2004

Small Business advisor

TIMELY TALK ABOUT BUSINESS, TAXES AND TRENDS SUMMER 2004 Volume X, Number 2

Brenda J. McGivern, CPA

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Volume X, Number 2/ SUMMER 2004

Here is your issue of Small Business Advisor. Enjoy!

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What is AMT? AMT is the acronym for Alternative Minimum Tax, which is simply another way of computing your tax liability without certain tax benefits included in the regular tax method. The final tax is the higher of the two computations. AMT was created by Congress to combat excessive use of tax preferences and tax shelters by wealthier taxpayers to insure they paid at least a minimum tax. However, years of inflation have brought the income of many middle-income taxpayers to levels that equal those of wealthier taxpayers at the time the AMT was created. As a result, more taxpayers each year are getting caught up in the AMT. click here for full article

Using Home Equity for Business Needs

Brenda J. McGivern, CPA

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Tax Calendar (June - August 2004)

June 15, 2004:

- U.S. Citizens living abroad on April 15, 2004 must file a 2003 Income Tax Return (if not already filed) or file for an extension.

- Second installment of 2004 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

June - July 2004:

- Time to review 2004 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

July 31, 2004:

- Due date for self-employed individuals and employers to file 5500 Series Returns for 2003 calendar year benefit plans (including Keogh/HR-10 plans).

August 16, 2004:

- Extended 2003 Individual Returns due (if 4-month automatic extension was filed).

-Last day to file for an additional extension of time to file the extended 2003 Return. The additional extension, if granted by the IRS, can extend the filing date to October 15, 2004.

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To reduce a recordkeeping burden, the IRS also announced that, starting in 2004, taxpayers who use no more than four vehicles at the same time for business purposes can use the standard mileage rate. Currently, those using more than one vehicle at a time cannot use the standard rate at all, leaving them to track the actual expenses for each vehicle. According to the IRS, with this change, more than 800,000 businesses will become eligible to use the standard mileage rate.

Beginning Jan. 1, 2004, the standard mileage rates for the use of a car (including vans, pickups or panel trucks) will be:

" 37.5 cents a mile for all business miles driven, up from 36 cents a mile in 2003;

" 14 cents a mile when computing deductible medical or moving expenses, up from 12 cents a mile in 2003; and

" 14 cents a mile when giving services to a charitable organization.

In addition, the cost of business-related parking and tolls is deductible. Caution: If the standard mileage rate is not used in the first year the vehicle is placed in service, it cannot be used in future years. If in a subsequent year there is a switch to the actual method, the straight-line method for depreciation must be used. If the car is leased, continue to use the standard mileage rate in future years if it is used in the first year.

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The AMT includes a myriad of adjustments and preference items and full or partial disallowances of certain deductions that are otherwise perfectly legal and allowed in figuring the regular income tax. There are far too many to discuss, especially when most are rarely encountered by the average taxpayer. There are, however, certain AMT issues that frequently affect taxpayers:

" **Medical Deductions** The regular tax requires the medical expenses included in itemized deductions to be reduced by 7 1/2% of the taxpayer s Adjusted Gross Income (AGI). For AMT purposes, this adjustment is increased to 10%.

" **Taxes** For regular tax purposes and as part of the itemized deductions, taxpayers are allowed to deduct certain taxes they pay, including real estate taxes, state income tax, personal property tax and foreign taxes. For AMT purposes, none of these taxes are deductible.

" **Home Mortgage Interest** Generally, for regular tax purposes, a deduction is allowed for interest paid on home acquisition debt and home equity debt within certain debt limits. For AMT purposes, however, only home acquisition debt interest is deductible. With mortgage rates at all-time lows, many taxpayers are incurring equity debt on their homes to pay off credit cards, purchase cars etc., in the belief that the equity debt interest is deductible. If the taxpayer is subject to the AMT, the equity debt interest is not deductible.

" **Miscellaneous Itemized Deductions** Certain miscellaneous expenses, such as investment expenses, union dues, employment-related expenses, certain legal fees etc., are allowed for regular tax purposes after being reduced by 2% of the taxpayer s AGI. For AMT purposes, the deduction is not allowed.

" **Interest from Private Activity Bonds** Interest from certain Private Activity Bonds (such as bonds used to finance mass transit, water treatment facilities and similar projects) is tax-free for regular tax purposes but is taxable for AMT purposes.

" **Incentive Stock Options** Some employers offer their employees the opportunity to acquire stock through Incentive Stock Option Plans. This allows the employees to purchase the company stock at a substantial discount and then qualify for long-term capital gain rates when they ultimately sell the stock, provided certain holding periods are met. However, for AMT purposes, the discount must be added to an employee s income in the year the stock is purchased.

" **Standard Deduction** Taxpayers who do not itemize their deductions are allowed a standard deduction for regular tax purposes. The standard deduction is not allowed for AMT purposes.

In computing the AMT, a substantial exemption amount is allowed against the AMT taxable amount based upon filing status. For 2004, the exemption amounts are:

Filing Status	Married Joint or Surviving Spouse	Single or Head of Household	Married Separate
Exemption Amount	$ 58,000	$ 40,250	$ 29,000

Whereas the rates for regular tax are in six tiers (10%, 15%, 25%, 28%, 33% and 35%), the AMT rates only have two tiers (26% and 28%).

