

Tax Reduction Letter

March 2008

Volume 17 Number 3



Pocket Self-Employment Taxes by Renting from Your Spouse

If you are single, consider forming an S corporation. Then, read this article with the thought that this S corporation could be your “no-hassle spouse” (we see that smile!), possibly producing the same basic results that the married person gets in this article.

The IRS Market Segment Specialization Program Training Guide tells IRS auditors that they need to be aware of the Cox¹ case, as it expands deductible spouse rentals to include those reported on joint tax returns. Before the Cox case, the IRS disallowed spouse rentals when joint returns were filed. The training manual directs the IRS’s field force to know that the court allowed a deduction for rent paid by one spouse to the other, even though they filed a joint tax return.²

In Cox, the court ruled that Sherman Cox could deduct the business rent he paid for his wife’s interest in their jointly owned office building. Thus, Mr. Cox could deduct this rent as a business expense on his Schedule C.

Maxine Cox, his wife, reported the rental income on Schedule E of their jointly filed tax return.

The deduction on Schedule C reduced Mr. Cox’s self-employment taxes. Rental income is not subject to the self-employment tax, so Mrs. Cox did not pay any self-employment taxes on the rental income. Presto!

The Cox family put money in their pockets by reducing their self-employment taxes.

Save Up to 14.13 Percent

For 2008, the published self-employment tax is 15.3 percent of your Schedule C income of up to \$102,000.³ Above this plateau, your self-employment tax drops to 2.9 percent (the Medicare part).

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STRATEGIES

In the News

Economic Stimulus for Your Business

We are still nailing down the business benefits contained in the economic stimulus package. We have them on our front burner, and they will appear in the April issue of *Tax Reduction Letter*. You will like the benefits available to you. ■

WOW! IRS Creates Safe Harbor for 1031 Exchanges of Vacation Homes and More

The two most magic words in tax law are “safe harbor.” Why? Clarity! There is nothing better than true clarity in the tax law.

Now, thanks to Revenue Procedure 2008-16, the IRS has created a safe harbor for Section 1031 tax-deferred exchanges of homes that are converted to rentals and vaca-

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However, the real self-employment tax is assessed on 92.35 percent of net earnings up to \$110,449, which gives you the \$102,000 maximum. This means that you can save at the effective rate of 14.13 percent on your first \$110,449 of net 2008 self-employment income.

Note the subhead of this section: "Save Up to 14.13 Percent." That's because the savings in your self-employment tax reduce your page 1 deduction for one-half of your self-employment tax. We will show you the net dollars in an example below.

Short History of the Spouse Rental Deduction

In 1974, the IRS ruled that a Wisconsin man could deduct the rent he paid his wife in that community property state on his separately filed Form 1040.⁴ This 1974 ruling updated a 1948 ruling.

In 1981, the IRS issued a private letter ruling to an individual, telling him that he could not deduct the rent he paid his wife because he

and his wife did not file separately as did the couple in Wisconsin.⁵

In 1993, the *Cox* case nullified the joint return requirement.

Today, things stand exactly as the IRS's training guide points out to its agents and auditors. If you pay your spouse a bona fide rent for his or her separate ownership of property that you use in your business, you may deduct the rent regardless of how you file your tax return.

Technique Does Not Increase Deductions for Passive Losses

As you are reading this, light-bulbs might be going off at the idea that you can count this spouse rental income as positive passive income. No dice. Lawmakers and the IRS saw you coming.

IRS Regulation 1.469-2(f)(6) recharacterizes rental income from an activity in which you materially participate as non-passive income. This is the self-rental rule. Further, regulations 1.469-5(f)(1) and 1.469-5T(f)(3) attribute your spouse's participation to you.

The result here is simple. You may not use the passive income generated by paying rent to your

spouse to increase your passive income and deduct more of your passive losses. Nevertheless, the self-employment savings may be more than enough to warrant serious consideration of this pay-rent-to-your-spouse strategy.

How You Pocket the Cash

Let's say that your net earnings from your Schedule C business are \$105,576. Now you pay your spouse \$20,000 in rent for your office space. Your spouse has no other source of income. (For purposes of pocketing cash with this strategy, the income of your spouse makes no difference. We mention "no other source of income" for the spouse only because we use that situation in the tax calculation example in the next paragraph.)

