

TAXOLUTIONS



►► *ideas on taxes*

RECORDKEEPING FOR TAX PURPOSES

Keeping thorough and accurate financial records is one of the less exciting tasks that business owners face, but it is a necessary one. In addition to enabling you to monitor the progress of your business and make informed decisions on a daily basis, keeping good records is essential when it comes time to prepare your tax returns. While the smallest businesses may be able to get by with the “shoebox method,” having in place a reliable and comprehensive recordkeeping system for your business finances is crucial if you want your business to grow.

The types of financial records you must keep are not mandated by law, but the Internal Revenue Service (IRS) demands that your recordkeeping system clearly shows your business’ income and expenses. A failure to keep good records of finances could result in underpayment or overpayment of taxes, penalties for filing late or for underpayment, and additional fees for tax preparation. Incomplete accounting records can also present problems if your return is audited by the IRS.

Rather than relying on handwritten journals or ledgers, many businesses now use small business accounting software to keep track of their revenues and expenses. Relatively easy to use and generally affordable, a basic accounting software application will help you generate balance

sheets, categorize transactions, track sales, record cash disbursements, manage payroll, create invoices, set up budgets,



conduct your banking, and monitor tax liabilities. Your tax professional may be able to recommend an accounting soft-

ware program that provides the level of functionality appropriate for your business.

But even the best electronic bookkeeping system does not eliminate the need for filing and storing paper receipts that may be necessary to substantiate deductions. In addition to recording transactions electronically, keep any printed documents that show the amounts and sources of gross income, such as invoices, cash register tapes, and credit card charge slips. The IRS may also want to see documents that show the amounts paid for purchases, such as canceled checks, credit card sales slips, and invoices.

It is especially important to have a paper trail when claiming deductions for certain types of expenses, such as business-

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YEAR-END TAX PLANNING

As you manage your taxes at year-end, one important, constant goal should be to reduce your adjusted gross income (AGI), which equals your gross income (salary, investment earnings, etc.) less your allowable deductions and exemptions. Maximizing your deductions and exemptions, as well as taking advantage of any tax credits available to you, is a great way to start thinking about saving money on your next tax bill.

Maximize your 401(k). A 401(k) plan has a maximum contribution amount, which limits your annual contribution. However, if your contributions have fallen short for the year, some plans will allow you to “catch up” at year-end. Not only can this help you save on taxable income, but also if your employer matches a portion of your contributions, then you will benefit in two ways.

Individual Retirement Accounts (IRAs). You may invest in your IRA for tax year 2007 until April 15, 2008. Contributions are limited to \$4,000, and deductions phase out for single filers with AGIs

greater than \$52,000 and for joint filers with AGIs greater than \$83,000.

Charitable donations. If you are considering giving a cash donation to a charity during the 2007 tax year, you must give it or mail it by December 31. You will be eligible for the deduction as long as the donation was made by the end of the year. Appreciated stocks that you have owned for over a year can also be donated to charity. If you do so, you will not owe taxes on the appreciation, and you will be entitled to deduct the expense of the stock from your taxes. If you wish to maintain ownership, the charity may be able to assist you in buying new shares.

Devalued stock. If you own stock that has lost value, you may be able to claim a capital loss. However, the Internal Revenue Service (IRS) has specific rules for what may qualify as a loss. Deductible losses can equalize any realized gains and up to \$3,000 of income.

Charge it. Any year-end deductible expenses, such as those for unreimbursed business-related expenses, can be charged

to a credit card. According to the IRS, you are allowed to deduct expenses that occurred within the taxable year, which means that you can take advantage of the deduction this year and, if need be, pay off the card next year. Many charities also accept donations by credit card, which would further your ability to make a tax-deductible charitable donation.

Prepay. If the **alternative minimum tax (AMT)** does not apply to you, and you are sure that your tax bracket has remained the same, consider prepaying your state and local taxes. Prepaying these taxes before the end of the year will enable you to claim a credit on the amount when you file.

You have until December 31 to get a head start on year-end planning. If you plan to itemize your deductions, then fulfill your promise to yourself and take action. Following these year-end deduction tips can benefit a charity or your retirement savings, while making your taxes a little less taxing. ■

TURNING A HOBBY INTO A BUSINESS

Many Americans dream of turning their favorite free time activities into money-making ventures. Creating a successful and profitable business is seldom easy, but the federal government offers tax incentives to business owners that could make converting an avocation into a business start-up an effective part of your overall tax planning strategy.

In determining whether your activities can be defined as a business for tax purposes, the IRS will want to see evidence that the amount of time and effort you are putting into the venture indicate an intention to make a profit. You may also be asked to show you have earned a profit from conducting similar activities in the past and prove that you or your advisors have the knowledge necessary to carry on the activity as a successful business. While many start-ups incur losses in the early stages, the IRS may require you to demonstrate that these losses are due to

circumstances beyond your control and to provide evidence of a willingness to change your methods of operation to improve profitability. To qualify for tax purposes as a for-profit business over time, the IRS may wish to see that the activity has generated a profit during at least three out of the last five tax years.

You can establish a profit motive by taking relatively inexpensive steps to market your products or services, such as running advertisements online, buying a Yellow Pages listing, or placing ads in the local newspaper.

Best of all, many of these expenses become deductible once you have established a business. Provided they are directly related to your business activities, you may be able to write-off entertainment and transportation expenses. You may also be able to hire your children to work for the business, thus shifting income to a minor child

subject to lower tax rates. If you have a home office and equipment that are used exclusively and regularly for business, you could qualify for deductions for the business portion of property taxes, mortgage interest, rent, utilities, insurance, depreciation, maintenance, and repairs.

