the bonus first-year depreciation percentage is 100% for eligible property that is generally:

(1) Placed in service after Sept. 8, 2010 and before Jan. 1, 2012, and

(2) Acquired by the taxpayer after Sept. 8, 2010 and before Jan. 1, 2012.

Eligible property includes heavy SUVs. Thus, a taxpayer that buys and places in service a new heavy SUV after September 8, 2010 and before January 1, 2012, and uses it 100% for business, may write off its entire cost in the placed-in-service year. There is no specific rule barring this result for heavy SUVs. Let's say a taxpayer purchased a heavy SUV in October of 2010 for $50,000 and used the vehicle 100% for business for the rest of 2010. This taxpayer can write off the full $50,000 cost of the vehicle on his 2010 return. If the vehicle is used less than 100% for business, the deduction is prorated.

If you have questions related to buying a heavy SUV and how this deduction will apply to your specific tax circumstances, please give this office a call.

Tax Records Piling Up? Don't Toss Them Just Yet!

Now that your taxes have been completed for 2010, you are probably wondering what old records can be discarded. If you are like most taxpayers, you have records from years ago that you are afraid to throw away. It would be helpful to understand why the records needed to be kept in the first place.

Generally, we keep "tax" records for two basic reasons: (1) in case the IRS or a state agency decides to question the information reported on our tax returns, and (2) to keep track of the tax basis of our capital assets so that the tax liability can be minimized when we actually dispose of them.

With certain exceptions, the statute for assessing additional tax is three years from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states is one year longer than the federal. In addition to lengthened state statutes clouding the recordkeeping issue, the federal three-year assessment period is extended to six years if a taxpayer omits from gross income an amount that is more than 25 percent of the income reported on a tax return. And, of course, the statutes don't begin running until a return has been filed. There is no limit where a taxpayer files a false or fraudulent return in order to evade tax.

If an exception does not apply to you, for federal purposes, most of your tax records that are more than three years old can probably be discarded; add a year or so to that if you live in a state with a longer statute.

Examples – *Sue filed her 2010 tax return before the due date of April 18, 2011. She will be able to dispose of most of her records safely after April 15, 2014. On the other hand, Don files his 2010 return on June 2, 2011. He needs to keep his records at least until June 2, 2014. In both cases, the taxpayers may opt to keep their records a year or two longer if their states have a statute of limitations longer than three years. Note: If a due date falls on a Saturday, Sunday or holiday, the due date becomes the next business day.*

THE BIG PROBLEM! The problem with the carte blanche discarding of records for a particular year because the statute of limitations has expired is that many taxpayers combine their normal tax records and the records needed to substantiate the basis of capital assets. They need to be separated and the basis records should not be discarded before the statute expires for the year in which the asset is disposed. Thus, it makes more sense to keep those records separated by asset. The following are examples of records that fall into that category:

- **Stock acquisition data –** If you own stock in a corporation, keep the purchase records for at least four years after the year the stock is sold. This data will be needed in order to prove the amount of profit (or loss) you had on the sale.
- **Stock and mutual fund statements –** Where you reinvest dividends. Many taxpayers use the dividends that they receive from a stock or mutual fund to buy more shares of the same stock or fund. The reinvested amounts add to the basis in the property and reduce gain when it is finally sold. Keep statements at least four years after the final sale.
- **Tangible property purchase and improvement records –** Keep records of home, investment, rental property, or business property acquisitions AND related capital improvements for at least four years after the underlying property is sold.

For example, when the large $250,000 and $500,000 home exclusion was passed into law several years back, homeowners became lax in maintaining home improvement records thinking that the large exclusions would cover any potential appreciation in the home's value. Now that the exclusion may not always be enough, records of home improvements are vital. Records can be important, so please use caution when discarding them.

Have questions about whether or not to retain certain records? Give us a call first; it is better to make sure before discarding something that might be needed down the road.

