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Taxlink 2007 Winter Newsletter

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Quick Tips:

- If you are a teacher who spent your own money for classroom supplies, this is the last year you can take a deduction for up to \$250 of those costs. Unless Congress extends the deduction, expenses you incur next year won't be deductible.
- If by year-end you haven't contributed funds to your 2007 IRA, or if you've put in less than the maximum allowed, don't worry. You can contribute to either a traditional or Roth IRA until the April due date for filing your tax return for 2007, not including extensions. You can contribute up to \$4,000 to your IRA each year. If you are age 50 or older, you are allowed to contribute an additional \$1,000.
- **NEW!** In 2007, premiums that are paid or accrued for "qualified mortgage insurance" in connection with home acquisition debt on your residence are deductible as home mortgage interest.
- You are permitted to make a one-time transfer from your IRA to your HSA from which you can pay future medical expenses. A "qualified HSA funding distribution" is a distribution from your IRA (other than a SEP or a SIMPLE IRA plan) to the extent that the distribution is contributed to your HSA in a direct trustee-to-trustee transfer. Once made, the election is irrevocable.
- The optional sales tax deduction has been extended for the 2007 tax year. This means you can elect to deduct your state sales tax in lieu of your state income tax when you itemize deductions.
- If you paid qualifying tuition and related expenses in 2007, you can elect to deduct up to \$4,000 of the costs.
- Use your credit card to buy equipment and supplies that you will need in the upcoming year. Charges on your credit card for deductible business expenses are allowed in the year you make the purchase, not in the year the charge is paid. Pay off your credit card after the beginning of the year and avoid finance charges.
- If you are a self-employed taxpayer, you may deduct 100 percent of your health insurance premiums from your income. The deduction for health insurance premiums does not reduce your self-employment tax, however.
- If you have contributed personal assets, such as a computer or vehicle to your business, the lower of the fair market value or your cost basis of these assets qualifies as a business deduction, subject to depreciation limitations, beginning with the date of conversion.

- The optional standard mileage rate for the business use of an automobile is 48.5 cents per mile in 2007.
- **Flight crew** and other employees who are subject to the Department of Transportation's "hours of service" rules are allowed to deduct 75 percent of their meals in 2007. In lieu of using actual expenses for meals and incidental expenses, **you can deduct the federal rate of \$52 per day.**
- Taxpayers in the 10% and 15% tax brackets get a 5% rate on long-term capital gains. However, once their gains lift their income into the 25% tax bracket, the balance of their profit is taxed at the standard 15% maximum rate.

Did You Move This Year?

Your moving expenses may be deductible

If you moved this year because of a change in your job location or because you started a new job, you may be able to deduct the reasonable expenses of moving household goods and personal effects to your new home. The expenses of traveling to the new home, including lodging expenses, are also deductible. Meals, however, are not.

If the move is closely related to the start of work and you meet both the IRS distance and time tests, your moving expenses are deductible. Certain members of the armed forces do not need to meet the tests if the move was due to a permanent change of station.

The move will meet the distance test if your new main job location is at least 50 miles farther from your former home than the old main job location. To determine whether you meet this test, use the shortest distance of the most commonly traveled routes between these points. First figure the distance between the former residence and the new job and then subtract the distance between the former residence and the old job. If the result is 50 miles or more, you've met the distance test.

You'll meet the time test if you work full-time for at least 39 weeks during the 12 months immediately following the move. If you are self-employed, you must work full-time for at least 39 weeks during the first 12 months and for a total of at least 78 weeks during the first 24 months after the move. The IRS makes exceptions to the time test in cases involving death, disability, or involuntary separation from service.

Making Gifts

Know what gifts are taxable

When an individual receives a gift, whether cash or property, the gift is generally not taxable to that individual. Sometimes, however, the gift giver may incur a gift tax liability when making certain gifts. If you make a gift to family members or other individuals, you can give \$12,000 or less in value to a single individual during the year and you do not have to report the gift or file a gift tax return. The so-called "annual exclusion" of \$12,000 simply means that gifts during the year to an individual that are equal to or below this exclusion amount are not considered reportable gifts.