Assuming no personal exemptions except for you and your spouse and only the standard deduction, your net after-tax cash from this rent is \$2,476. (The \$2,476 is less than the 14.13 percent because this is the net cash in your pocket after everything is considered, including the deduction for one-half of your self-employment tax on page 1 of your Form 1040.) This \$2,476 is money in the bank this year and every year that you can use this strategy.

Keep in mind that this savings strategy costs you nothing. You simply make a rent payment to your spouse. This is like moving money from your left hand to your right hand. You just have to do it right.

Think Commercial Lease and IRS Review

If you want the rent to your spouse to stand up to scrutiny from the IRS, you need to think and act as if you are paying the rent to an unrelated third party.⁶

This starts with paying a fair-market rent for the business

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Clarifying Taxes So You Take Control of Your Money

Tax Reduction Letter (ISSN 1066-3010) is published monthly, twelve (12) times a year, by Bradford and Company Publishing, Inc., 75 Gate 5 Road, Sausalito, CA 94965 (www.bradfordandcompany.com). POSTMASTER: Send change-of-address orders to Tax Reduction Letter, 75 Gate 5 Road, Sausalito, CA 94965. First class (priority) postage paid in Sausalito, California, and additional mailing offices. Printed on recycled paper.

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Subscriptions: \$147 for twelve monthly issues. To subscribe, call toll free 1-877-829-9673, Monday to Friday, 8:30 a.m. to 5:30 p.m.

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property or asset. If you don't pay fair rent, you likely will lose the business deductions.⁷

Making consistent, systematic, and timely rent payments to your spouse is very important here. That's what you would do with a commercial lease.

You want to make sure that you have rental money footprints, called an audit trail, from your sole and separate business account to your spouse's sole and separate account. Canceled checks and deposit slips identify and prove the money footprints. Likewise, electronic transfers verify the movement of money.

Besides proving that you paid the money, your audit-proofing strategies should include proof that you and your spouse signed a legal written lease and that the asset (or portion of the asset) you are leasing from your spouse is owned by your spouse. To stand up to IRS scrutiny, the lease must be an enforceable legal instrument.⁸

You can obtain model office and equipment leasing agreements from your local office store or online. You can engage your lawyer to draft a lease for you. Regardless of how you get the lease in place, make sure the terms are similar to those required by a third-party lessor and lessee. If two months' advance rent is normal, your lease should require two months' rent in advance. If a deposit is normal, your lease should require a deposit. You want to have a "normal" lease in writing.

State sales and use taxes might apply if the rental between you and your spouse involves equipment, furniture, or other personal property. If this is the case, your proper treatment of any applicable sales or use taxes helps prove your rental.

Getting Bigger Dollars in the Rental Equation

Short leases call for higher monthly payments and higher profits to your lessor spouse. With the shorter lease, you pay more rent each month. To learn about appropriate rental charges, phone, write, or e-mail commercial establishments that rent the items you and your spouse are considering.

Think of all the assets you need in your business. Think next of who owns what you need. In a community property state, you probably own half. You can rent from your spouse the half owned by your spouse, including your

- office;
- home office;
- cars, trucks, and vans; and
- furniture and equipment.

If you live in a non-community property state, your spouse may own the office building or vehicle in its entirety. This also can be true in a community property state.

Final Thoughts and Summary

The first question on this issue of renting from your spouse is: Will you or your spouse file a Schedule C with 2008 net income of less than \$110,449? If your answer is "yes," then the rent-from-your-spouse strategy can put self-employment tax money in your pocket. (If the net incomes are higher than \$110,449, then the savings are probably too little to justify the strategy.)

As the subhead to this article indicated, if you are single and you like this strategy, you might consider the S corporation as your leasing entity. It can provide the same basic benefits as the spouse rental without your having to get married. If you are considering an S corporation, you do need to look at the extra fees and possible extra state taxes associated with the S corporation.

If you are married, you spend no real money to make this strategy work for you. You simply move the money from your hand to your spouse's hand and allow the government to pay you for doing that. ■

News, from Pg 1

tion homes that you use primarily as rentals.

This procedure fixes the two-year standard for 1031 tax-deferred exchanges. It says that if the property you are exchanging is a defined rental property for 24 months before the exchange and if the replacement property is used by you as a rental for 24 months after the exchange, the properties can qualify for a like-kind exchange.

The nifty thing about this ruling is the 24-month clarity. If you are wondering how long your home has to be a rental before qualifying for like-kind exchange treatment, wonder no more—it's 24 months. If you are wondering how long you have to keep the acquired home as a rental, wonder no more—it's 24 months.

