

TAXOLUTIONS



►► *ideas on taxes*

MINIMUM WAGE LEGISLATION PASSES WITH SMALL BUSINESS TAX BREAKS

A \$4.84 billion package of tax incentives for small businesses and a long-delayed increase in the federal minimum wage were folded into the Iraq War supplemental spending bill (H.R. 2206) signed into law by President Bush on May 25, 2007.

Under the newly enacted legislation, the minimum hourly wage of \$5.15 is set to rise in three stages: to \$5.85 on July 23, 2007, to \$6.55 one year later, and finally to \$7.25 starting July 23, 2009. Among the provisions affecting small businesses are an extension and an expansion of the Work Opportunity Tax Credit (WOTC), an extension of the Section 179 expensing provision, and a simplification of S corporation rules. The law also allows employers to continue to receive the current level of tip tax credit, even as the minimum wage rises.

To help soften the impact of a higher minimum wage on small businesses, members of Congress have long called for tax relief for small businesses to be included in any legislation raising the minimum wage. In February of this year, the Senate approved a package of tax breaks for small businesses worth \$8.3 billion, while the House passed a minimum wage bill that included tax incentives amounting to \$1.3 billion.

Shortly before the supplemental spending bill came to a vote on May 24, the tax-writing committees of the House and Senate finally settled upon a small business tax relief package worth \$4.84 billion over 10 years.

Under Section 179, small businesses are permitted to write off qualifying capital purchases that would otherwise be depreciated. The new legislation raises the Section 179 expensing limit to \$125,000 and the phase-out to \$500,000 for taxable years beginning in 2007 through 2010. These limits are indexed for inflation for tax years 2008, 2009, and 2010. For businesses in the Gulf Opportunity Zone (GO Zone), enhanced Section 179 expensing of up to \$225,000 is extended through 2008.

The WOTC, which benefits businesses that hire members of certain economically disadvantaged groups, such as welfare recipients and high-risk youth, is extended through August 31, 2011. The law also expands WOTC eligibility for employers hiring disabled veterans and people in areas suffering from population loss. Additionally, employers paying the alternative minimum tax (AMT), which excludes most deductions, will nonetheless be permitted to claim the WOTC and the tip credit.

The legislation further allows an unincorporated business owned jointly by a married couple to file as a sole proprietorship instead of a partnership, thus ensuring that both spouses receive

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MAXIMIZING YOUR TRAVEL AND ENTERTAINMENT DEDUCTIONS

Winning new business and maintaining relationships with existing customers is not just time-consuming; it is also potentially very costly. Sales often involves extensive travel, entertaining at good restaurants, attending special events, and even taking clients on vacation. The good news is that many of these relationship-building expenditures are tax deductible, provided your company keeps accurate records and can prove that the outlays were in fact business-related.

Travel Expenses

While the cost of commuting to and from the workplace is not deductible, expenses incurred by business owners or sales representatives who drive, fly, take taxis, or use other forms of transportation to meet customers are. Your company can deduct all business travel expenses, which include the following:

- Travel from a work location to a client meeting
- Travel from one client meeting to another
- Travel from one job site to another
- Travel to a temporary assignment (generally one year or less) that is outside the employee's general area of residence

When you use your own car for business purposes, you or your company

may deduct the expenses in one of two ways: Either record and deduct your actual expenses, including depreciation, or record your mileage and deduct a standard amount per mile of travel, plus parking and toll fees. The standard mileage rate for 2007 is 48.5 cents per business mile.

If expenses include accelerated depreciation, deducting actual expenses may at first provide a larger deduction. But keep in mind that you may not switch to the standard mileage rate in later years when it provides the larger deduction. If you lease a vehicle, you can either deduct actual expenses or take the standard mileage deduction.

Detailed recordkeeping is important to substantiate your deduction. To simplify your recordkeeping,



you may want to keep a log in your car and use a designated credit card for gas and repairs related to business usage.

