Tax Planning for Realtors

Presented by

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Table of Contents

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Business Deductions

If you own your own business, you can deduct some of the costs of starting the business, as well as the current operating costs of running that business. If you have expenses that are partly for business and partly personal, you can deduct only the business part. To be deductible, business expenses must be both "ordinary" (common and accepted in your field of business) and "necessary" (appropriate and helpful for your business).

The following pages will discuss:

- Start-Up Costs
- Home Office
- Depreciable Assets
- Code Section 179 Election
- Business Use of Autos
- Travel Expenses
- Meals & Entertainment
- Keeping Records

Start-Up Costs

Start-Up Costs are costs for setting up an active trade or business or investigating the possibility of starting or acquiring an active trade or business. These expenses may include:

- Marketing the new business
- Travel costs incurred to investigate business opportunities and requirements
- Survey of potential markets
- Analysis of available facilities, labor, supplies, etc.
- Advertisements for the opening of the business
- Incorporating the business
- Legal and accounting services
- Training employees
- Locating customers and vendors
- Fees for attorneys, consultants, or for other professional services

Generally, costs that you incur prior to the time that you actually start operating the business are treated as capital expenditures, which are part of your cost basis in the business. Certain start-up expenses that qualify may be deducted either in the first year of business or amortized and deducted over a 15 year period. See below.

Start-Up Costs Deductible

There are two requirements that start-up costs must meet in order for them to be deducted currently:

1. The cost would normally be deductible as a business expense incurred to operate an existing active trade or business

2. It must be incurred before the business operations start

Start-Up Costs for purchasing an existing trade or business include only investigative costs incurred in the course of a general search for or investigation of the business. These costs to purchase an existing business are considered capital expenses so you may not deduct them in the current year or amortize. See IRS Publication 535 for more information.

Start-Up Costs for Corporations

To qualify for a deduction, corporate start-up costs must be incurred before the end of the first year in which the corporation was in business. A corporation using the cash method of accounting may deduct start-up expenses incurred within the first tax year, even if it does not pay them in that year. Corporate organizational costs include the following:

- Temporary directors expenses

- Organizational meetings expenses

- State and local incorporation and similar fees

- Accounting services for setting up the corporation

- Legal fees relating to setting up the corporation and issuing stock certificates along with minutes of the organizational meetings

Note: You cannot deduct as start-up expenses costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs, because they are not organizational expenses.

Start-Up Costs for Partnerships and LLCs

Partnership or LLC organizational expenses are the costs of creating the partnership or LLC. These costs include the following:

- Legal fees relating to setting up the partnership or LLC - The partnership/LLC agreement
- Accounting fees for setting up the partnership or LLC
- State and local filing fees
- Other fees to organize and start the entity

Amortizing (Deducting) Start-Up Costs

You may elect to deduct your business start-up and organizational costs (collectively referred to as start-up costs). If you make the election in the taxable year in which you actively start the business, you may deduct up to $10,000 of start-up costs. The $10,000 amount is reduced (but not below zero) to the extent that start-up costs for the business exceed $60,000. Thus, no first-year deduction is available if start-up costs exceed $70,000. The remainder of the start-up costs are amortized and deducted over a period of 180 months. The 180-month period begins during the month that you acquired the new business or began operations. You must make the election before the date (including extensions) that your tax return is due for the year that you acquired or started the business. It is important to note that once you make this election, you may not change such treatment. If you do not elect to deduct your start-up costs, you must capitalize them.

You deduct appropriate start-up costs in equal amounts over a period of 180 months. You take the total start-up costs, reduced by the amount you deduct in the year you start the business, and divide that amount by the 180 months in the amortization period. This figure is the amount of amortization deductible each month. If the business is terminated before the end of the 180-month amortization period, you may be able to deduct any remaining start-up costs that have not been previously deducted.

You are deemed to have elected to deduct eligible start-up expenses unless you elect to capitalize the expenses on a timely-filed federal income tax return.

Property Converted from Personal Use to Business Use

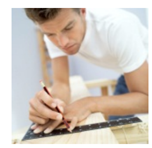
One may convert personal property, such as a desk, computer, car or other asset, to business use either as part of the start-up of the company or at the time the property changes from personal to business use. The conversion does not have to be in total, a taxpayer may convert only a portion of the property for use in their business. The property can then be depreciated annually as a normal operating expense. The basis for depreciation is the lesser of:

- Fair market value of the property on the date of the conversion
- Adjusted basis in the property on the date of conversion (generally cost plus improvements)

> ***Example:*** *Suppose Sarah owns a computer which she plans to use for bookkeeping in her new business. But as it is her only home computer, she also wants to have it available for personal use. She estimates that she will use the machine for personal purposes about one third of the time. A year ago, she purchased the computer for $1,300. Sarah added additional memory to the computer four months ago at a cost of $200. The fair market value (FMV) of the computer on the date of conversion is $700. Even though Sarah's adjusted basis in the computer is $1,500 ($1,300 + $200), the lower FMV is used. On the date that Sarah begins to use the computer for her business, the computer has a depreciable basis of $469 ($700 x 67%).*

Home Office

A home office may be defined as a room within your home, a portion of a room within your home, or a separate structure appurtenant to your home that you use exclusively and regularly to conduct business activities. If you use a home office to meet clients and customers or to run a business, either as an administrative office or as a place in which to make, assemble, or prepare items that you sell, you may be able to deduct a portion of your housing expenses on your federal income tax return.



Your home can be a house, apartment, condominium, mobile home, or a boat, as long as you live in it. It is important to note that your home office need not be located inside your home; a structure attached to or adjacent to your home, such as a shed or garage, can qualify as a home office if all applicable requirements are met.

Note: To qualify for the home office deduction, you must use the applicable portion of your home in an activity that qualifies as a trade or business.

Two Tests must be met to qualify for the Home Office Deduction

1. The place of business test

2. The exclusive and regular use test

Place of Business Test

In order to meet this test, you must use a portion of your home as:

- The principal place of business for any trade or business (see note below), or

- A place where you meet with clients, customers, or patients regularly, or

- If a separate detached structure from your home, used in association with your business.

Note: Your home office will qualify as your principal place of business if you meet the following requirements:

- You use it exclusively and regularly for administrative or management activities of your trade or business - this includes bookkeeping work at home

- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business - although you could have a separate location but decide to do it at home

These requirements are discussed in detail in the next section.

Administrative or Management Activities

Regarding administrative or management activities performed at locations outside of the home office, IRS Publication 587- Business Use of Your Home states that the following activities performed by the taxpayer or others <u>will not disqualify</u> a home office from being considered the principal place of business

- The taxpayer has others conduct his administrative or management activities at locations other than his home office. (For example: The taxpayer hires another company to do his billing from its place of business.)
- The taxpayer conducts administrative or management activities at places that are not fixed locations of his business, such as in a car or a hotel room.
- The taxpayer occasionally conducts minimal administrative or management activities at a fixed location outside of the home office.
- The taxpayer conducts substantial non-administrative or non-management business activities at a fixed location outside of the home office. (For example: The taxpayer meets with or provides services to customers, clients, or patients at a fixed location outside of the home office.)
- The taxpayer has a suitable space to conduct administrative or management activities outside of the home office, but chooses to use his home office for those activities instead.