Further, this procedure applies safe-harbor standards to your ski lodge, lake cottage, and other vacation homes. The basic rule says that if you use your vacation home for both personal and rental purposes and your vacation home meets the tests for classification as a rental, then the vacation home can qualify for like-kind exchange treatment.

The exact rules on the vacation homes go like this:

Your vacation home qualifies as a rental property if

1. you owned the property for at least 24 months immediately before the exchange, and

2. in each of the two 12-month periods immediately preceding the exchange, you
 - rented the dwelling unit to others at a fair rental for 14 days or more, and
 - your personal use does not exceed the greater of 14 days or 10 percent of the number of days rented at a fair rental during the 12-month period.

Your replacement vacation home property qualifies as like-kind property if

1. you own the property for at least 24 months immediately after the exchange, and
2. in each of the two 12-month periods immediately after the exchange, you
 - rented the dwelling unit to others at a fair rental for 14 days or more, and
 - your personal use does not exceed the greater of 14 days or 10 percent of the number of days rented at a fair rental during the 12-month period.

Caution. Keep your relatives away from your vacation homes. If your brother pays fair rent to stay in your vacation home for seven days, those seven days count as personal use by you.¹⁴ That's true even though your brother paid fair rent. If you own a vacation home that you want to treat as a rental, you should be aware of the rules that apply to relatives. ■

IRS Releases Luxury Vehicle Depreciation Limits for 2008

Apparently the combination of the decline in the value of the dollar and the huge increase in energy prices has made automobiles less expensive in 2008. At least that's what the IRS reflects in its luxury limit tables for vehicles purchased and placed in service during 2008.¹⁵

The new luxury depreciation limit for passenger autos dropped from \$3,060 in 2007 to \$2,960 for 2008 to reflect the IRS's current adjustment for vehicle prices.

As an aside, we have to note that the 2008 first-year limit of \$2,960 on luxury depreciation matches the 1994 limit (no, this is not a typo).¹⁶

On a more positive note, a NEW vehicle purchased and placed in service in 2008 qualifies for the new economic stimulus 50 percent bonus depreciation. Note how the bonus jacks up the first-year limit in the new luxury limits below:

2008 Luxury Limits for Passenger Autos; No Bonus Depreciation

<u>Tax year</u>	<u>Limit</u>
1st tax year	\$2,960
2nd tax year	\$4,800
3rd tax year	\$2,850
Each succeeding year	\$1,775

2008 Luxury Limits for Passenger Autos; With Bonus Depreciation

<u>Tax year</u>	<u>Limit</u>
1st tax year	\$10,960
2nd tax year	\$4,800
3rd tax year	\$2,850
Each succeeding year	\$1,775

2008 Luxury Limits for Trucks and Vans; No Bonus Depreciation

<u>Tax year</u>	<u>Limit</u>
1st tax year	\$3,160
2nd tax year	\$5,100
3rd tax year	\$3,050
Each succeeding year	\$1,875

2008 Luxury Limits for Trucks and Vans; With Bonus Depreciation

<u>Tax year</u>	<u>Limit</u>
1st tax year	\$11,160
2nd tax year	\$5,100
3rd tax year	\$3,050
Each succeeding year	\$1,875

Is Your S Corp. Adding to Your Bottom-Line Profits?

The major *tax* benefit to operating your business as an S corporation is the possible savings on self-employment taxes. This article examines the tax savings to see if this form of business is right for you as a single-owner or husband-and-wife-owned business.

You may not need an S corporation if liability protection is your only concern. You can achieve both liability protection and proprietorship status with a single-member limited liability company (LLC). In community property states, a husband and wife can elect single-member LLC status on their federal tax return and thus file a proprietorship return in either the husband's or the wife's name.⁹

This article focuses on the self-employment tax savings of the S corporation compared to those of the proprietorship. It also discusses the tax and record-keeping costs of these two forms of business.

You want to read this article if

- you are considering an S corporation as your form of business, or
- you are wondering whether your current S corporation is the best form of business for you.

Taking Cash from the S Corporation

As the business owner, you take cash from your S corporation in four ways:

1. W-2 income
2. Rent paid by the S corporation to you for its use of assets that you own and rent to the S corporation
3. Corporate reimbursements to you for your employee expenses

4. Distributions from the earnings and profits of the S corporation

The S corporation is a pass-through entity. This means that the income and losses pass through to the shareholders and are taxed on the shareholders' returns.