If you are on an overnight trip, you may also be able to claim deductions for travel-related expenses, such as the cost of meals (usually 50%), hotel expenses, telephone or computer rental fees, and even some tips. Expenses related to foreign travel are deductible, provided the main purpose of the trip is business-

related and the trip lasts one week or less.

If your company reimburses you for business travel, the reimbursement is not usually included in your income, and you are not permitted to deduct expenses. Travel expenses for which you are not reimbursed are deductible as miscellaneous itemized deductions, subject to a 2% of adjusted gross income floor.

Entertainment Expenses

Because tax breaks for wining and dining clients can be easily abused, the Internal Revenue Service (IRS)

has specific rules about what types of entertaining may be claimed as business expenses and under what circumstances. However, 50% of the cost of many types of entertainment are deductible, provided they pass the IRS's "directly-related" or "associated" tests.

To meet the directly-related test, you must be able to show that you had more than a general expectation of obtaining income or some other specific business benefit at some future time, that you engaged in business with the person being entertained during the entertainment period, and that the main purpose of the entertainment was the active conduct of business. To pass the

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credit for paying Social Security and Medicare taxes. Modifications to the S corporation rules include changes to the tax treatment of certain types of stock transactions.

The cost of these tax breaks is offset in a number of ways, including enhanced penalties for violations of tax filing rules. Congress also anticipates a reduction in the amount of credits taxpayers will claim under the FICA/tip tax credit as

a result of the increase in the minimum wage.

Among the largest revenue generators is an expansion of the "kiddie tax"—which currently applies until a child reaches age 18—to all children under age 19, or 24 if the child is a student. Under the kiddie tax, children's investment income in excess of \$1,700 is taxed at the parents' top rate. This change in the kiddie tax rules discour-

ages the practice of transferring assets to children to avoid paying higher taxes.

Commenting on the passage of the legislation, Senate Finance Committee Chairman Max Baucus (D-MT), said, "Thanks to this bill, America's minimum wage workers are finally going to get their pay raise, and small businesses will get needed tax cuts." ■

IS YOUR HOME OFFICE TAX DEDUCTIBLE?

Whether you own your own business or are an employee, if you work at home regularly, you may be able to claim a tax deduction for your home office and for related expenses. Because the IRS guidelines for tax deductions pertaining to the use of a home office are complex—and because the IRS has been known to audit filers whose home office deduction claims appear suspicious—many home workers are reluctant to claim tax breaks to which they are entitled. But if your situation clearly fits the IRS's specific criteria, taking advantage of these home office deductions could trim a substantial sum off your tax bill.

The amount you may deduct is related to the percentage of your home used to conduct business. For tax purposes, the IRS defines "home office" as any business space in a "home" that is otherwise occupied as a residence, including a house, apartment, condominium, mobile home, or boat. It is even permissible to claim a deduction for a separate structure on a residential property used exclusively for business purposes, such as a studio, garage, or barn. The types of expenses you are permitted to deduct for the business use of your home include the business portion of property taxes, mortgage interest, rent, utilities, insurance, depreciation, maintenance, and repairs.

To claim expenses for the business use of your home, you must use a specific area of your home regularly and exclusively for your business or trade, or as a place to meet or deal with clients or

customers in the normal course of your trade or business. To qualify under this test, the area must be a separate room, or a clearly identifiable space within a room, that is not used for personal activities. The room or area you designate as your office may not, for example, double as a bedroom or dining room.

To satisfy the IRS requirements, the office must also be used on a regular—not incidental or occasional—basis. While "regular" is not defined specifically, it is generally considered possible to meet this test if you use the office at least two days a week or a few hours every day.

Even business owners who do most of their work in the field can qualify for this deduction if they use the office space to handle most of the management and administrative tasks of the business, such as billing customers, bookkeeping, ordering, arranging appointments, or writing reports. The home office must, however, be the principal place of business. Under certain conditions, it may also be possible to deduct space used for storing inventory or product samples.

