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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Preserving Tax Deductions for Business Travel

If a taxpayer's trip is undertaken solely for business reasons, reasonable and necessary travel expenses, including travel fares, lodging, meals, and incidental expenses in getting to and from the destination are generally deductible on federal tax returns (subject to the 50% disallowance for meals and entertainment). Transportation, lodging, meals, and incidental expenses incurred while at the destination should also qualify as federal tax deductions. However, if the taxpayer's trip involves both business and personal activities, a portion of the travel expenses may actually be nondeductible personal expenses rather than deductible business expenses.

If a taxpayer travels on business in the United States and while at the business destination extends his or her stay for a vacation, makes a nonbusiness side trip, or has other nonbusiness activities, the proper treatment of the taxpayer's travel expenses depends on how much of the trip was business-related. The following guidelines generally apply:

a. If the trip was *primarily for business*, the deductible travel expenses include the costs of getting to and from the business destination and any business-related expenses while at the business destination. Personal (vacation) costs incurred while at the destination are not tax-deductible.

b. If the trip was *primarily for personal reasons*, such as a vacation, the costs of getting to and from the destination are personal (nondeductible) travel costs. Personal costs incurred while at the destination are also nondeductible. However, any business costs incurred while at the destination are tax-deductible expenses.


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Whether a trip is primarily business or personal depends on the facts and circumstances of each case. The amount of time spent on business activities compared to the time spent on personal activities is an important factor. It is essential to note that time spent is only one factor to consider and may not be the dominant

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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.

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Baby Boomers' Medicare Sign-up

For many older Baby Boomers, it may be difficult to believe that age 65 and the time to sign up for Medicare is either here or fast approaching. There are numerous options and decisions to be made, but it is important to note that if you don't sign up when first eligible, future Medicare premiums could be higher than normal.

If you began receiving social security retirement benefits before age 65, the Social Security Administration will automatically enroll you in Medicare Part A and Part B effective the month you turn age 65. For example, if your 65th birthday is September 20, 2011, your Medicare effective date will be September 1, 2011. Your Medicare card will be mailed approximately three months before your 65th birthday.

If you are close to age 65 and not yet receiving social security retirement benefits or Medicare, you can apply for both at the same time. To ensure your Medicare Part B coverage start date is not delayed, you should apply three months before the month you turn age 65. This is the beginning of the seven-month initial enrollment period. If you wait until age 65, or in the last three months of the initial enrollment period, your Medicare Part B coverage start date will be delayed. You can apply for Medicare at a local Social Security office or online at **www.ssa.gov**.

Gym Fees as Medical Expenses

The IRS recently clarified the circumstances under which a taxpayer may deduct gym fees as medical expenses. As background, taxpayers can currently deduct expenses paid for medical care to the extent those expenses exceed 7.5% of their adjusted gross income. Medical care is defined as those amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting a structure or function of the body.


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In its release, the IRS indicated fees paid to *health institutes* where the taxpayer exercises are generally personal expenses. However, these expenses may be deductible as medical expenses when a physician prescribes the treatments and provides a statement indicating they are necessary to alleviate a physical or mental defect or illness of the individual receiving the treatments.

Fees an individual pays for participation in a weight loss program as treatment for a specific disease (e.g., obesity or hypertension) that a physician has diagnosed generally are deductible as medical expenses. However, where a taxpayer participates in a weight loss program to improve his or her appearance, general health, and sense of well being, and not for the purpose of curing any specific ailment or disease, the cost is not a deductible medical expense.

Retirement Plan Limitations Unchanged

The IRS has determined the 2011 cost-of-living adjustments for retirement plans. Generally, the limits remain unchanged from 2010. The contribution (elective deferral) limit for employees who participate in Section 401(k), 403(b), or 457(b) plans and the federal government's Thrift Savings Plan remains unchanged from 2010 at $16,500 in 2011. For those age 50 or older at year-end, the catch-up contribution limit under these plans also remains unchanged at $5,500. The limitation for SIMPLE plans is unchanged at $11,500 in 2011, as is the catch-up contribution for those aged 50 or older at year-end at $2,500.