For tax purposes, think of your S corporation as a funnel into which you put income and deductions. At the bottom of the funnel are two spouts: spout one for your salary and spout two for pass-through income. The beauty of this pass-through income is that it is not subject to self-employment or any other payroll taxes. This is what produces the tax savings by operating as an S corporation compared with the proprietorship.

Example. Your proprietorship earns \$100,000 for the year. You pay self-employment taxes on the \$100,000. You now switch to an S corporation and take a salary of \$40,000. The remaining \$60,000 passes through to you and is taxed on your personal return where it escapes self-employment taxes putting an additional \$8,478 in your pocket.

That's the good news, but it's not the complete story. Your savings may actually be less.

State Income Taxes

State law may not treat your S corporation in the same manner as federal law does. In California, for example, state law imposes on the S corporation a minimum tax of \$800, if that is less than the 1.5 percent S corporation tax. So, in California, the S corporation itself pays state taxes on its income. You, of course, also pay taxes on this income. Thus, operating an S corporation in California produces savings not at the self-employment rate, but at the rate after paying the California taxes.

The same is true in many states.

For example, in states with no personal income tax, the S corporation income might be subject to state taxes. Thus, in Texas, a state with no personal income tax, the state corporation tax applies to S corporations.

Planning tip. Consider the state tax in your S corporation net savings.

Salary Too High

Consider this: Taxpayer X creates an S corporation which pays him a salary of \$160,000 and gives him pass-through income of \$150,000. (Thus, his total income is \$310,000). Because he is already above the FICA limit with the \$160,000 salary, this S corporation saves him Medicare taxes of \$4,017 on the pass-through income of \$150,000 (2.9% times \$150,000 times 0.9235).

Now this taxpayer has to consider the state taxes on his S corporation. In this case, the state tax on his S corporation income adds \$9,000 to his tax bill. His net result: operating as an S corporation costs this taxpayer \$4,983 in additional taxes. He also spent money to organize the corporation, file the separate tax return, and change his letterhead and promotional materials. This was an expensive mistake. It's a true story.

Salary Too Low

When deciding to switch from a proprietorship to an S corporation in an attempt to save on self-employment taxes, you have to decide on a salary that's less than your net income. Say you are the one sole source of income for the operation. How do you justify a salary lower than what you earn?

This is a perplexing problem for everyone. In fact, not so many years ago the Treasury inspector general for tax administration did a study that found many S corporations with no salary at all going

to the owner-employee.¹⁰ The inspector general recommended that the IRS audit these entities and take that easy money for the government.

Although the salary range can be broad, this is certain: You need to take some salary. Further, you must justify the salary. Ideally, you would have documentation of why the salary you are taking is a reasonable salary.

The good news when you have a salary is that the IRS has had a most difficult time overturning salaries. The bad news is that for S corporations paying no salary, the IRS has been a consistent winner.

Planning tip. Make sure you take a salary from your S corporation.

What Do You Give Up to Have Your S Corporation?

Some of the rules that apply to the S corporation are different from the rules that apply to a proprietorship. For tax purposes, the S corporation is a separate legal entity in spite of pass-through taxation.

When you decide whether to be or not to be an S corporation, consider all the effects of the change. For example, with the S corporation, you must consider the following:

- Your solo 401(k) and other defined contribution retirement plan contributions are based on salary. If you take a low salary to save on self-employment taxes, you will have a low contribution base for your 401(k) or other retirement plan contribution. (With the proprietorship, you look at your total income for the contribution limits.)
- Your Section 105 medical reimbursement plan benefits are not available to you or your spouse when you are the S corporation owner. The best

you can do as the S corporation owner is to take a self-employed medical deduction for health insurance on page 1 of your Form 1040—and that's only if the corporation buys the health insurance in its name or reimburses you if the health insurance is in your personal name. (With a proprietorship, you can hire your spouse to obtain the Section 105 medical reimbursement benefits. If single, you can use a C corporation to obtain the Section 105 medical reimbursement plan benefits.)

- The pocket tax money strategy, where the parent hires his or her under-age-18 children, blows up when you operate as an S corporation, because the corporation is a separate legal entity from the parent and that separate entity triggers payroll taxes on the wages your S corporation pays the children.