Qualified Leasehold Improvements Eligible for 100% Write-Off

In an effort to get the economy back on the rails again, the 2010 Tax Relief Act permits businesses to claim a 100% depreciation deduction (100% bonus depreciation allowance) in the year that qualifying assets are placed in service. Qualified leasehold improvements clearly are eligible for this special 100% write-off.

Bonus depreciation basics – In general, a leasehold improvement qualifies for the 100% bonus depreciation allowance if it is acquired and placed in service after September 8, 2010 and before January 1, 2012, and the original use of the improvement commences with the taxpayer.

Qualified leasehold improvement property – Generally, qualified leasehold improvement property includes interior improvements to a building which is nonresidential real property if:

(1) The improvement is real property;

(2) The improvement is made to leased property. A lease for this purpose is defined as any grant of a right to use property, either by the lessee, sublessee or lessor of the building portion;

(3) The leased portion of the building is occupied exclusively by the lessee (or sublessee); and

(4) The improvement is placed in service more than 3 years after the date the building was first placed in service.

The following expenditures, however, do not qualify: amounts paid for the enlargement of a building, a structural component that benefits a common area, an elevator or escalator, or the internal structural framework of the building.

Whether you have already made leasehold improvements or are contemplating on doing so, and have questions on how this special write-off can fit into your business planning for 2011, please give this office a call.

Tax calendar

June – September 2011

June 15, 2011:

- U.S. citizens living abroad on April 18, 2011 must file a 2010 income tax return (if not already filed) or file for an extension.
- The second installment of 2011 individual estimated taxes is due. If your income or deductions have significantly changed, call this office to determine if any adjustment in estimates is appropriate.

June 30, 2011:

- This is the last day to report a financial interest in or signature or other authority over any foreign financial accounts with an aggregate value over $10,000 by filing Form TD F 90-22.1. There are no extensions and substantial penalties will apply for failing to file.

June-July 2011:

- It's time to review 2011 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

August 1, 2011:

- This is the due date for self-employed individuals and employers to file 5500 series returns for 2010 calendar year benefit plans (including Keogh/HR-10 plans). Since the normal July 31 due date falls on a Sunday, this due date is extended to August 1, 2011.

August 31, 2011:

- This is the last day for taxpayers with undisclosed income for offshore accounts to become current under a special voluntary disclosure initiative offered by the IRS.

September 15, 2011:

- The third installment of 2011 individual estimated taxes is due.

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.

Client advisor
CURRENT INFORMATION, NEWS AND TRENDS

11620 Wilshire Boulevard
Suite 220
Los Angeles, CA 90025

Telephone 310.478.9200
Facsimile 310.479.7426
www.SilkRoadRealtyInc.com

D.R.E. License No. 01874990

Since You Asked...

You Asked: Since I have been unemployed for quite a while and need some funds to carry me over, I am thinking of tapping into my IRA for some cash. What are the tax ramifications?

Answer: Withdrawals from tax-deferred retirement accounts, such as Traditional IRAs, are generally taxable and will be added to your other income for the year and taxed at your highest marginal rate. In addition, if you are under 59½ years of age, the distribution will also be subject to a 10% federal penalty (and possibly a state tax penalty depending where you live), unless you meet one of the penalty exceptions such as payment of unreimbursed medical expenses, medical insurance and higher education expenses. So the actual tax cost to you will depend upon your tax bracket for the year, your age, if you are subject to the early withdrawal penalty, and whether one of the penalty exceptions applies.

You Asked: The self-employed health care deduction seems to be getting complicated. I have received conflicting information as to whether the Medicare Part B premiums can be included in that deduction. Also, someone told me I can now include a non-dependent child in my self-employed policy and include those premiums in the deduction. Can you elaborate?

Answer: There was a time when the IRS was taking the position that Medicare Part B premiums were not deductible as self-employed health insurance. However, the 2010 instructions for the 1040 clearly state that they are deductible. With respect to the non-dependent child, the answer to your question is yes, provided the child is under the age of 27. There are no other restrictions; the child can even be married. Under prior law, the child had to be your dependent.