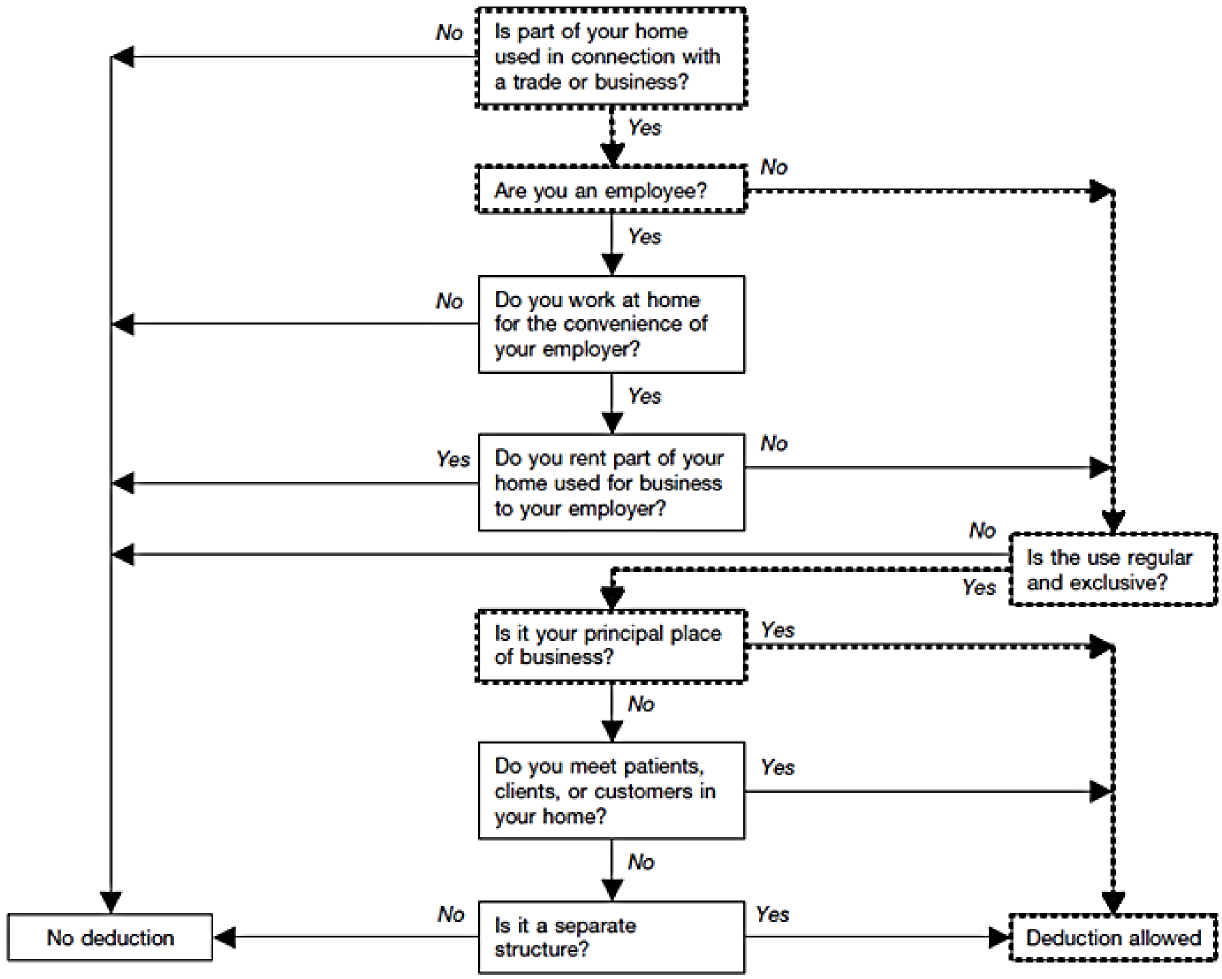
Example: As a realtor, you have a desk at the broker's location and you meet clients there and conduct other business. However, you conduct substantially all of your administrative and management activity (bookkeeping, etc.) at home and use an office space regularly and exclusively for this purpose. This would qualify for the Home Office Deduction because you have met the "Principal Place of Business" requirement.

Exclusive and Regular Use Test

In addition to the place of business test, you must also pass the exclusive and regular use test before you can take a home office deduction. To pass this test, you must show that you exclusively use a portion of your home for your trade or business on a regular basis.

Can You Deduct Business Use of a Home Office?

This flowchart from IRS Publication 587- Business Use of Your Home can help the taxpayer determine whether they may deduct expenses for a qualified home office. The path outlined with the dotted line illustrates the logic that allows a realtor to deduct a home office, even if they rent space or have a desk at their broker's location.



From IRS Publication 587- Business Use of Your Home

Home Office Expenses

You can deduct both direct and indirect expenses that apply to a portion of your home that you use for business purposes.

1. Direct expenses are costs associated only with the portion of your home you use for business purposes. These costs can be deducted in full.

2. Indirect expenses are costs that benefit your entire home, including the portion of your home that you use for business purposes. You can deduct the business use percentage of these expenses.

Calculating the Business Use Percentage

You can use any reasonable method to calculate the percentage that you use for business purposes. The two most common are:

1. Square foot method - Divide the square footage of the portion of your home that you use for business purposes by the total square footage of your home.

2. Number of rooms method - If all the rooms in your home are relatively equal in size, divide the number of rooms you use for business purposes by the total rooms in your home.

Starting in 2013 a simplified home office deduction is available. You may multiply the office square feet by $5 up to a maximum of $1500. There is no deduction for depreciation. Mortgage Interest and Real Estate Taxes are deducted on Schedule A. Typically this will result in a lower deduction for most taxpayers. All the other rules for use and qualifying are the same.

Allowable Expenses

The following expenses are considered indirect deductible expenses:

- Mortgage Interest (after applying the business use portion you take the balance to Schedule A - Itemized Deductions). Note: This includes only your original acquisition debt and improvement debt.

- Real Estate Taxes (after applying the business use portion you take the balance to Schedule A - Itemized Deductions).

- Rent

- Utilities - Electricity, gas, water, sewer and garbage service, etc.

- Homeowners or Renters Insurance

- Repairs and Maintenance

- Security systems and fees

- Depreciation on the home - excluding the land value

Important: Claiming a home office as your principal place of business may allow you to convert commuting mileage to business mileage. If your principal place of business (as defined earlier) is in your home, you may deduct daily transportation expenses incurred in traveling between your home and another work location.

Home Office Deduction Limitations

To be currently deductible, your home office deductions generally must be equal to or less than your net self-employment income from the trade of business the deduction is related to. If not, you may be able to carryover excess deductions to the next tax year.

Note: There may be exceptions. See your Tax Advisor for details.

Tax Benefits of a Home Office - An Example

Let's assume the following:

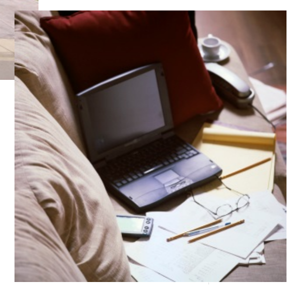
- Diane, a taxpayer in the 25% tax bracket, meets both the Business Use Test and the Exclusive and Regular Use Test qualifying her to claim a home office deduction.
- The Diane's purchased her home for $300,000 several years ago. According to property tax records, the land that the home sits on is valued at $135,000 or 45% of the purchase price (300,000 x .045 = $135,000). The building, valued at $165,000 would be subject to depreciation.
- The home has a total of 2,800 square feet, of which the home office occupies a 10 x 14 room (140 square feet).

Diane's business use percentage for determining her home office deduction is computed as follows:

Square footage of home office	140	square feet
Total square footage of home	2,800	square feet
Home office percentage	**5%**	(home office percentage = 140/2800)

Diane's direct and indirect expenses for her home will be apportioned between her personal itemized deductions and home office deduction. She will be able to deduct 95% of her mortgage interest and real estate tax as an itemized deduction. The remaining 5% of her mortgage interest and real estate tax as well as 5% of the home operating costs and 5% of the depreciation on her home can be deducted as business expenses for the home office.
Note: A brief explanation of how to calculate the depreciation on Diane's home office is provided at the end of this example. (Additionally, depreciation on business assets is discussed in detail later in this narrative.)