If you are thinking about changing your form of business to the S corporation, consider the net after-tax cash in your pocket after all savings and pay outs. The best way to do that is with your tax advisor's help on a side-by-side comparison that drills down to the after-tax cash benefit or detriment.

Protect Your Corporate Veil

Without question, you need to do the paperwork right or your S corporation can be disregarded for both tax and legal purposes. This means paying attention to the corporate minutes, shareholder notices, and corporation filings. You can set this up so that it does not take much time, but you cannot ignore it and you need to get it right.

Because the S corporation is a separate legal entity from you, it is not a checkbook for your personal activities. To avoid trouble, you should use the corporation only for corporate activities.

Tax law contains a general rule that you may not pay and deduct the expenses of another. The S corporation is a separate legal entity from you. Thus, you cannot personally pay bills on the S corporation's behalf and the S corporation cannot pay your individual bills.

Because you are an employee of your S corporation, you must submit expense reports or other supporting documentation for reimbursement of your travel, entertainment, and vehicle expenses. You might want to consider a corporate credit card to help in this regard. Documentation of the expenses for the S corporation must meet the same high standards that exist for the proprietorship.

You need to keep the corporate accounting and tax records in good order with a decent audit trail. If you are a sloppy record keeper, the S corporation strategy is probably not for you.

Owning Stuff and Reimbursing in the Right Way

Say you are about to buy a vehicle for your business. If you operate your business as an S corporation, who should own this vehicle?

The answer might surprise you, but it's very practical. Ownership should belong to the one who can obtain the vehicle at the best price, considering all the costs, including insurance. More than likely, that's going to be you personally.

Now, let's say you own the vehicle and use it for the S corporation business. How is the S corporation going to get the deductions? Answer: The S corporation is going to reimburse you for your business use of this vehicle. The corporation has two basic choices for this reimbursement.

First, your S corporation could reimburse you at IRS standard mileage rates. This gives the corpo-

ration the deduction and you have no taxable income for the reimbursed employee expense.

Now, even though the expenses were reimbursed to you and the employee reimbursements are not reportable as taxable income, the vehicle for which you were reimbursed is a business vehicle. When you sell this vehicle, you will have a deductible tax loss or a taxable profit.

In fact, you could collect your mileage reimbursements and report them on IRS Form 2106 of your personal tax return as employee business expense reimbursements. You could then take actual expenses against that reimbursement. We don't recommend this, as it subjects you to the 2 percent of adjusted gross income floor and the alternative minimum tax.

Your second choice for reimbursement, and this is probably the most cash-beneficial method for you, is for your S corporation to reimburse you for the actual expenses of gas, oil, insurance, car washes, tune-ups, depreciation, Section 179 expensing, and all other expenses.¹¹ In this case, the corporation takes the deductions on its return and you receive reimbursed employee business expenses, which are not taxable to you and don't even show up on your tax return.

Of course, just as with the mileage rates, this vehicle is a business vehicle to the extent of your business use, and that means you experience gain or loss when you sell the vehicle.

Doing the Extra Home-Office Deduction Paperwork

You can claim the home-office deduction as an employee of your S corporation, but only if you use the home office for the convenience of your corporation.

So, have a good talk with your S corporation to determine if there is a need for a home office. For example, the S corporation might insist that you use the main office only for sales or seeing patients and that you do all your administrative work in an office away from the main office (hint, hint: you can choose the home office).

Whatever the reason, put it in writing. Make sure it's signed by both the employee and the corporation. (Yes, yes, we know, you are signing in both places; you are talking to yourself, true—but that is the crazy nature of you operating your business as an S corporation.)

Also, you will want your S corporation to reimburse your home-office deduction to avoid losing out to the 2 percent of adjusted gross income floor and the alternative minimum tax.

Assigning Your Income to Your S Corporation Probably Means Your S Corporation Is a Sham

The general tax rule is that income is taxed to the person or entity who earns it.¹² If you get checks in your personal name and then endorse those checks to your corporation, in all probability, neither the IRS nor the courts will recognize your corporation for tax purposes.

For example, say you work as a 1099 sales agent, but all the commission checks are paid to you in your personal name. In fact, the company for which you work as a 1099 agent does not recognize any of its agents as corporations. Assigning this income to your “corporation” does not make it a corporation. As you might suspect, this is going to be a big problem for you in the event of an IRS audit.

This also is true of a medical practice where the doctor accepts

the payments in his personal name and then assigns those payments to his corporation. The patient was not dealing with the corporation. The patient was dealing with the doctor, and the doctor earning the income will be taxed on it. Again, this creates a big mess for the doctor who does not instruct his patients to deal with his medical corporation.