Depending upon the type and scale of your business, you may have to file papers with state and local authorities to register for sales and other business taxes, and to obtain any relevant licenses or permits. As a self-employed individual, you will have to pay income and self-employment taxes as estimated installments on a quarterly basis. If you have employees or are operating as a partnership, you will have to obtain an employer identification number (EIN) from the IRS. Your accountant can help you with these tasks and advise you on selecting the business entity that best suits your needs. ■

TIPS FOR STAYING CLEAR OF THE DREADED AMT

Originally designed to apply only to rich Americans who were attempting to shelter their wealth from the taxman, the alternative minimum tax (AMT) is increasingly ensnaring families whose earnings fall in the middle- to upper-middle income range. Taxpayers who have two or more dependents, live in high-tax states, itemize deductions, or exercise incentive stock options are especially likely to fall into the AMT trap. Until debate in Congress about modifying or abolishing this unpopular “stealth” tax translates into action, the best approaches for coping with the AMT threat include managing your tax burden so that the chances of triggering the AMT are minimized and finding ways to reduce the amount owed when the AMT cannot be avoided.

The AMT eliminates all standard and many of the itemized deductions available under the regular tax system. Itemized deductions for state and property taxes, unreimbursed employee business expenses, investment and home equity loan interest, and medical expenses that do not exceed 10% of adjusted gross income are examples of the deductions that are not permitted when the AMT applies.

Under the AMT formula, all disallowed deductions are added back in, and a single AMT exemption is used to reduce your taxable income before the tax is calculated. For tax year 2006, the exemption amounts were \$42,500 for single filers and \$62,550 for married couples filing jointly. The exemptions for 2007 are currently set at \$33,750 for singles and \$45,000 for married couples, but Congress will likely enact a “patch” that will raise these amounts in line with inflation. Any income above these exemption levels is then taxed at flat rates of 26% up to \$175,000 (or \$87,500 for married filing separately) and of 28% in excess of this amount.

If there is a chance you will be subject to the AMT, you must calculate your tax liability under the rules of both the regular tax code and the AMT, and pay the higher amount. In some cases, the

difference in the amounts owed under the AMT and the regular tax system can be substantial. Families may find themselves having to pay the AMT in a given tax year because they have claimed a large number of itemized deductions on top of claiming a large number of standard deductions. Planning away personal exemptions for dependent children is hardly feasible, but there may be ways you can organize your other expenses to avoid entering the AMT zone, or to minimize the amount you owe if you are liable to pay the AMT.

Planning for the AMT means turning the conventional tax planning strategy on its



head: Instead of accelerating deductions and deferring income, attempt to accelerate your income and defer deductions. Examine all the itemized deductions you expect to claim in this or the coming year, and think about whether it makes sense to try to defer or accelerate those expenses. If you are likely to face the AMT this year, consider deferring payment on state and local taxes, provided any penalties incurred would be lower than the additional taxes owed.

It is not always possible to control when potentially deductible medical ex-

penses are incurred, but it may be possible to control when the bills are paid. If your employer offers a cafeteria plan, consider using this option to pay medical expenses in advance on a pre-tax basis, rather than claiming an itemized deduction on your tax return. Whenever possible, schedule the payment of any items not deductible under AMT rules, such as business or investment expenses, for years when you are not likely to be subject to the AMT. If you are employed and claim unreimbursed business expenses on your personal income tax return, consider asking your employer to reimburse you directly for these expenses.

Similarly, consider the potential AMT consequences of selling long-term investments, and time those sales accordingly. While long-term capital gains are taxed at the same rate under the AMT as under the regular income tax system, adding a large capital gain to your income can serve to reduce or eliminate the AMT exemption.

Accelerating income may be advisable if the AMT's flat rates of 26% and 28% are lower than the tax brackets you would be subject to under the regular tax system. Ways to accelerate your income include asking for prepayments of salary or bonus, cashing in certificates of deposit or savings bonds, taking a short-term capital gain, or withdrawing funds from taxable retirement accounts.

It is especially important for AMT planning purposes to take care when exercising employer-provided incentive stock options (ISOs). The difference between the fair market value of the stock at the time of purchase and the amount paid for the stock is considered taxable under the AMT. If you fail to sell the shares in the same year the ISOs were exercised, you could end up with a very large AMT liability. If the stock declines in value during the holding period, you may actually lose money on the transaction. Because of the risks involved, you should always consult your tax professional before exercising ISOs. ■

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related gifts, entertainment, travel, and meal expenses. In addition to keeping paper receipts, maintain a diary or calendar to record details of business meetings, including who was in attendance and what was discussed. While you are not required to keep receipts for entertainment and meal expenses of less than \$75, you should still maintain written records of any meetings for which expenses are deducted. If you use your personal car for business part of the time, keep a log in the car that records mileage, tolls, and parking fees incurred in the course of business usage.

Documents relating to the purchase price of any assets owned by the business should be securely stored, as these will be needed to determine gain or loss when the assets are sold or to compute annual depreciation. Businesses with employees have additional obligations to keep



track of all employment taxes, employee Social Security numbers, and W-4 certificates, as well as a history of wages and benefits paid.

When a business-related transaction is conducted online, you may want to print out a record of the transaction and keep it on file. If you choose to store this data electronically, make sure backup copies of all important information are made and stored in a secure location.

Setting up a financial recordkeeping system for tax purposes may, at least initially, demand some extra effort on your part. But, in addition to maximizing your opportunities for deducting business expenses, getting into the habit of maintaining thorough and accurate accounting records can help you run your business more efficiently, and make it easier to obtain additional financing when needed. ■

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