Assuming Diane incurs the following home expenses during the year; her home office deduction is calculated as follows:



Home expenses for the year	**Total Expense**	
Mortgage interest	13,000	These expenses are 100% deductible as a personal itemized deduction.
Real estate tax	3,800	
Insurance	650	A portion of these expenses are deductible only if the home office deduction is taken.
Utilities	3,000	
Repairs	200	
Depreciation	212	Only deductible when a home office is claimed.
Total	**$20,862**	

Expense Apportionment		**Personal Itemized Deduction**		**Home Office Deduction**	
% of Annual expenses *(listed above)*		95%		5%	
Mortgage interest	(13,000 x .95)	12,350	(13,000 x .05)	650	Expenses are apportioned between itemized and home office deductions.
Real estate tax	(3,800 x .95)	3,610	(3,800 x .05)	190	
Insurance	(650 x .95)	-	(650 x .05)	33	Home office deduction yields an additional deduction of $405 per year.
Utilities	(3,000 x .95)	-	(3,000 x .05)	150	
Repairs	(200 x .95)	-	(200 x .05)	10	
Depreciation		-		212	
Total		**$15,960**		**$1,245**	

Tax Savings

Recalling that Diane is in the 25% tax bracket, her tax savings consists of income tax savings and self-employment tax saving. Self-employment (SE) tax of 15.3% is paid on 92.35% of the taxpayer's profit from self-employment, (Total SE tax = .9235 x .153 or approximately 14% in total). Tax savings realized from the home office deduction stems from the income tax savings from home operating costs plus the SE tax savings on mortgage interest, real estate tax and home operating costs. This is illustrated by the following diagram.

Note: All calculations are rounded.

Diane is in a 25% income tax bracket.

Total Annual Tax Savings *(Personal + Home Office)*

Mortgage interest	(13,000 x .25)	3,250
Real estate tax	(3,800 x .25)	950
Insurance	(650 x .25)	8
Utilities	(3,000 x .25)	38
Repairs	(200 x .25)	3
Depreciation	(212 x .25)	53
Total Savings		**$4,302**

Income tax savings does not change when a home office is claimed, but self-employment tax is saved on these expenses.

Home office deduction yields an additional income tax savings of $102.

		Personal		**Home Office**			
		Itemized Deductions		**Business Deductions (Schedule C)**	**Self-Employment Tax**	(b)	
Tax Rate		25%		25%	14%		
Mortgage interest	(12,350 x .25)	3,088	(650 x .25)	161	92		(650 x .14)
Real estate tax	(3,610 x .25)	903	(190 x .25)	48	27		(190 x .14)
		3,991		209	119	(c)	
Total savings from mortgage interest & real estate tax			4,200 (a)				
Home Operating Costs:							
Insurance			(33 x .25)	8	5		(33 x .14)
Utilities			(150 x .25)	38	21		(150 x .14)
Repairs			(10 x .25)	3	1		(10 x .14)
Depreciation			(212 x .25)	53	30		(212 x .14)
Total savings from home operating costs				102	57	(d)	
Self-employment tax savings from mortgage interest & real estate tax					119		
Total self-employment tax savings					176		
Additional Annual Tax Savings from Home Office				**$278**		(e)	

Notes:

a Claiming a home office does not change the income tax savings of $4,200 garnered from mortgage interest and real estate tax as these expenses qualify as personal itemized deductions.

b The home office deduction reduces self-employment tax.

c The home office deduction yields additional self-employment tax savings of $119 derived from mortgage interest and real estate tax. This tax savings is lost if a home office is not claimed.

d Home office deductions for operating costs such as insurance, utilities, repairs and depreciation result in additional savings of $102 from income tax and $57 from self-employment tax. If a home office is not claimed, these savings would not be realized.

e Annual tax savings, assuming a 25% tax bracket, equals $278 (home office operating deductions: $102, total self-employment tax savings: $176). These tax savings are only available if a home office is claimed.

5-Year Tax Savings Projection from Home Office

Now, let's examine the 5-year tax savings that Diane will realize if she sells her home at the end of 5 years.

5- Year Income Tax Savings from Home Office			**Total 5-Year Tax Savings**
Mortgage interest		-	
Real estate tax		-	
Insurance	($8 income tax savings x 5 years)	40	
Utilities	($38 income tax savings x 5 years)	190	
Repairs	($3 income tax savings x 5 years)	15	
Depreciation	($53 income tax savings x 5 years)	265	
Total 5-Year income tax savings from the home office		510	510
Depreciation Recapture after 5 Years ***(Reduces Total Tax Savings)***			
Note: When business property is disposed of before it has been fully depreciated, some or all of the depreciation may need to be "recaptured." With regard to the home office, this recaptured depreciation is treated as ordinary income and is taxed at a the taxpayer's regular tax rate up to a maximum rate of 25%.			
Depreciation to be recaptured over 5 years	($212 x 5 years)	1,060	
Diane's ordinary income tax rate		25%	
Total tax on recaptured depreciation on the home office		265	(265)
5- Year Self-Employment Tax Savings			
Note: When the home is sold, the taxpayer is not required to re-pay any of the tax savings realized from a reduction in self-employment tax related to the home office.			
Mortgage interest	($92 SE tax savings x 5 years)	460	
Real estate tax	($27 SE tax savings x 5 years)	135	
Insurance	($5 SE tax savings x 5 years)	25	
Utilities	($21 SE tax savings x 5 years)	105	
Repairs	($1 SE tax savings x 5 years)	5	
Depreciation	($30 SE tax savings x 5 years)	150	
Total 5-Year self-employment tax savings from the home office		880	880
Total 5-Year Tax Savings from the Home Office			**$1,125**

Depreciation Calculation for the Home Office

Depreciation is the act of expensing the cost of property over its useful life. The depreciation on Diane's home was determined by the following calculation:

Purchase price of the home	$300,000	
Less: Value of the land	$135,000	(The value of land is not depreciable.)
Depreciation basis of the home	$165,000	
Home office percentage	5%	(calculated above)
Depreciation basis of home office	*$ 8,250*	(165,000 x .05)
Depreciation factor	2.564%	(see note below)
Annual depreciation	**$ 212**	(8,250 x .02564)

Note: A home office is depreciated over 39 years at a rate of 2.564% after the first year. For simplicity, this example uses the rate for the second year, as depreciation rates for the first year vary depending on the month that the taxpayer begins using the home office.

Summary - Benefits of the Home Office Deduction

There are clear advantages to claiming a home office deduction. Providing the taxpayer meets the required tests (Place of Business Test and Regular and Exclusive Use Test) to take the deduction, a home office reduces both personal income tax and self-employment tax, by allowing the taxpayer to deduct a portion of the home operating costs and depreciation (subject to limitations). Additionally, the home office reduces the taxpayer's self-employment tax, resulting in permanent self-employment tax savings in the years that the home office is claimed. Although the taxpayer is required to recapture some or all of the income tax savings derived from depreciation (when the home is sold), he is not required to re-pay any savings gleaned from this self-employment tax reduction. Aside from these direct tax benefits, the home office may also enable the taxpayer to convert commuting miles to business miles, resulting in additional tax savings. Issues related to vehicle usage are discussed later in this narrative.

Depreciation on Business Assets

Depreciation is the annual deduction that allows you to recover a portion of the cost or adjusted basis of an asset used in a trade or business each year. If you purchase an asset to be used in your trade or business that has a useful life beyond one year, you must spread the deduction of that cost over more than one year. However, see Bonus Depreciation and Section 179 Election below.
Generally, you depreciate the asset according to the Modified Accelerated Cost Recovery System (MACRS) for assets placed in service after 1986, or you may elect to depreciate the asset using the Straight Line method. Details of these methods are beyond the scope of this presentation.

Depreciable Property

In order to be depreciable, property must have all of the following characteristics:

- It must be used in a trade or business or used for production of income
- It must have an accurately determined useful life of more than one year
- It must be something that wears out, decays, gets used up, becomes obsolete, or loses value over time
- It must be placed in service during the current year

> ***Example:*** *If you purchase a new car on December 28, 2013. But decide to have some special equipment installed on the car and do not actually start using the car until January 5, 2014. You will not be able to depreciate the car in 2013. The car is considered to be placed in service on January 5, 2014 and depreciation will begin in the 2014 tax year.*

Bonus Depreciation Deduction

Under previous legislation a special 50% additional first-year depreciation deduction is allowed for qualifying assets (both regular and AMT). The American Taxpayer Relief Act of 2012 extends these provisions through 2013. Additionally, the special 50% bonus depreciation is available for certain transportation and longer period production property through 2014. Qualifying assets must meet the following requirements:

- The asset must be acquired before January 1, 2014*
- The asset must be placed into service before January 1, 2014*
- The asset, generally, must be considered new (exceptions apply for new property purchased for personal use and converted to business use)
- The asset must be subject to the general rules of MACRS, and
- One of the following must apply:
    - The asset must be tangible property with a depreciable life of 20 years or less
    - The asset must be purchased computer software, or
    - The asset must be qualified leasehold improvement property

** January 1, 2015 for certain transportation and longer period production property*

Note: Bonus depreciation is automatic and the default for qualifying assets. If you do not want Bonus Depreciation you must elect out of it. The election applies to all assets in the same MACRS class.

