

CPA CLIENT

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TAXLETTER

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America Counts on CPAs

Maximize Tax Benefits for Business-Car Use

If you're an employee, you may drive a car for business. If you're an employer, some of your employees are likely to do some business driving. With gas prices climbing toward \$4 per gallon (as of this writing), such driving can be extremely expensive. To help trim your costs, you should know the tax rules.

Employees' cars

When employees use their own cars for business driving, the company can reimburse them. (Reimbursement isn't allowed for commuting to and from work, however.) Typically, employees will report business use of their cars and receive a payment from the company. Often, reimbursement is based on cents-per-mile. As long as this reimbursement rate is equal to or less than the IRS standard rate, there are no tax consequences. In 2008, that rate is 50.5 cents per business mile.

Example #1: Alice Wilson drives her own car 1,000 miles for business this month, and the company reimburses her at 50 cents per mile. Alice receives a check for \$500: 50 cents times 1,000. Alice does not have to report the income and she owes no tax.

Employees must submit reports to the company in order to avoid owing taxes on their reimbursement. The reports should describe the time, place, and business purpose of the travel. Regardless of whether the company has a suitable reporting system in place, however, excess reimbursements will trigger income tax.

Example #2: Suppose the company's reimbursement rate is 55 cents. Alice Wilson would get a check for \$550. Her

company would report \$45 on her W-2 form as additional income, subject to tax. That's 4.5 cents (55 cents minus the standard 50.5 cents) times 1,000 miles.

Company cars

Another common arrangement is for the company to provide cars to certain employees for business use. If this is the case, owners or executives won't have to use their own funds to pay for a business car. Moreover, this perk may help attract and retain valued employees. If you're a business owner, you should weigh these benefits against the cost of using the company's capital to acquire cars.

If the company acquires the cars, some or all of its outlays will be tax deductible. Then employees report personal use of the company car and pay tax on that use. How is this personal use determined? Generally, the company will use an IRS table that lists an "annual lease value" of the car, which is based on the purchase price. The ratio of personal miles to total miles is multiplied by the annual lease value to compute taxable income.

Example #3: ABC Co. purchases a car for \$30,000 and allows its CEO, Barry Thomas, to use it. He drives 20,000 miles this year, including 5,000 personal miles. His personal use thus equals 25% of the total miles. According to the IRS, a car worth \$30,000 has an annual lease value of \$8,250. Barry will pick up \$2,062.50 (25% times \$8,250) of taxable income.

Lease or buy?

If you're a business owner who wants to provide company cars for some employees,

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should you lease or buy the cars? Historically, leasing has offered the better deal when you take the tax benefits into account. When a company leases the cars, the lease payments are tax deductible. The company will pick up a modest amount of taxable income, called the lease inclusion amount. The purpose of this addition to income is to make the tax treatment of leasing versus owning a vehicle more equitable. Employees will have taxable income for personal use of a leased company car, using the method described above.

This year, buying company cars may be relatively more attractive. The **Economic Stimulus Act of 2008** raises the maximum first-year depreciation deduction for business cars from around \$3,000 to about \$11,000 for cars purchased in 2008 and used primarily for business. Slightly higher deductions are available for vans and trucks. (The new law does not alter the limitation imposed on sport utility vehicles, which have an expense limit of \$25,000.)

Our office can help you crunch the numbers under the new law to see

whether buying or leasing will work better for you.

Automobile	
Fair Market Value	Annual Lease Value
\$20,000	\$ 5,600
\$25,000	\$ 6,850
\$30,000	\$ 8,250
\$35,000	\$ 9,250
\$40,000	\$10,750
\$45,000	\$11,750
\$50,000	\$13,250

Source: IRS

Age-Weighted Profit-Sharing Plans: Elder Shelter

If you run a small company or professional practice and you're considerably older than your employees, an age-weighted profit-sharing plan may be appealing. Most of the company's contributions under such a plan can go into your own retirement account and the accounts of co-owners who are starting to show a few grey hairs.

Generic profit-sharing plans

In a standard profit-sharing plan, the company will contribute a certain percentage of pay to participating employees' accounts within the plan. That percentage can vary each year, from 0%–25% of pay, regardless of the company's profitability. Each employee gets the same percentage of pay. Contributions are tax deductible for the company.