The following example illustrates the impact from typically encountered regular tax and AMT tax computations. In this example, Joe and Susan have three children and are filing a joint return. For 2004, they have wages, some interest income and deductions consisting of taxes, home acquisition debt interest, home equity debt interest and charitable contributions.

	Regular	*AMT*
Wages	$132,000	$132,000
Interest Income	500	500
Taxes	<14,475>	0
Acquisition Debt Interest	<9,105>	<9,105>
Equity Debt Interest	<6,145>	0
Contributions	<800>	<800>
Exemptions	<15,500>	<58,000>
Taxable	86,475	64,595
Tax	15,094	16,795
		<15,094>
Increase due to AMT		***$1,701***

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Generally, interest on debt used to acquire and operate your business is deductible against that business. However, depending upon the circumstances of the loan structure, debt secured by the home may be nondeductible, only partially deductible or wholly deductible against your business.

Home mortgage interest is limited to the interest on $1 million of acquisition debt and $100,000 of equity debt secured by a taxpayer s primary residence and designated second home. The interest on the debts within these limits can only be treated as home mortgage interest and deducted as part of your itemized deductions. Only the excess can be deducted on your business, provided the use of the funds can be traced to your business use. This creates a number of problems:

" **Using the Standard Deduction** If you do not itemize your deductions, you would be unable to deduct the interest on the first $100,000 of the equity debt, which cannot be allocated to your business.

" **Subject to the AMT** Even if you do itemize your deductions and you happen to be subject to the Alternative Minimum Tax (AMT), you still would not be able to deduct the first $100,000 of equity debt interest, since it is not allowed as a deduction for AMT purposes.

" **Subject to Self-Employment (SE) Tax** Your self-employment tax (Social Security and Medicare) is based on the net profits from your business. If the net profit is higher, because not all of the interest is deductible by the business, your SE tax may also be higher.

Example: Suppose the mortgage you incurred to purchase your home (acquisition debt) has a current balance of $165,000, and your home is worth $400,000. You need $150,000 to acquire a new business. To obtain the needed cash at the best interest rates, you decide to refinance your home mortgage for $315,000. The interest on this new loan will be allocated as follows:

New Loan:	$ 315,000	
Part Representing Acquisition Debt	<165,000>	52.38%
Balance	$ 150,000	
First $100,000 Treated as Equity Debt	<100,000>	31.75%
Balance Traced to Business Use	$ 50,000	15.87%

If the interest for the year on the refinanced debt was $10,000, then that interest would be deducted as follows:

Itemized Deduction Regular Tax	$ 8,413
Itemized Deduction Alternative Minimum Tax	$ 5,238
Business Expense	$ 1,587

There is a special tax election that allows you to treat any specified home loan as not secured by the home. If you file this election, interest on the loan could no longer be deducted as home mortgage interest, since it is a requirement that qualified home mortgage debt be secured by the home. However, this election would allow the normal interest tracing rules to apply to that

unsecured debt. This might be a smart move if the entire proceeds were used for business and all of the interest expense could be treated as business expense. However, if the loan were a mixed-use loan and part of it actually represented home debt (such as a refinanced home loan), then the part that represented the home debt could not be allocated back to the home, and the interest on that portion of the debt would become nondeductible and would provide no tax benefit.

Example: Using the same scenario as the previous example, but electing to treat the mortgage as unsecured by the home, the deductible business interest for the year would be $4,762 [($150,000/$315,000) x $10,000]. None of the balance of the interest would be deductible.

As you can see, using equity from your home can create some complex tax situations. Please contact this office for assistance in determining the best solution for your particular tax situation.

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Question I expect to have a substantial increase in my income this year. I want to minimize my estimated tax payments but make sure I don't get a penalty for underpaying my estimates. Do you have any suggestions?

Answer To accomplish what you are requesting, you should pay your estimates based on the "safe-harbor" amount. Taxpayers can avoid the underestimated tax penalty by paying an amount that is at least 110% of the prior year's tax liability. If your prior year's adjusted gross income was $150,000 or less ($75,000 or less if you are married but file a separate return from your spouse), the minimum payment with which to avoid penalty is 100% of the prior year's tax. In either case, each estimated tax installment should equal at least one-fourth of the total safe-harbor amount for the year. Be sure the payments are made by the installment due dates (usually April 15, June 15 and September 15 of the current year, plus January 15 of the next year). Failing to pay in a timely manner can result in the underpayment of estimated tax penalty being imposed even if the "right" amount of tax has been paid.

If your state has a state tax, the safe-harbor amount may be a different percentage.

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Answer It just goes to show that you can t believe everything you hear. To prevent taxpayers from giving away their assets before they pass on and thereby circumvent the inheritance taxes, the Revenue Code restricts the amount that can be given away during an individual s lifetime. That amount has varied over the past few years and is currently at $1 million. In addition to the lifetime limitation, an individual can annually make gifts of $11,000 (was $10,000 before 2002) to as many separate individuals as they wish; the individual s relationship to the taxpayer is of no significance. Neither the $1 million nor the annual $11,000 gifts are deductible by the giver or taxable to the recipient. If the gifts exceed the limitation, they may be subject to gift tax. If you make gifts during the year to any single individual in excess of $11,000, you will generally be required to file a gift tax return.

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