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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Business and Investment Expense Documentation

Even though there may be no question as to the deductibility of a business or investment expense, it may be disallowed by the IRS for lack of supporting documentation. You can generally avoid this embarrassing and costly problem by maintaining adequate documentation to substantiate tax deductible expenses.

Substantiation rules apply to expenses incurred for business or investment purposes such as (a) overnight travel, including meals and lodging; (b) meals, entertainment, and recreational activities; (c) local transportation expenses; (d) gifts; and (e) the use of property such as an automobile, cell phone, or computer for a business purpose. IRS rules disallow a deduction for these expenses *unless* you maintain adequate records to substantiate the:

- Expense amount.
- Time and place the expense was incurred.
- Business purpose of the expense.
- For gifts, a description of the item given and the business relationship you maintain with the person receiving the gift.
- For entertainment expenses, your relationship to the person or persons entertained.

Documentary evidence (a paid bill, written receipt, or similar evidence) is required to substantiate all travel and entertainment (T&E) expenses of $75 or more. A written receipt is always required for lodging while traveling away from home, regardless of the amount. A credit card statement is not sufficient documentary evidence of a lodging expense. Instead, a hotel bill showing the components of the charge is required. For transportation charges, documentary evidence is not required if not readily available (e.g., cab fare). Although the IRS requires documentation of T&E expenses only when they are at least $75, many businesses set a lower threshold for their own internal purposes.

Please call us if you have questions concerning the documentation required to substantiate business and investment expenses or about setting up a system to maintain the required records.

The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

Annual Gift Tax Exclusion

The Annual Gift Tax Exclusion provides a tax advantaged way to reduce your taxable estate and make generous gifts, as well. The exclusion allows any individual to gift property valued at $12,000 (in 2007, indexed for inflation) or less without having to file a gift tax return or reduce their $1 million lifetime Gift Tax Exemption. The annual exclusion applies on a per-donee basis, and there is no limit to the number of donees to which gifts subject to the annual exclusion can be made.

The purpose of the annual exclusion is to allow taxpayers relief from reporting numerous small gifts. The $12,000 amount was intended to be large enough to cover wedding, holiday, birthday, and other occasional gifts. However, many taxpayers fail to take these occasional gifts into consideration when making $12,000 gifts intended to take advantage of the annual exclusion. Taxpayers who undertake a gifting program should be aware that the $12,000 annual exclusion amount includes *all* gifts made to the donee for the year.

2007 Saturn Aura Certified as a Qualified Hybrid Vehicle

The Internal Revenue Service has acknowledged the certification by General Motors Corporation that its 2007 Saturn Aura Hybrid vehicle meets the requirements of the Alternative Motor Vehicle Credit as a qualified hybrid motor vehicle. The credit amount for the hybrid vehicle certification of the 2007 Saturn Aura Hybrid is $1,300.

Taxpayers should keep in mind that a tax credit, unlike a tax deduction, reduces their tax obligation on a dollar-for-dollar basis. In addition, the alternative motor vehicle credit is not phased out for high-income taxpayers. However, the availability of the hybrid motor vehicle credit for vehicles from a specific manufacturer (e.g., General Motors) will begin phasing out over a period of four calendar quarters once the manufacturer sells a cumulative total of 60,000 qualifying vehicles for use in the United States.

2006 IRS Data Book

The IRS recently released its 2006 Data Book describing activities conducted during Fiscal Year 2006 (FY 2006) from October 1, 2005, through September 30, 2006. The Data Book contains information about returns filed, taxes collected, enforcement, taxpayer assistance, and the IRS budget and workforce.

During FY 2006, the IRS collected more than $2.2 trillion in taxes and processed over 228 million tax returns. Over 108 million individual income tax return filers received refunds totaling $243 billion. The IRS spent an average of 42 cents to collect each $100 of tax revenue.

The IRS examined nearly 1.3 million individual income tax returns in FY 2006, more than double the number examined in FY 2000. Examinations of business tax returns grew for the second year in a row, reaching over 52,000 in FY 2006.

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New Tools Make College Planning Easier

Planning for college is quite often a very stressful process. First, you determine which educational institution your student will attend and deal with the process of gaining admittance. Once that decision has been made, you begin the follow-up routine of figuring out the best way to finance that education while remaining solvent for the next few years.