Example #1: Connie Simmons is the sole owner of DEF Co., earning \$100,000 per year. She decides to make 25% profit-sharing contributions for all employees. Thus, Connie's account gets \$25,000, while a salesman earning \$60,000 gets a \$15,000 contribution, and a secretary earning \$40,000 gets a \$10,000 contribution. The maximum

contribution for 2008 is \$46,000, per the IRS. If a profit-sharing plan also includes a 401(k), participants 50 and older will be able to make a \$5,000 catch-up contribution in 2008, bringing their maximum to \$51,000.

Cost control

From a business owner's perspective, a standard profit-sharing plan may be expensive. To bring the owner's contribution up to the \$46,000 maximum, the company might have to contribute 20%–25% of pay for each employee. To cut costs while maximizing your personal contribution, consider an age-weighted profit-sharing plan. The older you are, compared with the company's other workers, the more you can tilt such a plan in your favor.

Depending on the makeup of the company workforce, a 50-year-old business owner might get 20% of pay contributed to his account while a 25-year-old assistant gets only 3% of pay. The IRS may allow this difference because the assistant's contribution has 25 more years to grow, untaxed. Thus, the disparate contributions may be deemed equivalent.

The weighting game

In a simple scenario, an age-weighted plan may work well for business owners. That's not always true, however.

Example #2: GHI Co. has four owners, ranging in age from the upper 30s to the low 50s. With a straight age-weighted plan, a larger contribution will go to the oldest owner, which might displease the youngest one. An age-weighted plan also may prove to be impractical if a lower-wage employee is older than the business owners. That employee might be entitled to a large profit-sharing contribution, as a percentage of pay.

In such situations, a specific type of age-weighted plan might be more appealing. In a "new comparability" or "cross-tested" plan, the age weighting is done by groups of employees, not by individuals. Profit-sharing contributions are determined by the average age within the group. Thus, if the average age of the owner group (which might consist of only one person) is greater than the average age of other employees, contributions can be tilted towards the owners. Often, 90% or more of the company's contributions can go

to owners and other key employees, who receive maximum or near-maximum contributions while relatively little goes to the rank-and-file.

Proceed with caution

Age-weighted profit-sharing plans—

especially new comparability plans—can require steep setup and administrative costs. IRS rules in this area can be complex. Our office can help you put together a plan that will stand up to scrutiny. You also should be aware that such plans can be detrimental to

morale if young workers feel their retirement plan contributions are too low. Nevertheless, if amassing a large retirement fund for your own use is a key goal, an age-weighted profit-sharing plan may suit your purposes.

Equipment Expensing Reaches the Quarter-Million Mark

The Economic Stimulus Act of 2008 increases the Section 179 tax break. This tax code section permits you to buy business equipment and take an upfront deduction.

Normally, that's not the case. Most equipment outlays must be recovered over several years of tax deductions.

- Suppose your company buys a \$20,000 machine. The company might be able to deduct \$4,000 (20%) of the machine's cost the first year. The remaining cost will be deducted over time.

However, Section 179 permits a special "expensing election." Equipment buyers can choose to deduct the entire cost right away. There are limits to this tax break. Under prior law, you could expense up to \$128,000 in business property this year. The new law raises the ceiling to \$250,000 for 2008.

- If you spend \$300,000 on business equipment in 2008, you can immediately deduct \$250,000 of its cost. The other \$50,000 might qualify for another feature of the new law, *bonus depreciation*. (See "More Stimulus for Businesses, Homeowners" on page 4).

Over the limit

The \$250,000 limit applies to taxpayers who purchase no more than \$800,000 worth of equipment this year. Above \$800,000, you lose the benefit of expensing, dollar-for-dollar.

- Suppose your company buys \$874,000 worth of equipment in 2008. The expensing election is reduced by

\$74,000, from \$250,000 to \$176,000. The other \$698,000 (\$874,000 purchased minus \$176,000 expensed) must be depreciated. If your equipment purchases exceed \$1,050,000 this year, no expensing will be permitted.