Bonus Depreciation expires December 31, 2013. Congress has not made adjustments at this time.

Section 179 Deduction

The American Taxpayer Relief Act of 2012 extends Section 179 of the Internal Revenue Code and allows for an election to deduct the cost or adjusted basis (up to $500,000 for 2013 - see limitations below) of depreciable property acquired for use in a trade or business in the year of purchase.   The amount for the section 179 deduction is reduced to $25,000 for 2014 and beyond unless Congress makes a change.

Note: You are not required to elect the full Section 179 on the asset. You can elect to take just a portion if you prefer. If so, then the balance is subject to Bonus Depreciation (on a qualifying asset) and then regular MACRS depreciation.

Electing Section 179 Treatment

You can make the Section 179 election on new or used property and it is applied on an item-by-item basis for qualifying property. You make the Section 179 election in the year the property is first placed in service. The election is made on Form 4562.

Section 179 Deduction Limitations

For 2013, if the cost of your Section 179 property placed in service in a year exceeds $2,000,000 for the tax year, your allowable Section 179 deduction is reduced by one dollar for each dollar of cost over the limit. For 2014, this amount is reduced to $200,000.

Qualifying property must be used more than 50%for business in the year the asset is placed in service to be eligible for the Section 179 deduction.

The Section 179 deduction is limited to the net taxable income from the trade or business during the year.

Section 179 Deduction Carryover

If a limitation occurs, the unused portion of the Section 179 deduction may be carried over to the next tax year.

Section 179 Recapture Rules

The tax benefit from the Section 179 election must be recaptured if business use of the property falls to 50% or less during its regular depreciation recovery period. The recapture amount equals the Section 179 expense deduction taken minus the depreciation on the same amount that would have been allowed under regular depreciation rules. The excess is recaptured as ordinary income and placed on the form where it was deducted. The basis of the property is increased by the recaptured amount.

Vehicle Depreciation

Special depreciation limitations apply to cars and SUVs. These rules were created to prevent taxpayers from purchasing expensive luxury automobiles and writing off their entire cost within the normal recovery period (generally, 5 years). The annual depreciation allowed for the vehicle is dependent on whether the vehicle is considered a car, minivan, van, truck or SUV.

> Passenger car: Any four-wheeled vehicle that has an unloaded gross weight under 6,000 lbs., which is primarily designed to be used on public streets, roads and highways.

Minivan, light SUV, van or truck: Any passenger vehicle that is built on a truck chassis and has an unloaded gross weight under 6,000 lbs., which is primarily designed to be used on public streets, roads and highways.

Heavy SUV: Any passenger vehicle that is built on a truck chassis and has an unloaded gross weight between 6,000 and 14,000 lbs., which is primarily designed to be used on public streets, roads and highways. Several popular sport utility vehicles weight-in at over the 6,000 lbs., among them the Cadillac Escalade, BMW X5 and Lincoln Navigator.

	Depreciation Limits for Passenger Cars under 6,000 lbs.				
Year Placed in Service	**2013**	**2012**	**2011**	**2010**	**2009**
1st Year (elect bonus depreciation)	$11,160	$11,160	$11,060	$11,060	$10,960
1st Year (no bonus depreciation election)	$3,160	$3,160	$3,060	$3,060	$2,960
2nd Year	$5,100	$5,100	$4,900	$4,900	$4,800
3rd Year	$3,050	$3,050	$2,950	$2,950	$2,850
All Years Thereafter	$1,875	$1,875	$1,775	$1,775	$1,775

	Depreciation Limits for Minivan, Light SUVs, Vans and Trucks under 6,000 lbs.				
Year Placed in Service	**2013**	**2012**	**2011**	**2010**	**2009**
1st Year (elect bonus depreciation)	$11,360	$11,360	$11,260	$11,160	$11,060
1st Year (no bonus depreciation election)	$3,360	$3,360	$3,260	$3,160	$3,060
2nd Year	$5,400	$5,300	$5,200	$5,100	$4,900
3rd Year	$3,250	$3,150	$3,150	$3,050	$2,950
All Years Thereafter	$1,975	$1,875	$1,875	$1,875	$1,775

Note: The depreciation deduction may be further limited if the vehicle is used less than 100% for business purposes.

***A slight increase ($100 or so) is projected for these limits in 2014. These numbers have not been issued at this point in time.*

***Reminder: Bonus Depreciation expired on December 31, 2013.*

All new vehicles qualify for the special 50% bonus depreciation, as well as a Section 179 deduction for 2013. However, the total deduction for the year may not exceed the annual limit outlined above.

Any depreciation that would otherwise be allowable if the vehicle were not subject to the above limitations is known as an "unrecovered basis". If a taxpayer continues to use a vehicle for business purposes after the normal recovery period, he may continue to depreciate the vehicle beyond the normal recovery period until the full unrecovered basis is expended.

Special Rules for Heavy SUVs

SUV owners may also qualify to deduct an increased Section 179 deduction of $25,000 (subject to the Section 179 limitations discussed above). To qualify, the SUV must meet the definition and weight limits to be classified as a Heavy SUV. Additionally, the SUV may not:

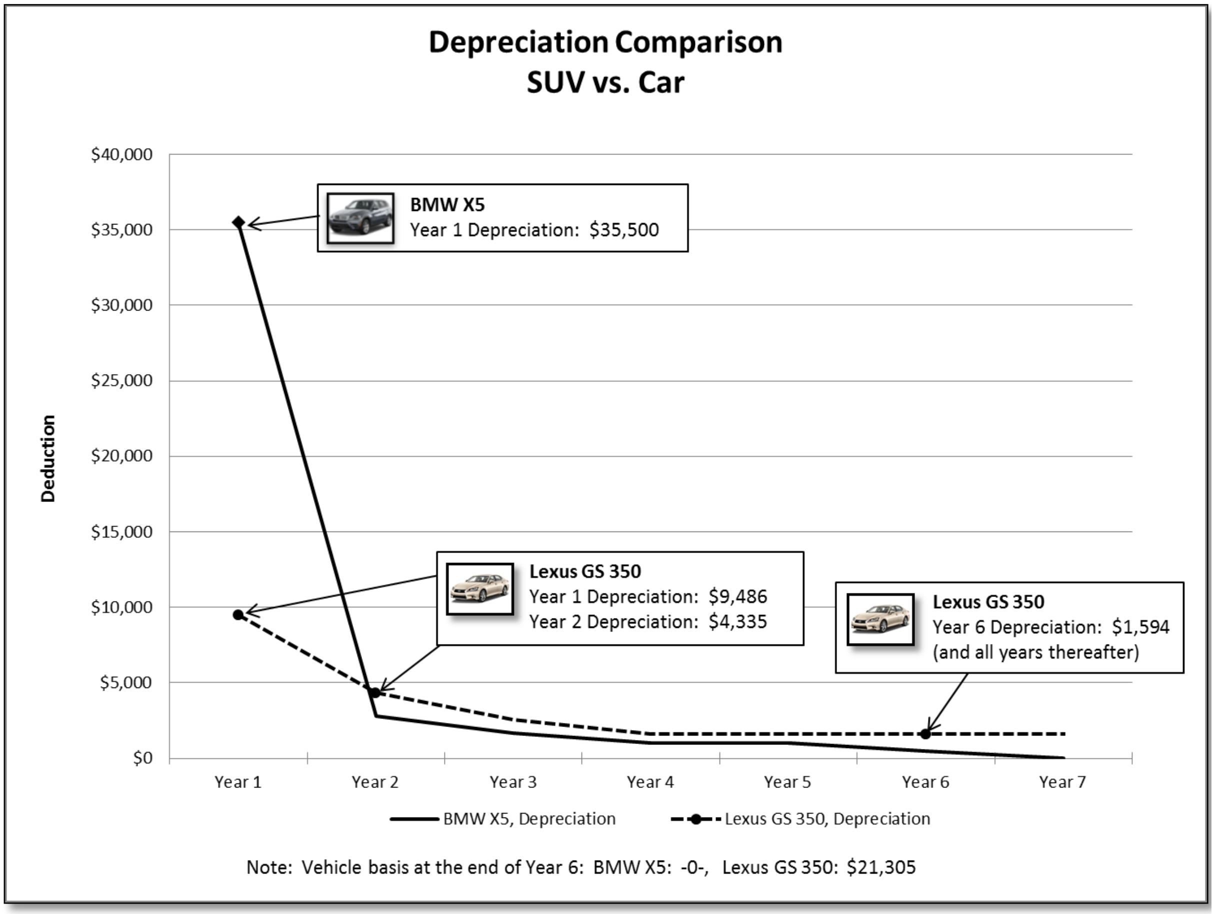
- Be designed to seat more than nine persons behind the driver's seat.
- Be equipped with a cargo area (either open or enclosed by a cap) of at least six feet in interior length that is not readily accessible from the passenger compartment, or
- Have an integral enclosure fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and have no body section protruding more than 30 inches ahead of the leading edge of the windshield. (IRS Publication 946)