The Loss Problem

When you operate as a proprietorship and incur a net operating loss on your business operations, it's no problem. That loss is deductible, either against other income that year or in a carryback or carryforward year.

When you operate as an S corporation, you need to consider some net operating loss fundamentals. First, you need sufficient basis (generally investments in and loans to your S corporation) to deduct the S corporation losses on your personal return.

If you are having a bad year and need to make a cash infusion into the business, you probably want to make an additional contribution to capital rather than a loan. Should the business fail, you may deduct the additional investment as a capital loss, but the loan lands in the miscellaneous deduction category, where it can be lost to the alternative minimum tax.

Planning tip. Avoid even thinking about these loss deduction problems with your S corporation—simply focus on making money.

No Double-Taxation Issue

Because this article compares the proprietorship to the S corporation, double taxation is not a concern. The double-taxation concern pops up when you compare the C corporation to other entities that you might choose.

Income Splitting

Sad to say, the traditional benefits of using the S corporation to split income with your college-age children no longer exist as a result of the 2007 Iraq War Funding law. This law extends the application of the kiddie tax to students under age 24, and that eliminates this benefit for this age group.¹³ You may still use the S corporation to split income with relatives who are not subject to the kiddie tax, but we've found the most common use of this tactic is for getting tax dollars to help pay for college. Thus, we deem the income-splitting tactic too narrow a fit for this article.

Summary

Is your S corporation producing the tax savings that you want? If not, consider the limited liability company as your choice of entity. With a single-member LLC, you can get the liability protection and the simplicity of the proprietorship, though in some states you still face extra taxation when the LLC is treated as a corporation for state tax purposes. Should the state taxes be high, you might consider the cost of adequate insurance with a proprietorship to take away the liability reason for a corporation or an LLC.

Perhaps the one major point to take away from this article is that you need to compare the cash results of how you operate today with how you *could* operate today. If there are little cash and effort differences in the way you operate, stay as you are. But if you find major differences, make the change, pocket the cash, and save the effort.

You need to know the basic rules to make your S corporation work properly for tax purposes. Keep this article handy, and review it at least annually to keep yourself on target. ■

IRS Audit

The IRS is auditing my 2005 and 2006 tax returns and asking for \$61,000 in taxes before penalties and interest. I learned of your services the other day and, according to my trusted friends, should have taken your tax course.

From what I have learned so far, I have made three mistakes:

1. I kept poor tax records.
2. I used TurboTax and depended on its review for audit flags prior to filing my returns.
3. I purchased TurboTax Audit Defense but am getting unsatisfactory results from this defense.

I have been working on this for over two months. The IRS is after me for a response or payment. I think my only solution is to engage a lawyer. Can you help? (R.M., Mission Viejo, Calif.)

You are in big trouble. Your thought of engaging a lawyer is probably a good one, but this is unlikely to save you any money. In fact, we could project that you could pay a lawyer \$15,000 and still end up paying the IRS the full \$61,000. We think at this stage that you would spend your money more wisely on an enrolled agent (EA) or a CPA willing to help you. If this doesn't help, you can engage the lawyer to take your case to court, where you will likely lose.

Your first step is to see what the IRS will accept as proof of your deductions. This means having a dialogue with the IRS and then seeing if you can produce what they want.

For many of your deductions, it is too late. For example, your car

log was supposed to be kept on a contemporaneous basis, meaning within a week. Reconstruction almost never works. Thus, you need the IRS examiners to tell you what they will accept as proof of your car deductions, if anything. You might have the components of a contemporaneous record when you consider combining the notes you have in your appointment book, on your gas receipts, in your correspondence, etc. This will take some time to reconstruct, so you want clarity between you and the IRS before you undertake this effort.

Let's go back to your basic problem. First, ignoring your tax records is a major mistake. Reconstructing records after the fact takes tremendous time, as the two months you have already spent in this useless exercise demonstrates.

Second, TurboTax, a CPA, or an EA can only put on your tax return the numbers you give them. We doubt that TurboTax caused your audit problem or that the audit flags in TurboTax were inadequate. For the most part, TurboTax is on the more conservative side of a deduction, hardly the side that causes an audit.

We prefer the tax advisor, with whom you can speak, over TurboTax. In general, tax law is confusing, and the ability to speak with your advisor allows you to get questions answered more accurately.