The College Board recently estimated that the average annual cost for a four-year private college is in excess of $22,000 for 2006–2007, and that's only for tuition and fees. The College Board estimates the average annual cost of tuition and fees for an in-state student at a public institution is just under $12,000 for 2006–2007. So, it's obvious that the cost of a higher education will be a major item in the family budget, and any help with the financing process will be welcome.

Two new planning tools can help eliminate some of the headaches associated with college financing and make that task a bit simpler for many folks. The first, FAFSA4caster, helps parents get a handle on the confusing financial aid system.

The other tool, available at the College Savings Plan Network's website, targets those who are saving for college; it provides comparisons of state qualified tuition plans (also known as 529 plans).

Financial Aid

The FAFSA4caster was developed by the Department of Education and is available at **www.FederalStudentAid.ed.gov**. It gets its name from the Free Application for Federal Student Aid (FAFSA), which is the starting point for all families seeking need-based financial aid, including loans, grants, and work-study.

The calculator takes family financial and household data and estimates the amount of student aid families can expect and whether they qualify for certain federal grants. The tool helps families get a preliminary version of their expected family contribution (EFC), which colleges use to determine the financial aid package they will offer the student. Of course, FAFSA4caster is only as accurate as the data entered. The actual FAFSA (which must be completed separately) uses figures from the family's federal income tax return. Other EFC calculators are available at **www.petersons.com**, **www.collegeboard.com**, and **www.finaid.org/calculators**.

529 Plans

529 plans are tax-favored college funding vehicles. The earnings inside these plans escape current taxation, and distributions for qualified educational expenses are tax-free. Every state sponsors at least one plan, and each state and plan has its own set of unique benefits and requirements.

The College Savings Plan Network, an affiliate of the National Association of State Treasurers, offers 529 plan information at **www.collegesavings.org**. A new tool at the site allows parents to filter through the vast array of state plans to find the particular plans that meet certain criteria. Parents can input factors that are important to them such as state income tax benefits, fees and expenses, investment options, minimum and maximum contributions, and investment manager. Currently, data from 99 different state plans can be compared.

Another helpful website for information on 529 plans is **www.savingforcollege.com**. Some data on this site is available to all, while more detailed information is available for a fee.

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Tax Aspects of Owning a Second Home

Many taxpayers currently own or plan to purchase a second home. You may view your second home for personal pleasure only or as an investment for tax benefits and appreciation. Perhaps you are somewhere in between. But, regardless of how you view your second home, planning for its tax implications will enable you to either own the property in the most tax efficient way possible or, if your purchase is somewhat tax driven, maximize the allowable deductions the property generates. A second home can fall into one of three categories for tax purposes depending on how it is used. These categories are a personal residence, vacation home, or rental property.

A property used for personal purposes more than 14 days during the year, or more than 10% of the rental days if that number is greater, is considered to be a *residence*. If this residence is rented for *fewer than* 15 days during the calendar year, it is considered to be a *personal* residence. As such, you are not entitled to deduct rental expenses, if any, but rental income received is not taxable. However, interest expense (to the extent it is qualified residential interest) and real estate taxes are fully deductible subject to the overall limitation on itemized deductions.

If the property is used as a residence (see above) and is rented *more than* 14 days during the calendar year, it is considered to be a vacation home, and the reporting of income and deductions is subject to limitations. In this situation, interest, taxes, and casualty losses are normally fully deductible. Other property-related expenses are deductible to the extent of rents received, but only after first considering the interest, taxes, and casualty losses previously mentioned.

Where personal use does not exceed 14 days (or 10% of rental days, if greater) and the property is rented for *at least* 15 days, the second home is considered to be rental property. For second homes classified as rental property, interest, taxes, casualty losses, and other operating expenses are fully deductible. However, these expenses must be prorated for any period of personal use. In addition, the property is subject to the passive activity loss rules and at-risk limitations, meaning net losses may have to be deferred to a future tax year and not currently recognized.

If all this sounds technical and confusing, it is. But, the proper treatment of second homes is extremely important at tax time. So, please call us if you have questions on how to handle income and expenses related to your second home.

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