Essentially, these restrictions mean that the vehicle may not be considered a pick-up truck or van. This beneficial tax advantage allows the business person who purchases the SUV to write-off most of the cost of the vehicle in the first year of use.

Example: *Jennifer, a successful realtor, is interested in purchasing a new car for her business. She is comparing the BMW X5 with the Lexus GS 350 and is interested in how each vehicle will affect her tax situation.*

Depreciation Comparison Heavy SUV vs. Luxury Car				
	BMW X5		**2013 Lexus GS 350**	
Gross vehicle weight (in lbs.)		6,052		4,830
Price		50,000		50,000
Business usage		85%		85%
Business basis		42,500		42,500
Depreciation basis	(42,500 - 25,000 - 8,750)	8,750	(42,500 - 6,800)	35,700
Section 179 deduction		25,000		-
Special bonus depreciation, 50%	((42,500 - 25,000) x .5)	8,750	(8,000 x .85) depr. limited	6,800
Year 1 Depreciation	(8,750 x .2)	1,750	(3,160 x .85) depr. limited	2,686
Total Year 1 Depreciation write-off		35,500	Sum of all (B)	9,486
Year 2 Depreciation	(8,750 x .32)	2,800	(35,700 x .32) depr. limited	4,335
Year 3 Depreciation	(8,750 x .192)	1,680	(35,700 x .192) depr. limited	2,593
Year 4 Depreciation	(8,750 x .1152)	1,008	(35,700 x .1152) depr. limited	1,594
Year 5 Depreciation	(8,750 x .1152)	1,008	(35,700 x .1152) depr. limited	1,594
Year 6 Depreciation	(8,750 x .0576)	504	(35,700 x .0576) depr. limited	1,594

Example (continued): *Luxury car limitations reduce the annual amount of depreciation allowable, which results in an unrecovered basis at the end of Year 6 (the regular recovery period) of $21,305. Providing Jennifer's business usage remains 85%, she may continue to depreciate this vehicle at a rate of $1,594 per year until the entire basis is recovered.*



Note: The highly beneficial nature of the Heavy SUV tax advantage has garnered the attention of several special interest groups who feel that this tax provision encourages the purchase of luxury SUVs over smaller, more fuel efficient vehicles. Given the uncertain tax environment, a prudent business person would consult their Tax Professional before purchasing a new vehicle for their business.

Business Use of Autos

You can deduct either the Standard Mileage Rate or the Actual Expenses for the business use of your auto. However to substantiate the deduction, it is important that you maintain a diary or log that details your business usage of the automobile for the year.

Standard Mileage Rate

Each year the IRS publishes the standard mileage rates. For 2013, the standard mileage rate is 56.5¢ per mile; for 2014 it is 56¢ per mile. The standard mileage rate contains a depreciation component.

To use the standard mileage rate, you must own or lease the vehicle and you must have used the standard mileage deduction or use straight-line depreciation in the first year the vehicle was placed in service. After the first year, you can use either the standard mileage rate or actual expenses. Note: If you lease the vehicle you must continue to use the standard mileage rate for the term of the lease and may not switch to actual.

You cannot use the standard mileage rate if any of the following applies:

- You operate five or more vehicles at the same time in your trade or business.
- You claimed actual expenses for a leased vehicle.
- You claimed depreciation on the vehicle using a method other than straight line.
- You elected and claimed a Section 179 deduction on the vehicle.

Note: When using the standard mileage rate you cannot deduct actual expenses, however, you may be able to deduct the following expenses:

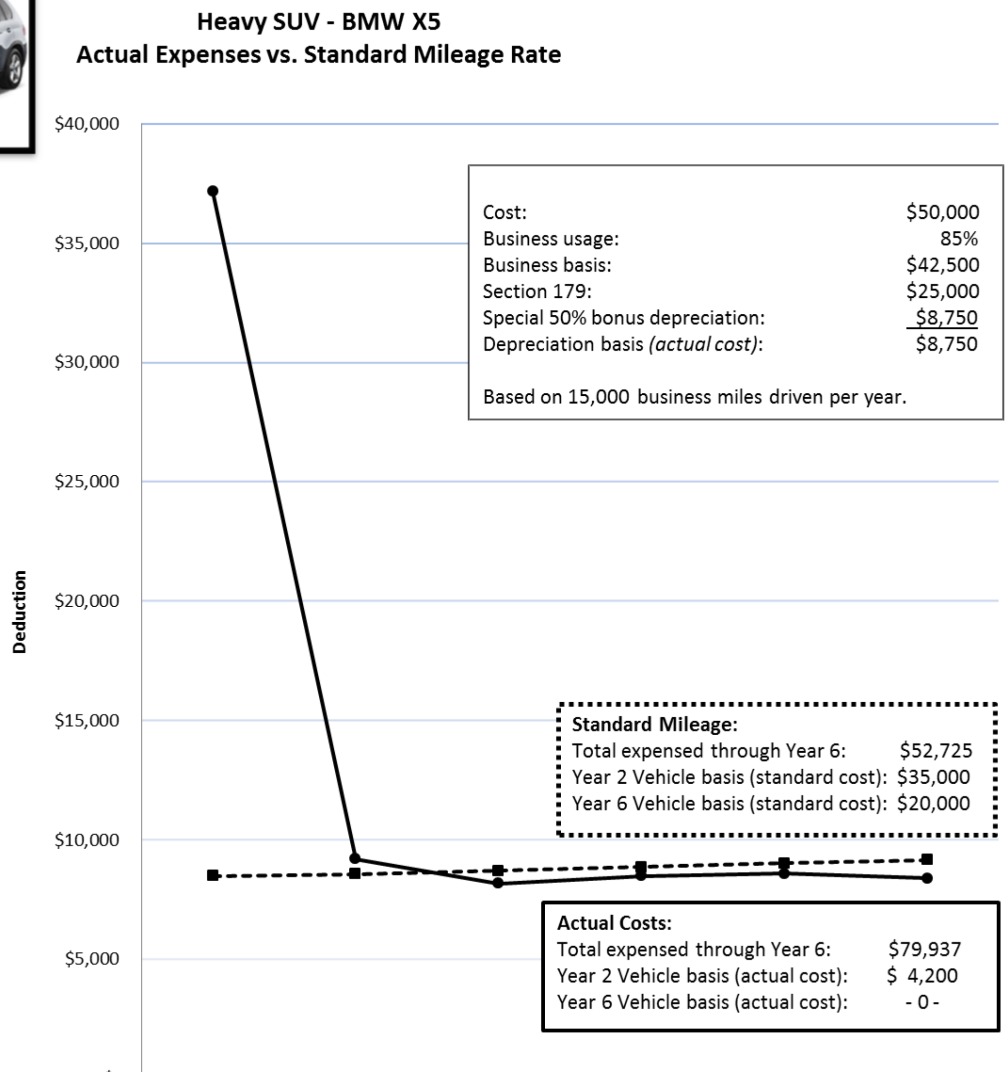
- Business use percentage of loan interest
- Parking fees and tolls related to business activity

Actual Expenses

If you select or must use actual expenses, you can deduct the business use portion of the actual costs of using your vehicle including fuel and oil, repairs, insurance, license and registration fees, loan interest, and depreciation.