Zero can be a negative

What's more, the expensing deduction can't exceed the taxable income of the taxpayer purchasing the equipment. If you run a regular C corporation that "zeroes out" taxable income through salaries and bonuses, there won't be any tax benefit for the corporation from the expensing election. In that case, your corporation can pay less compensation to its principals and retain enough taxable income to cover a Section 179 election. To avoid losing this tax benefit, your corporation might reduce or defer bonuses so that it will have sufficient taxable income to benefit from expensing.

Some taxpayers will take the 179 election on a personal tax return. That will be the case if you're self-employed or if you own a pass-through entity such as an S corporation. When one spouse reports equipment purchases on a joint tax return, the other spouse may help to pass this taxable income test.

- Suppose your spouse starts a sideline business and spends \$50,000 on equipment in 2008. The startup has no taxable income this year, so expensing would not be allowed. However, if you file a joint return with your spouse, your income could be used to reach the \$50,000

mark and permit a full expensing deduction in 2008.

Business and pleasure

Equipment you use for both work and play must meet another test. Suppose you buy a new computer and peripherals this year. You use them for work but also for various personal pursuits.

If your business use exceeds 50% the first year, you can expense a portion of what you paid for the computer, monitor, printer, scanner, etc. If business use is 65%, for example, you can take a 65% deduction for the money you spent. However, if business use the first year is 50% or lower, you must use extended depreciation. And if your business use falls below 50% within the next few years, you'll have to repay to the IRS some of the tax benefits you've taken.

Therefore, you should keep a log to document business use of mixed-use equipment.

Final thought

For equipment to be expensed in 2008, it must be placed in service this year. If the equipment is operating by December 31, you can take a 2008 deduction even if you don't pay for it until 2009.

- What if you buy equipment in December 2008, but it's not installed until 2009? You won't qualify for a 2008 deduction even if you pay in full this year. Therefore, if you want to take an expensing deduction this year, be sure the equipment is up and running by the end of December.

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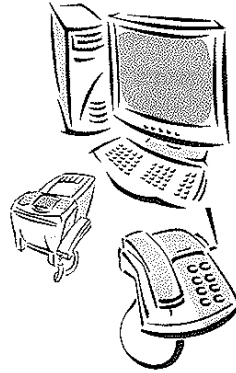
More Stimulus for Businesses, Homeowners

Other provisions of the Economic Stimulus Act include the following:

■ **Bonus depreciation:** Property purchased and first placed in service in 2008 may qualify for 50% first-year depreciation if it can't be expensed. If your company buys \$500,000 worth of equipment this year:

- It could expense \$250,000 worth.
- Of the other \$250,000, your company would be able to use bonus depreciation to deduct \$125,000 (50%).
- Of the last \$125,000, \$25,000 (20%) could be deducted, assuming the property would qualify for a 20% first-year depreciation deduction under prior law.

Thus, \$400,000 of the \$500,000 spent on equipment would be deductible in 2008.



■ **Jumbo mortgages:** A jumbo mortgage is a home loan that exceeds a certain amount. Nationwide, the threshold had been \$417,000. The new law temporarily raises the threshold in some expensive housing areas to as much as \$729,750.

This provision covers mortgages originating or approved for origination between July 1, 2007, and December 31, 2008, regardless of when the actual home purchase occurs. This provision will allow Fannie Mae and Freddie Mac to purchase and guarantee larger home loans, which can be packaged and sold to investors. Thus, the securities backed by these mortgages will have an implicit federal guarantee.

With such a guarantee, investors can be expected to accept lower yields, so lenders can make loans at lower interest rates. The bottom line, lawmakers hope, will be lower interest rates on some new and refinanced home loans between \$417,000 and \$729,750.

Dodge Double Tax After Inheriting an IRA

If you have inherited an IRA recently, you may have skipped one of the most overlooked deductions in the tax code. Fortunately, you probably can reclaim some of the money you've paid in excess tax.