Certain gifts for medical expenses and educational expenses do not count toward the \$12,000 exclusion and allow you to maximize your gifts for the year. For medical expenses, amounts you pay directly to the person or organization providing the medical service or care are excluded from the gift tax. To qualify for the exclusion, the medical expenses must meet the requirements for deductibility and generally include expenses paid for diagnosis, cure, mitigation, treatment, or prevention of disease. It also includes amounts paid for medical insurance.

With regard to educational expenses, similar rules apply. Transfers made to qualifying educational institutions for tuition are not subject to the gift tax and do not count toward the \$12,000 annual exclusion. The exclusion applies to tuition for full or part-time students paid directly to the educational institution. Amounts paid for expenses such as books, room, board, or other supplies are not eligible for the exclusion.

Gifts made during the year that exceed the annual exclusion are considered “taxable” gifts and are required to be reported on a gift tax return. You are allowed a lifetime exclusion of \$1 million in taxable gifts before any out-of-pocket gift tax is actually due.

Divorced?

Know the rules before claiming a dependent

If you are a divorced or separated parent, the rules for determining which one of you can claim the children as dependents is confusing at best. A few years ago, the IRS created rules that provided a uniform definition of a child for purposes of claiming certain tax benefits such as the head of household filing status, the child tax credit, the dependent care credit, and the earned income tax credit.

When parents divorce, the decision of who will claim the children is generally outlined in the divorce decree. In most cases, the judge will award to the noncustodial parent the dependency exemption for the children because he or she is paying child support while the children reside with the custodial parent. This arrangement tends to even out the tax burden somewhat by allowing the noncustodial parent a deduction for the child’s personal exemption since there is no deduction for child support payments.

This works great when the parents abide by the judge’s ruling. There are cases where they do not. This is when the trouble starts. Why? Because the IRS doesn’t care what the divorce decree states. The IRS makes the assumption that the custodial parent is entitled to the dependency deduction—period. The only exception to this assumption is when the custodial parent releases the claim by signing Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, or a similar statement. If Form 8332 is not used, a similar statement must contain the same information—the name of the child(ren), the tax year to which it applies, and the name and social security number of the parent releasing the claim. The noncustodial parent can no longer attach the pages of the divorce decree that states he or she is entitled to the dependency exemption and satisfy the waiver requirement, unless the wording in the decree includes the specific wording as used on Form 8332.

In the event the custodial parent refuses to sign the waiver and claims the children, the noncustodial parent cannot claim the same children. If both parents claim the same children, the IRS will promptly send a notice stating that there has been an error. Each parent’s refund will be adjusted to reflect the denial of the dependency exemptions until the matter is settled. If the custodial parent still refuses to release the claim to the other parent, the only recourse is to go back to the judge that issued the original divorce decree and have the ruling enforced. Until that is done, the IRS will award the dependency exemptions to the custodial parent provided that parent can prove the children lived in his or her home for more than half of the year.

Money for College

Are scholarships taxable?

Many college students receive scholarships or fellowships to help pay for their education. If you are in college and received a scholarship or fellowship grant, there are a few key points to keep in mind. Qualified scholarships and fellowships are treated as tax-free and not included in taxable income if all of the following conditions are met:

- You are a candidate for a degree at an educational institution.
- The amount received as a scholarship or fellowship is used for tuition and fees required for enrollment or attendance at the educational institution, or for books, supplies, and equipment required for courses of instruction.
- The amounts received are not a payment for services.
- If the scholarship or fellowship received exceeds the cost of tuition, fees, books, or other qualified expenses listed above, the excess will be taxable.

Deducting the Business Use of Your Home

Don't overlook your home office

If you use a portion of your home for business, you may be able to take a home office deduction whether you are self-employed or an employee. Expenses that you may be able to deduct for business use of the home may include the business portion of real estate taxes, mortgage interest, rent, utilities, insurance, depreciation, painting, and repairs.

You may claim this deduction for the business use of part of your home only if you use that part regularly and exclusively:

- As your principal place of business for any trade or business; or
- As a place to meet or deal with your patients, clients, or customers in the normal course of your trade or business.

Generally, the amount you can deduct depends on the percentage of your home that you used for business. Your deduction will be limited if your gross income from your business is less than your total business expenses. The percentage of your home used for business is based on either the total number of rooms or square footage. If you use a separate structure not attached to your home for an exclusive and regular part of your business, you can deduct expenses related to it.