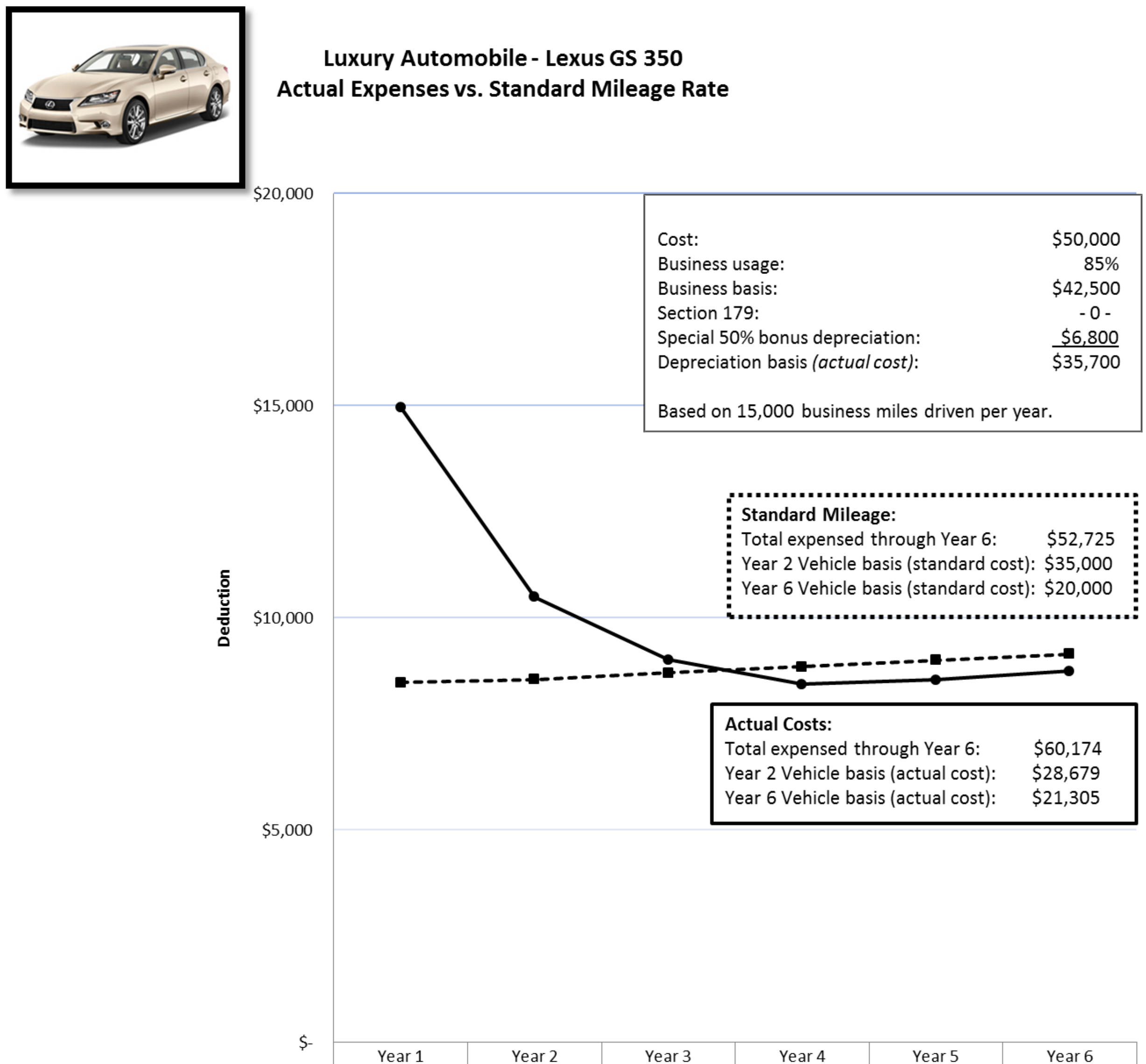
Actual vs. Standard Mileage Rate Comparison

If we compare the estimated actual expenses for the BMW X5, Lexus GS 350 (illustrated previously) to the standard mileage rate, we can see how the methods compare. Let's assume 15,000 business miles are driven each year. Actual costs are based on industry comparisons.



	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Estimated Annual Actual Costs **	37,149	9,195	8,163	8,468	8,580	8,382
Standard Mileage	8,475	8,550	8,700	8,850	9,000	9,150

** *Estimated annual actual costs include depreciation, gas, insurance, financing costs, repairs, maintenance and incidentals.*



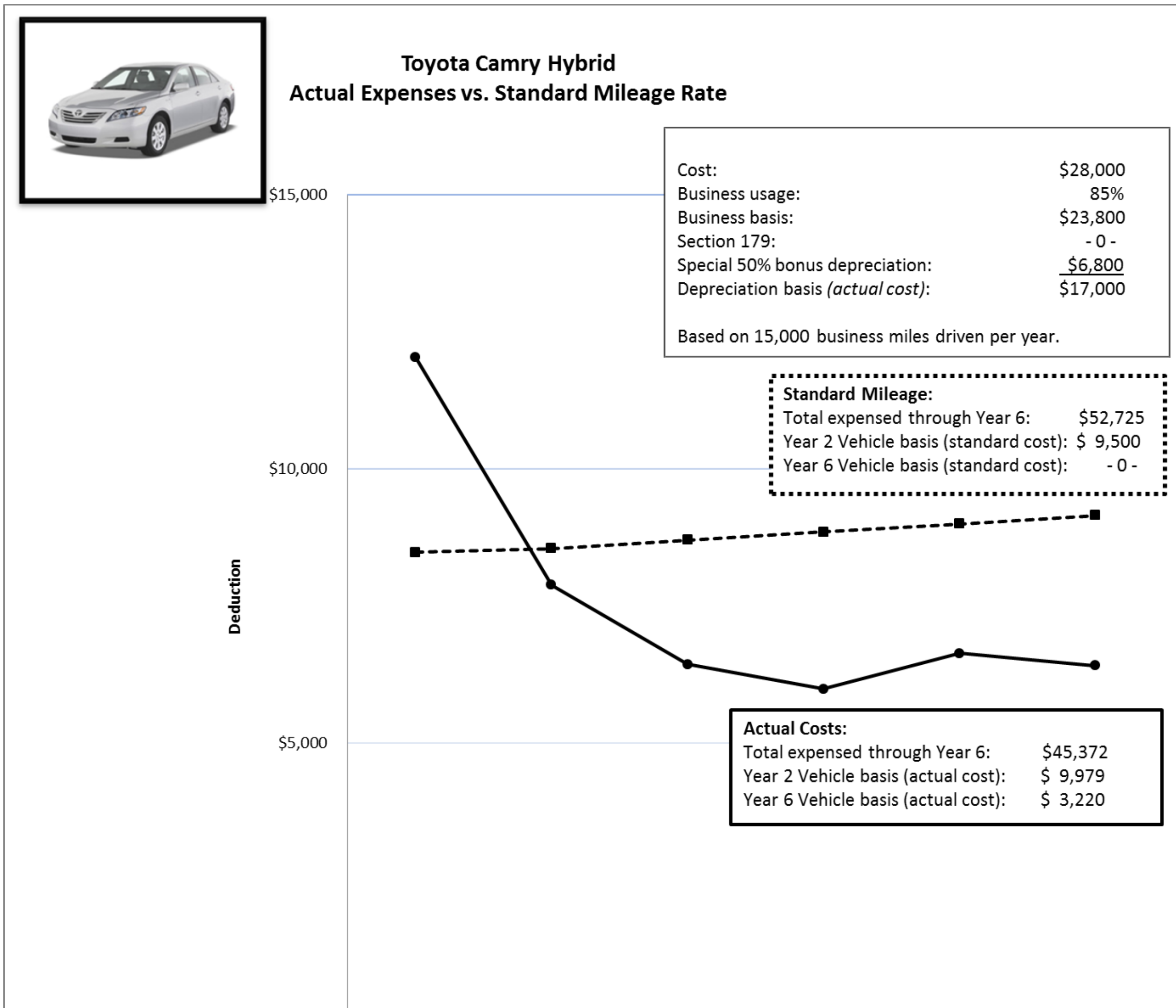
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Estimated Annual Actual Costs **	14,960	10,489	9,010	8,437	8,533	8,745
Standard Mileage	8,475	8,550	8,700	8,850	9,000	9,150

** *Estimated annual actual costs include depreciation, gas, insurance, financing costs, repairs, maintenance and incidentals.*

Calculating the vehicle expense deduction based on actual expenses generally results in higher deductions in the short-term for high-end automobiles. This may be more beneficial to the taxpayer who plans to own and use the vehicle for business less than 5 years (the normal recovery period for most vehicles), as this method accelerates the write-off and helps the taxpayer to recover most or all of the cost of the vehicle prior to selling or disposing of it. It is especially beneficial for SUV owners that meet the requirements for the special $25,000 Section 179 deduction.