The IRS frowns upon home office deductions for what is essentially a hobby, not a legitimate, profit-making business. You may deduct all of your business expenses only if the gross income from your home business equals or exceeds your business expenses. Business expenses that cannot be deducted due to gross income limits may, however, be carried forward to the next year.

Different tests apply if you are an employee who telecommutes. As an employee, you are not permitted to claim a home office deduction if you are working from home for your own convenience, but you are entitled to a tax break if your employer has asked you to work from home as a condition of employment. You would, for example, qualify for a home office deduction if you work from home because your employer wishes to save money by no longer providing you with a work station.

Even if you are unable to qualify for the home office deduction, you may be able to deduct other business-related expenses not reimbursed by an employer, such as the cost of separate business phone lines, office supplies, computers, and other types of equipment.

It is essential to keep good records if you wish to claim these deductions. In addition to holding onto receipts for any home business-related purchases, you should maintain appointment books and calendars that provide evidence that your home is used to meet clients or conduct business. It is also helpful to use your home address for business correspondence and business cards.

Under certain circumstances, the sale of your house could result in a capital gains liability if you have taken advantage of home office tax breaks. Because claiming these deductions can be complicated, it is essential to seek advice from a tax professional before filing. ■

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associated test, you must show that the entertainment was associated with the active conduct of your business and directly followed or preceded a business discussion.

In practice, this means that a wide range of activities are potentially deductible, including restaurant meals, visits to sporting events and nightclubs, and

even entertaining in your own home. There are, however, restrictions on the amount you may deduct when you take clients on certain types of trips, such as hunting, fishing, or yachting. While the cost of renting and maintaining entertainment facilities is generally not deductible, the cost of providing meals is. You are not allowed to deduct membership fees for country clubs, but you

can write off part of the cost of joining professional and civic associations.

The rules for claiming these types of deductions can be complex. We can help you determine what tax breaks you may be entitled to receive, as well as help you tailor your sales activities to maximize your savings. ■

EXERCISING INCENTIVE STOCK OPTIONS

Compared with other forms of compensation, incentive stock options (ISOs) can provide employees with substantial tax breaks. If held for a certain period of time, shares purchased as ISOs may escape all taxes other than the relatively low long-term gains rate of 15%. But as many “paper millionaires” discovered, exercising ISOs can be very risky, especially if the employee fails to weigh all the potential tax consequences before cashing in.

When you exercise ISOs, there are no taxes due immediately. Instead, the entire gain, including the spread and any additional appreciation, is taxed at long-term capital gains rates, provided the employee does not sell the shares until at least two years after the option was granted and one year after the date of exercise. The gain would lose its qualified status only if these holding period requirements were not met.

Sometimes, however, exercising and then holding ISOs into the next tax year can carry a very substantial hidden sting. When calculating tax liability, the spread between the grant price and the market value must be added as a “preference item” on the Alternative Minimum Tax (AMT) worksheet. If the amount you would pay under the AMT were higher than your regular income tax, you would be required to pay the AMT.

Under the AMT, people are taxed on the amount of their taxable income above the exemption amounts. For 2007, these are \$33,750 for singles or heads of household, and \$45,000 for joint filers. The AMT exemptions phase out gradually at higher income levels.

Some employees who held onto their companies’ shares for more than a year after exercising ISOs have found

themselves in the unfortunate position of owing more in AMT taxes than their shares were actually worth.

Fortunately, there are ways to reduce the chances of falling into this trap, which include the following:

- Selling shares immediately after exercising ISOs
- Exercising ISOs incrementally
- Exercising ISOs at a time when the share price is unusually low
- Exercising ISOs early in the year
- Taking other steps to reduce your chances of having to pay the AMT
- Choosing not to exercise the options

The most appropriate strategies for you will depend on your personal financial and tax circumstances. For specific tax advice, please consult your tax professional. ■

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