Third, audit defense insurance is like any insurance. Great, if you don't need it. We suspect the real reason you are unhappy with this insurance process is that the audit representative told you that the audit insurance cannot make up your deductions or defend deductions for which you have no support.

Like we said above, you are in big trouble.

Planning tip. We have had a number of customers who were under audit before taking our tax course and who then used the knowledge gained from the course and our tax diary system to put together their deduction documentation for presentation to the IRS. Since the audits were already under way, this reconstruction was done with the blessing of the IRS and supported by the taxpayers' records—records kept in a most unorganized fashion, but records nonetheless. Some of these taxpayers even survived these reconstructed audits with no change in their taxes, getting “no change” letters from the IRS.

You might ask your IRS examiner if he or she would accept such an after-the-fact presentation from you. ■

Fishing Trip with CE

Iam one of 18 dentists going on a fishing trip to Alaska with our dental study group. We will have continuing education (CE) programs with CE credits available on this trip. The CE courses will be taught by some of the dentists in this study group.

Although it seems like this would be tax deductible, the CE could be done anywhere, as the courses are just lectures given by some of the dentists. In other words, these courses could take place in our hometown or in Alaska. There are handouts, sign-in sheets, etc., but would this count?

One problem I can see is that we paid our deposit to the dental study group, but we pay the balance to the fishing charter company in Alaska. The fishing company provides the fishing and the lodging.

This is a three-day trip and I would assume about two hours of CE per day. Do you think this is going to fly as a tax deduction? (J.K., Tucson, Ariz)

This trip needs some work to make it deductible. Here is one scenario that will pass muster.

Let's start with a basic rule: when entertainment precedes or follows a directly related business discussion, the entertainment is deductible as associated entertainment.¹⁸

Your dental study group is a formal organization established to assist members in both the clinical and business sides of dental practice. This study group is putting the Alaska meeting together for the primary purposes of educating its members as specified in the CE content of the programs that will be presented.

Ideally, the cost of fishing would be separated from the cost of meetings, lodging, and airfare. The bundling of the fishing in your study group's package makes it critical that you clearly establish your business purpose for this trip.

Step one in this process is to set forth that the fishing entertainment part of the meeting is designed simply to encourage more of the study group members to attend this CE program. The advantage of using the fishing is that it promotes business discussions outside of the formal meetings; for example, those additional business discussions that will occur on the boat and during cocktail hours, breakfasts, and dinners. Thus, the

combination of the CE meetings and recreational time is superior to one or two meetings in Tucson because the proximity of the group before and after the CE simply extends the value of the meetings and makes it more convenient and practical for each of the dentists to participate in the business discussions.

As a technical note, when we are done, your business meetings will be far greater in scope and content than those on that fishing trip that passed muster with the court in *Townsend*.¹⁹

Let's get to the nuts and bolts of how you make the primary purpose of this trip business and how you make each day of the trip a business day. For the trip, we are going to create the business CE sessions as the reason for the trip and we are going to make the CE days count as business days. Thus, your business reason for the travel is to get to this educational activity, and once there, each day of the trip is going to be either a deductible travel day or a deductible business education day.

For the CE days to qualify for deduction as business days, you must pass a facts-and-circumstances test that shows that your CE meetings provide specific business benefit to the conduct of your dental practice.²⁰ The fact that the courses qualify for CE automatically says they are of bona fide benefit to your business.

Next, you need to establish that the principal character of your combined entertainment and business activity is the active conduct of these CE courses.²¹ We assume you are going to spend more time fishing each day than you are going to spend in the CE classes. That's okay; the regulations specifically state that you don't need to spend more time devoted to business than to entertainment.²²

Next, you need the CE courses to qualify the day as a business day. Before Public Law 96-608 changed the travel rules, a business day at a foreign convention was deemed by former Section 274 as attending at least four out of six hours of scheduled convention activity. Focus here on the four hours.

If the principal purpose of your day must be business, and if principal means more than half a work-day (which is generally considered eight hours), then four hours and one minute of work would make your principal purpose for the day... work.

Thus, forget the two hours of CE a day and go for four hours and one minute or more. The four hours of CE in combination with the other business gatherings far surpasses the results in *Townsend* and sets your days to qualify as business days.