If you are an employee, you have additional requirements to meet. The regular and exclusive business use must be for the convenience of your employer. This means you are not allowed a home-office deduction if your employer does not require you to work at home.

Electing to Expense the Cost of Your Business Assets

Section 179 deduction limits increase

The IRS allows taxpayers the option of either depreciating business assets over a specified number of years or deducting all or a portion of the cost in one year. The expense election, commonly referred to as the Section 179 deduction, is made in the year the asset is placed in service. The benefit is a large deduction in the current year that is not reduced even if the asset is placed in service late in the tax year.

The Section 179 deduction is not without other limits, however. For example, the most you are allowed to expense in 2007 is \$125,000, a \$17,000 increase over last year. If more than \$500,000 of qualifying property is placed in service, the Section 179 deduction is reduced dollar for dollar until the total investment reaches \$625,000, resulting in a deduction of zero. Additionally, your Section 179 deduction is limited to your taxable income from all your active trades or businesses, including wage income reported to you or your spouse on Form W-2.

If you elect to use the Section 179 deduction, you may change your mind and revoke the election. Conversely, if you do not make the election in the year the property was placed in service, you may amend your return and claim the deduction.

New Rules for Spouses Who Operate a Business Together

Do you qualify for simplified reporting?

Spouses who operate a business together have a new option for reporting their business income. In the past, husband and wife joint owners were considered a partnership for reporting purposes. New rules, which took effect this year, give spouses the option of reporting their business income as two separate sole proprietorships.

Filing as two sole proprietorships reduces the number of returns that are required while reporting the income from the business just as before. The income and expenses from the business are allocated to each spouse based on their respective ownership interest. In most cases, income and expenses are split equally. Each spouse will report their share of the net earnings and pay self-employment tax on the total.

There are a few key points to consider before making this election. First, the spouses must file a joint return. Second, the spouses can be the only owners of the business. Third, each spouse must agree to the treatment as sole proprietorships. And lastly, both spouses must materially participate in the trade or business.

Employee Meals: When Does the 50-Percent Limit Apply?

Don't reduce your deduction if you aren't required to

In most cases, an employer is only allowed to deduct one-half of the expense that is paid to employees for meals. However, in some instances, the full amount is allowed.

If you have an eating facility on your business premises, and you provide meals to at least half of your employees as a convenience to you, then the full amount of the meals is deductible as a business expense.

An allowance you pay to your employees for meals is allowed in full as an expense to you if you include the reimbursement as compensation to your employees.

If you pay a per diem to your employees for meals, and they account to you for the cost, or you pay them a per diem at the federal per diem rate, you are only allowed a deduction for 50 percent of what you pay. The cost is not included on their W-2.

De minimis costs for food or beverages are also allowed in full as a business expense. A de minimis cost is one in which the frequency you provide the benefit is so small that accounting for it would be unreasonable or impractical. De minimis costs for meals include a holiday party, group meals or picnics, traditional holiday gifts of turkeys or hams, or coffee and donuts.

Clothing for Your Job is Not Always Deductible

Understanding the rules

Many taxpayers are required to maintain a certain personal appearance or wear special clothing for work. However, not all your purchases for work-related attire or personal grooming reap a tax deduction. If you are required to wear a uniform or other special clothing that has the name of your employer or some other logo on it, that cost is deductible as a miscellaneous employee business deduction.

Other employees, such as models, flight attendants, or other professionals who are required to maintain a highly professional, well-groomed appearance, may find that the cost of their expensive clothing and cosmetics will not save tax dollars. Even if your employer tells you that you must wear certain clothing, if it is not in the nature of a uniform, the cost is personal.

Remember, the general rule of thumb is that if the clothing is suitable for every-day wear, it's not deductible.

Kiddie Tax Changes

Some things to consider in 2008

Under old law, unearned income of certain children under age 14 was subject to tax at their parent's marginal rate. In 2006, the age increased to children under 18. Starting in 2008, the provision expands the kiddie tax to children who are 18 years old or full-time students over 18 but under 24.

For Your Convenience...

Available links at [www. taxlinkinc.com](http://www.taxlinkinc.com): Contacts

IRS.gov

Publication 17 – Taxpayer's Guide

Publication 561 – Valuation of Donated Property

Publication 463 – Travel, Entertainment, Gift and Car Expenses

Publication 509 – Tax Calendar

AMT Calculator