Aside from simplifying recordkeeping, using the standard mileage rate to calculate expenses allows for a more even distribution of costs. For more expensive vehicles, this method generally results in a much lower deduction than when actual expenses are claimed. However, if the taxpayer intends to use the vehicle for business purposes beyond 5 years (the normal recovery period for most automobiles), standard mileage may be more beneficial as the taxpayer can continue to claim deductions for their business use based on the miles driven each year.

The model changes when we look at a moderately priced car, such as the Toyota Camry Hybrid.



	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Estimated Annual Actual Costs **	12,032	7,879	6,434	5,985	6,633	6,409
Standard Mileage	8,475	8,550	8,700	8,850	9,000	9,150

** *Estimated annual actual costs include depreciation, gas, insurance, financing costs, repairs, maintenance and incidentals.*

When comparing the actual expense to the standard mileage method on a moderately priced vehicle, it is evident that taking the standard mileage rate deduction is much more beneficial across the life of the vehicle. Taxpayers using the standard mileage method receive the same write-off regardless of the car driven, as the deduction is a function of the number of miles driven instead of cost. Note that in each scenario, the total expensed over the 6 year period of the example is $52,725. Additionally, the unrecovered basis for a low or moderately priced car at the end of the recovery period is less than that of a high-end vehicle. This is because the difference between the calculated depreciation and the allowable depreciation expense (after limits) is reduced. Thus, the owner recoups the entire cost of the car within a shorter period of time. As depreciation has the greatest impact on the actual expense method, once the automobile basis is fully depreciated, the deduction is somewhat limited.

Reminder: Bonus depreciation is only allowed on new vehicles.

So far we have only examined a comparison based on each vehicle's annual business expense deduction, but this is only half of the discussion. If the percentage of business use drops below 50%, or when the vehicle is sold or otherwise disposed of, the taxpayer may be required to recapture a portion of the depreciation as income. In the examples discussed previously, note the difference between the basis in Year 2 and in Year 6. This basis will determine any gain or loss on the property and in some cases may have additional tax implications.

As the disposition of business assets is complex, it is wise to discuss the decision to buy, sell or trade any business property with a Tax Professional prior to taking any action.

Travel Expenses

If you are self-employed, you may be able to deduct the ordinary and necessary expenses of traveling away from home for your business. These expenses can include the cost of transportation, lodging, and/or meals.

Tax Home

Your Tax Home is your principal place of employment or business. For tax purposes, you must be traveling on business away from your tax home, not your personal home (your residence), to be able to deduct travel expenses. For example, if you work in Alaska but live in Oregon, Alaska is your tax home for the purpose of deducting travel expenses.

More than one Regular Place of Business

If you work at more than one place of business, your principal place of business (tax home) is determined by:

- Where you spend the most time
- Where you conduct the most business activity
- Where you derive the most earned income

Local Travel Expenses
If you are self-employed and your residence is your principal place of business, you can deduct expenses you incur in traveling from your residence to any other work location.

Travel Expense Limitations:

- If you travel on a business trip during one day within the general area of your tax home, you may deduct your transportation costs but not your personal meal expenses.

- If you have multiple places of business, you may deduct the cost of traveling directly from one business location to the other.

- If your tax home is in one location and you travel a distance from your principal residence to your place of work, your travel expenses are not deductible.

- If you are temporarily assigned to work in an area away from your normal place of work for one year or less, you may deduct the cost of traveling to that area, as well as the cost of meals and lodging.

Overnight Travel Expenses
The following travel expenses are deductible when you are on an overnight business trip away from your principal place of business - tax home:

- Auto, train, plane, boat, taxi and other transportation expenses

- Hotel or other lodging expenses

- Meal expenses. (See *Determining Travel Meal Expenses* later)

- Telephone, communication, and fax expenses

- Baggage charges and insurance

No Principal Place of Business
If the nature of your work is such that you are constantly traveling, you may be able to designate your principal home as your tax home for the purpose of deducting travel expenses. However, to do so, you must be able to prove the following:

- You maintain a personal residence on which you pay expenses both while living there and while on the road

- You conduct some of your business in the area of your personal residence and live at the residence when in the area

Commuting Expenses

Generally, the cost of traveling between your home and your work place is not deductible. Commuting costs you spend as part of a car pool are also not deductible.

Exceptions to Commuting Expenses Rule

There are two exceptions under which you can deduct commuting expenses:

1. When traveling away from your tax home on a business trip, you may deduct transportation costs from your place of lodging to your day's first business call.

2. You may deduct the cost of using your vehicle to carry equipment to work if you can show that the expenses are in addition to your ordinary commuting costs.

Travel Meal Expenses

In order to deduct travel meal expenses you must be away from your tax home on a business trip where you stay overnight.

Determining Travel Meal Expenses

Instead of deducting the amount you actually paid, you can elect to use the Per Diem amount allowed by the IRS. The Per Diem amount, which covers meals and tips, ranges from approximately $46 to $71 per day, depending on the location. Check IRS Publication 1542 for the meal allowance rate. If the location is not listed then you must use the lowest rate. Note: The rates are updated in October each year.

Caution: The Per Diem rate is used to calculate the allowable daily expense for meals. However, only 50% of this amount may be deducted. The business meals deduction is limited to 50% of the expense regardless of whether the taxpayer chooses to use his actual expenses or Per Diem amounts.

Claiming the Meal Allowance

The IRS meal allowance splits each day into four six-hour portions (starting at midnight), and you may claim 25% of the meal allowance for each six-hour portion of each day you are away.

> Example: If you leave on a business trip at 6 a.m. Tuesday and return at 12 p.m. Thursday, you would take a 75% meal allowance for Tuesday, a 100% meal allowance for Wednesday, and a 50% meal allowance for Thursday.

Travel Expenses for a Spouse or Dependent on Business Trip

You cannot deduct the travel expenses of a spouse or dependent who goes along with you on a business trip or a business convention unless your spouse or dependent is your employee and had a business reason for going on the trip.

Meals and Entertainment Expenses

You can deduct 50% of your costs of meals and entertaining clients and/or customers if the activity is related to a business purpose.

Deductibility Tests

For your meals and entertainment costs to be deductible, they must meet one of the two following tests:

1. Directly Related test - To meet this test, you must actively participate in the business meeting, discussion, or activity with the person or persons being entertained and *expect* to derive income or some other business benefit other than just goodwill.

2. Associated test - To meet this test, the entertainment activity must clearly have a business purpose and the entertainment must directly precede or directly follow a meeting or discussion that has a clear, substantial, and bona fide relationship to your business.

Entertainment

If the entertainment meets either of the tests above, you can deduct the costs of the entertainment if it pertains to any of the following:

- Established or prospective clients and customers
- Suppliers, vendors, and subcontractors
- Employees or Partners
- Agents
- Established or prospective professional advisors

Goodwill Entertainment

If the purpose of business-related entertainment is strictly to promote goodwill, then the cost is not deductible. However, if the purpose is both goodwill and has a related business purpose, then the entertainment is deductible.