Avoiding Constructive Dividend Treatment

Payments made by a corporation primarily for the benefit of a shareholder, as opposed to the business interests of the corporation, will often be treated as constructive dividends. Constructive dividends generally occur in closely held corporations where dealings with shareholders are often informal. Constructive dividends have the same general federal tax consequences as true dividends. That is, the dividend is income to the shareholder, but not deductible by the corporation (as reasonable compensation would be). Such treatment can cause unexpected and adverse tax consequences.

Corporate management should be aware of the various constructive dividend scenarios in an effort to avoid an unfavorable tax outcome. For example, amounts paid to a shareholder in excess of what the IRS considers reasonable may give rise to a constructive dividend. Payments may include not just salary, but also directors' fees and rent for property leased to the corporation. Where the corporation ties compensation to the amount of shares owned, rather than the value of any services provided, the IRS may treat such compensation as a nondeductible dividend. The courts have also treated excessive amounts paid to family members for services provided to the corporation as constructive dividends. Likewise, personal shareholder expenses paid by the corporation without expectation of repayment can be constructive dividends to the shareholder in an amount equal to the fair market value (FMV) of the benefit received.

Depending upon the facts and circumstances of the transaction, the IRS may attempt to treat a shareholder advance that is not a bona fide loan (e.g., poor or nonexistent documentation) as a constructive dividend. Interest on shareholder loans with below-market interest rates can also constitute a constructive dividend. Likewise, if a corporation, without adequate consideration, assumes a debt or other legal obligation of a shareholder, or makes payments on such a debt, a constructive dividend may result.

Use of corporate property by shareholders can also result in a constructive dividend. Typical situations include the use of corporate-owned autos, boats, airplanes, vacation homes, and other property if the shareholder does not repay the value of such usage to the corporation, or the corporation does not include the value in a shareholder/employee's salary or wages. The amount of the constructive dividend equals the fair rental value of the property. In addition, the value of improvements made by the corporation to property leased from a shareholder that were in excess of normal lessee improvements (based on the type and value of the property, and the term of the lease) can be a constructive dividend.

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Finally, bargain purchases of corporate property by a shareholder can also result in a constructive dividend to the extent the FMV of the property exceeds the purchase price.

As you can see, there are a number of instances where corporate shareholders and management must be vigilant to prevent unexpected constructive dividends and the accompanying adverse tax consequences. Please contact us to discuss constructive dividends or any other tax compliance or planning matter.

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factor given the facts and circumstances. If the taxpayer would not have taken the trip except to achieve the business purpose, a strong argument can be made that the trip was primarily for business.

The proper allocation of travel expenses between business and nonbusiness categories is often difficult to determine. Please contact us to discuss specific travel expense allocation issues or any other tax planning or compliance matter.

Converting a Residence to Rental Property

For various reasons, including the generally depressed real estate market, homeowners may consider converting their personal residence to rental property. The process for making this decision should include an analysis of economic factors, such as the homeowners' marginal tax rate and the potential loss of the ability to exclude up to $250,000 ($500,000, if married) of gain from the sale of their principal residence for federal income tax purposes.

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Other economic factors to consider include the expected growth rate for rental property in the area, length of time the house will be rented before being sold, cash flow from renting, effect of passive activity rules (which limit and defer tax deductions), and expected rate of return available on other investments. Generally, the economic advantage of converting a personal residence to a rental rather than selling it is increased as the growth rate of the rental property increases and the rate of return on alternative investments decreases. But, each situation should be thoroughly analyzed given its particular facts and circumstances.

If selling a personal residence would result in a nondeductible loss, the homeowner can seriously consider converting the residence to a rental property. Tax savings opportunities generally are limited for residential rental conversions, primarily because of the passive activity loss rules. Converting a personal residence into rental property may allow the homeowner to eventually recognize a loss for tax purposes on the property's subsequent sale if the property continues to decline in value, but provide cash flow in the interim.

The fact that a residence is rented at the time of the sale does not automatically preclude gain attributable to such use to be excluded under the gain exclusion rules. Instead, the exclusion of gain depends on whether the homeowner meets the ownership and use requirements and the one-sale-in-two-years test at the time of the sale. In all cases, however, gain exclusion cannot be claimed to the extent of depreciation adjustments attributable to periods after May 6, 1997.

The decision to convert a residence to rental or investment property is complex, and the ramifications of this decision are far-reaching. Please contact us to thoroughly explore the numerous tax and economic issues related to such a conversion.

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