Double trouble

This situation arises if you are the beneficiary of an IRA that was owned by someone whose estate owed estate tax. If so, the IRA probably was subject to double taxation:

1. **Estate tax.** For deaths in 2007 and 2008, estates over \$2 million owe tax on the excess, at a 45% rate. In 2009, that exemption increases from \$2 million to \$3.5 million.
2. **Income tax.** When you inherit a traditional (not a Roth) IRA, you must

pay income tax on withdrawals. The tax rate can be as high as 35%.

A valuable offset

Where is the overlooked deduction? In the above situation, where the IRA owner's estate paid estate tax, the estate tax that was paid will become a future tax deduction. You must calculate the amount of estate tax that was paid because of the IRA. That amount is deductible over time, to offset the tax on IRA withdrawals.

Example #1: Olivia Farrell dies in 2008 with a \$2.7 million estate, including \$1 million in an IRA. Her entire estate goes to her son Angelo.

Olivia's estate is \$700,000 over the \$2 million exemption. At a 45% rate, her estate owes \$315,000 in federal estate

tax. Without her \$1 million IRA, her estate would not have owed any estate tax. Therefore, Olivia's \$1 million IRA causes a \$315,000 estate tax bill: a 31.5% ratio. This result is called the income in respect of a decedent (IRD) ratio. When Angelo withdraws money from the inherited IRA, he can use this ratio to determine his income tax deduction.

Example #2: Angelo withdraws \$50,000 from the inherited IRA in 2009. Using a 31.5% ratio, \$15,750 is deductible. In effect, Angelo is paying tax on a \$34,250 withdrawal, net of the deduction, instead of paying tax on a \$50,000 withdrawal.

End of the line

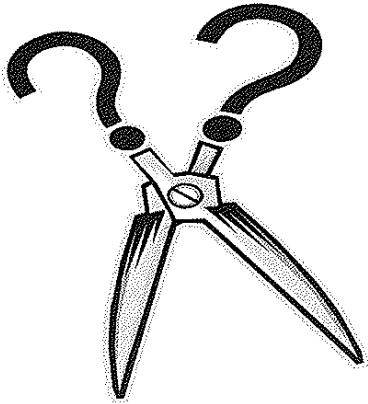
In the above example, the inherited IRA causes \$315,000 in estate tax

More Year-End Tax Changes

Another recent tax law, the **Mortgage Forgiveness Debt Relief Act of 2007**, includes provisions that may prove helpful to you . . . or perhaps not.

More time for surviving spouses

Under current law, you can exclude \$250,000 worth of gains from the sale of your home. Married couples filing jointly get an even better break: They can exclude up to \$500,000 of gains as long as both spouses occupied the house as a principal residence for at least two years (730 days) of the five years preceding the sale.



That sounds fine, but what if a hypothetical Beth Williams died in late 2007, and her widower Bob decides he wants to sell the big house in which they lived. Under federal law, as an unmarried surviving spouse, Bob would be able to claim the larger exclusion available to married couples only if he sold the house within the calendar year of the deceased spouse's death. As a result, many surviving spouses had to settle for a \$250,000 exclusion rather than a \$500,000 exclusion. That's not the case under the new law. Effective for sales after 2007, an unmarried surviving spouse can exclude up to \$500,000 worth of gains on a home sale, providing the sale occurs within two full years of the spouse's death.

Example: Beth dies on October 31, 2008.

Old law: To get the \$500,000 exclusion, Bob must sell the house in the year of death—by December 31, 2008.

New law: Bob has two full years, until October 31, 2010, to sell the house and take the larger tax break.

To get the bigger tax break, all of the requirements for the \$500,000 exclusion must have been met at the date of the spouse's death.

Mortgage insurance deductions

Many homeowners buy mortgage insurance when they take out a home loan. Prior law called for the insurance premiums to be tax deductible, but that law was scheduled to expire after 2007. The new law extends this provision; premiums paid through 2010 may be deducted as if they were home mortgage interest. Unlike home mortgage interest, however, the mortgage insurance premium deduction is subject to a phaseout. If your adjusted gross income (AGI) is over \$100,000, each additional \$1,000 of AGI cuts the write-off by 10%.

Example: With an AGI of \$100,001, you can deduct only 90% of your mortgage insurance outlays. At an AGI of \$101,001, you can deduct only 80%, and so forth. As you can see, if your AGI is \$109,001 or higher, you'll get no deduction at all.