Entertaining at Home

You can deduct the cost of having business clients or customers to your home for dinner or another meal if a meaningful business-related discussion takes place before, during, or after the meal.

Meal Related Entertainment Costs

If you entertain business customers or clients while away from home on business, you can deduct 50% of the cost of your meal as part of your own travel expenses, or as an entertainment expense. The cost of the client's meal would be deducted as a meal and entertainment expense.

Spouse's Entertainment Related Costs

If you can deduct the cost of entertainment under the Directly Related test and, if your spouse was present, the cost associated with your spouse can also be deducted. Your spouse's share is also deductible for goodwill entertainment that qualifies for the deduction.

Deducting Facilities Used for Entertainment

You cannot deduct the cost of maintaining an entertainment facility (vacation home, cabin, yacht, or a swimming pool) even if you regularly use it for business entertainment purposes. However, you can deduct direct costs for the food or other entertainment provided at an entertainment facility if it qualifies under the Directly Related or Associated tests described above.

Tickets to Events

Season tickets to sporting events or theatrical events are not considered entertainment facilities and therefore may be deducted as a business expense when used for a qualifying entertainment purpose as long as they are not for a skybox or private luxury box. Note: You may deduct only for the face value of the cost of tickets. Additional charges like processing fees, ticket agency fees, or other fees are not deductible.

Luxury Boxes

There are limitations on the deductibility of rental payments incurred for skyboxes or private luxury boxes at sporting arenas, even when such boxes are used for business entertainment that meets either the Directly Related or Associated test. Skybox or luxury box seats at an entertainment or sporting venue are subject to a non-luxury box ticket price limitation.

> Example: Your business pays for a 12-seat skybox at a professional sporting arena. The cost per seat per game in your luxury box equals $95. Similar non-luxury box seats cost $55 per game. In this case, you could only deduct $330 per game when the luxury box is used to entertain business clients or customers ($55 multiplied by 12 = $660, and then reduced by the 50% limitation on the meal and entertainment costs). The cost of food served is also deductible and is also subject to the 50% rule.

Note: If your business rents a luxury box for only one event, the luxury limitation does not apply.

Deducting Club Membership Dues and Costs

You cannot deduct the costs of memberships and dues paid to clubs like country clubs, golf clubs, athletic clubs, or community organizations. You may not deduct membership fees or dues even if the club is professional in nature and conducts lunch or dinner meetings in settings generally considered to be conductive to business discussions. You may, however, be able to deduct the costs of certain business-related professional associations like fees paid to a chamber of commerce or a bar association. (See IRS Publication 535)

Exceptions to the 50 Percent Limitation Rule

As a business, the 50% limitation on the deduction of meal costs does not apply to you if you are reimbursed by your customer and you have adequately separated and stated the meal cost in your invoice along with providing a receipt copy of the expense to the customer. In this case, your business would deduct 100% and your customer should deduct 50%. (This is very similar to an accountable reimbursement plan for employees).

Business Gifts

Gifts to business clients or customers are deductible, up to a maximum amount of $25 per recipient per year. However, when figuring the $25 limitation per recipient, do not include the following items:

- Specialty advertising items (pens, key chains, and other items that have your or your company's name printed on them) that cost $4 or less

- Signs, displays, or other promotional items that you give to a business customer or client to be used at his or her place of business

- Related incidental costs, such as the cost of wrapping or sending the gift

Note: Gifts made to the spouse of a business customer or client, or gifts made to a corporation or company that are intended to be used by a specific business customer or client, are considered for business gift tax purposes to be gifts made to the business customer or client.

Entertainment or Gift?

If an item can be considered either as a gift or as a qualifying entertainment expense, it can generally be considered and taken as an entertainment expense but would still be subject to the 50% limitation. However, see the following two conditions below:

- Theater or sporting tickets must be considered a business gift if you do not accompany the business customer or client to the event

- Packaged food or drink given to and intended for consumption at a later time by a business customer or client must be considered a business gift

Keeping Records of Travel, Meal, and Entertainment Expenses

The IRS generally requires that you have two types of evidence to back up your deductions for expenses.

1. A written record. This can be a journal, diary, accounting book, or other written record that details the time, place, and business-related purpose of the travel expense or entertainment expense

2. Documentary evidence which can include itemized payment slips, receipts, or other written records showing you paid for specific travel or entertainment expenses that cost $75 or more

Recordkeeping Rules in Audit

- You will need a written record showing you paid for all lodging expenses, even if an expense was for less than $75

- Transportation expense receipts are required only when such written receipts are readily available

- You cannot use a canceled check alone to back up a deduction claim. If your only record is a canceled check, you may be required to obtain a copy of the bill from the payee or a written statement from a witness stating the business purpose of the expense

Journal, Diary, or Accounting Book Records

Your journal, diary, or accounting book records of your travel, meal, and entertainment expenses do not need to exactly duplicate the information shown by the required receipts and documents you retain to back up the deduction. You should note in your written record all business-related travel, meal, and entertainment charges paid with a credit card.

Caution: It is important for taxpayers who claim a deduction for vehicle use, whether using actual expenses or the standard mileage rate, to keep a detailed mileage log to substantiate their automobile usage.

Requirements for Meals and Entertainment Expenses

For meals, a restaurant receipt is generally enough to substantiate the expense for a business meal if it includes:

- The name of the restaurant

- The number of people served

- The date and amount of the expense

The records you keep of entertainment expenses should list the following:

- Cost

- Date of entertainment

- The names of the people entertained and your business relationship

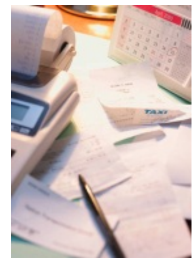
- Where the entertainment took place

- The entertainment's business purpose and the nature of the business discussion or activity

Acceptable Receipts

For a receipt or voucher to be acceptable to the IRS, it must show the following:

- The date and amount of the expense
- Where the expense was incurred and the nature of the expense



Restaurant Receipts

Receipts from restaurants must list the following:

- The restaurant's name and location
- The number of people served
- The date of and the amount of the expense
- An itemization of any additional nonfood or beverage expenses

Hotel Receipts

Receipts from hotels or other places of lodging must list the following:

- The hotel's or other place of lodging's name and location
- The amount of the expense, including an itemization of lodging expenses and separate non-lodging expenses, such as phone calls, food, and beverages

How Long to Keep Records and Receipts

You should keep your travel, meal, and entertainment expense records for at least three years after the date on which you file the tax return (or filing deadline if later) for which the deductions are claimed. For example: If you filed on March 1st and the return is not due until April 15th, you would use April 15th as the start of the three years.

Missing or Lost Written Records

If you can show you made a good-faith effort to comply, the IRS will not necessarily disallow a deduction simply because all record requirements were not met.

If you keep a diary detailing all of your travel, meal, and entertainment expenses and you have retained the required receipts backing up most but not all of these expenses, the IRS may determine that you acted in good faith and may not disallow the few deductions for which you don't have required receipts.

Exceptions to Record Rules

If your records of travel, meal, and entertainment expenses are destroyed due to circumstances out of your control you can back up your deductions by reconstructing these records, as long as the reconstruction is deemed reasonable. In addition, if you can demonstrate that you were unable to comply with IRS record-keeping rules due to the inherent nature of the situation in which an expense was incurred, the IRS may accept evidence of the expense that does not strictly comply with their rules.

Conclusion

It is important for small business owners to understand tax laws in order to keep good records and to plan for the future. Every taxpayer's situation is different…

Per IRC Sec. 162(a), a deductible business expense must be *ordinary and necessary* for the taxpayer's business.

- An ordinary expense is one that is usual and customary in the taxpayer's industry. It is possible for an unusual expense to qualify as ordinary if it is reasonably related to the taxpayer's trade or business.
- A necessary expense is one that is appropriate and needed in maintaining or developing the taxpayer's trade or business.

Some courts and IRS have held that in order to be deductible, the expense must also be *reasonable* in relation to the purpose. However, the fact that a taxpayer may have erred in judgment as to what was ordinary and necessary may not cause the deduction to be disallowed.

Generally, to be deductible, the expense must be directly associated to the activity and the expense must benefit the person or entity claiming the deduction.

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