Revenue raisers

Two not-so-helpful provisions of the new law may affect small companies:

- **Partnership returns.** Failure-to-file penalties relating to partnership returns are now in effect for 12 months, up from 5 months under prior law. The penalties have been increased, too, from \$50 to \$85 per partner.

- **S corporation returns.** Penalties for failing to file an S corporation return or failing to provide required information on the return can be assessed for 12 months. The penalty is \$85 per shareholder per month.

Alleviating the AMT

Yet another new law, the **Tax Increase Prevention Act of 2007**, provides a "patch" for the alternative minimum tax (AMT). The law increases the 2007 AMT exemption amounts beyond their 2006 levels and sets them much higher than they would have been without the one-year relief. The 2007 AMT exemption amounts have been set at \$66,250 for joint returns and \$44,350 for single filers. Those numbers were \$62,550 and \$42,500, respectively, in 2006. In addition, the new law allows taxpayers to use personal tax credits to offset the AMT, as has been the case in the past. These two provisions will allow an estimated 20 million taxpayers to avoid the AMT for 2007.

States Most Heavily Hit by the AMT

State	Percentages of Tax Returns Paying the AMT—2005
New Jersey	6.82%
New York	6.00%
Connecticut	5.90%
District of Columbia	5.19%
Maryland	5.02%
California	4.86%
Massachusetts	4.74%
U.S. Total	3.01%

Source: Tax Foundation

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payments. Thus, Angelo is entitled to \$315,000 in income tax deductions. After taking a \$15,750 deduction for 2009, Angelo can take \$299,250 in future tax deductions. Once all \$315,000 has been deducted, ongoing IRA withdrawals will be fully taxable.

What if Olivia had two children, Angelo and Maria, and had named them as equal co-beneficiaries of her IRA? The IRD ratio would be the same 31.5%; thus, Angelo and Maria would each have \$157,500 (half of \$315,000) in total tax deductions to offset future IRA withdrawals.

As mentioned, this deduction is frequently overlooked. If you were entitled to such deductions but did not claim them, our office can help you file amended tax returns for the past three years to claim a refund, with interest.

Roth 401(k)s—Right for You?

Since 2006, companies with 401(k) plans have been able to offer Roth 401(k) plans as well. Increasingly, both types of 401(k)s are being offered to employees. If you have the opportunity to contribute to a "Roth K," should you do so? Before deciding, you should know the ground rules.

Either or both

In 2008, total 401(k) contributions can be up to \$15,500. If you'll be 50 or older by year end, the maximum contribution is \$20,500. These contributions can go to a traditional 401(k), to a Roth K, or to both plans. If you divide your contribution between the two plans, it can be split in any ratio you choose.

Contributions you make to a traditional 401(k) are not subject to income tax right away. Instead, that

tax (and the tax on investment income inside your account) is deferred until money is withdrawn. In contrast, contributions you make to a Roth K are made from taxable earnings. The advantage is that all withdrawals will be tax free after you've had the account for five years and after age 59½. Thus, there are two key factors to making your decision: your current effective tax rate and your expected future tax rate.

High-low

If you think your tax rate is now higher than it will be in the future, a traditional 401(k) is the better choice. But if you think your rate will be higher in the future, opt for the Roth K.

Example #1: Mike Green is 25 years old, starting his career with a low salary. Contributing to a traditional 401(k) will provide him with a

relatively small tax benefit because his tax bracket is low. He chooses a Roth K because he expects to be in a much higher tax bracket when he retires.

Example #2: Linda Harris, age 56, is now in a 33% tax bracket. She expects to retire in a few years and drop to a lower bracket. For Linda, a traditional 401(k) probably is a better choice.

For all 401(k) participants, future income tax rates are uncertain. Income tax rates are relatively low now, by the standards of the last half century, but financial pressures might cause tax rates to rise in the coming years. One strategy is to split your contribution between a traditional and a Roth 401(k), if you have the opportunity. You will get a tax break now, from the traditional 401(k) contribution, while you also build a tax-free retirement fund inside the Roth K.

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