Make sure that the courses take place in an educational setting—



Endnotes



- 1 Cox v Commr., T.C. Memo 1993-326.
- 2 MSSP Training Guide, Independent Used Car Dealers, Chapter 6, Expense Issues, Rent Expense.
- 3 <http://www.ssa.gov/pressoffice/factsheets/colafacts2008.htm>.
- 4 Rev. Rul. 75-209.
- 5 Private Letter Ruling 8404004.
- 6 Logan Lumber Co. v Commr., (CA-5) 365 F.2d 846.
- 7 International Color Gravure, Inc., 20 TCM 61, T.C. Memo 1961-15.
- 8 Currier Farms, Inc., v Commr., 7 TCM 677.
- 9 Rev. Proc. 2002-69.
- 10 Treasury Inspector General for Tax Administration, Audit # 200130027, Reference # 2002-30-125.
- 11 Reg. Section 1.62-2(d)(1) allows as reimbursements the expenses in Part VI, Subchapter B, Chapter 1 of the Internal Revenue Code.
- 12 United States v Basye, 410 U.S. 441, 449, 451; Lucas v Earl, 281 U.S. 111 (1930).
- 13 PL 110-28, Section 8241, 5/25/2007.
- 14 IRC Section 280A(d)(2)(A).
- 15 Rev. Proc. 2008-22.
- 16 Rev. Proc. 94-53.
- 17 Gregory J. Farris v Commr., TC Summary Opinion 2007-192.
- 18 Reg. Section 1.274-2(d)(3)(ii).
- 19 Townsend Industries Inc. v. U.S., 342 F.3d 890 (8th Cir. 2003).
- 20 Reg. Section 1.274-2(d)(3)(i).
- 21 Ibid.
- 22 Ibid.

you might use a private room at the restaurant or in the lodge where you are staying.

We don't know much about the three days, but for this answer we will assume that you spend three nights at the lodging facility. We will assume that you travel on day one, fish on days two and three, and return home on day four. Thus, we have you away from home for three nights.

In this case, you want the more than four hours of CE to take place on days two and three.

With this setup, you have

- tax-deductible lodging for three nights.
- tax-deductible travel costs to and from Alaska.
- tax-deductible meals, drinks, and other costs of sustaining life during the three-day trip, and
- tax-deductible entertainment with your fellow dentists.

As to your question about the location of the course, location is not a problem when the course takes place in the tax-defined North America area. In general, you may take the course in Alaska even when that same course is offered on that same day in your hometown. This is a long-standing rule.

Technically, the rule is that you have to have an ordinary and necessary business reason for your education and trip to Alaska. Your first reason is to be with 18 other dentists from your area in a close environment where you can gain substantial insights from the other dentists. If you did this in your backyard, it's unlikely that you could create such a locked-in proximity to your colleagues.

Your other question concerned the check to the charter fishing company. The only problem this check poses is how much of the money is for lodging and how much is for fishing. Keep these points in mind: The fishing is deductible as entertainment, and this type of entertainment produces a deduction

for only 50 percent of the entertainment cost. Lodging is 100 percent deductible when incurred for CE purposes. (Lodging is not deductible at all if incurred for entertainment purposes—this is another reason to get business reasons for this trip correct.) ■

From the Courts

Renting to Your Corporation Does Not Produce Passive Income

Gregory J. Farris of Gardiner, Maine, owned the building that he rented to his law practice.

He made a profit on the rent and characterized the profit as coming from a passive activity, which he used to offset passive losses from other properties. The IRS disagreed with the passive income classification and asked Mr. Farris for additional taxes of \$13,259; \$17,251; and \$17,482 for the three years before the court.

The court had a simple decision: if the income from the rental to the corporation was not passive income, then Mr. Farris owed the taxes.

The court noted that property rented by the taxpayer to an entity in which the taxpayer materially participates (such as his law firm) does not produce passive income. This is exactly what was going on here: Mr. Farris had a majority interest and materially participated in the law firm to which he rented this property.

This is called the "self-rental rule," and on this point Mr. Farris lost his case. But he had another point.

During the years before the court, Mr. Farris held the property as an individual sole owner. The law firm was organized as a corporation.

The property housing the law firm had been owned by Mr. Farris and a partner in the form of a

partnership, and this partnership had rented the property to the law firm while the law firm operated as a partnership. At the time of this partnership-to-partnership lease, the law allowed a transition that did not apply the self-rental rule to leases entered into before February 19, 1988. Mr. Farris attempted to hang his hat on this transition, claiming that the old partnership now was simply his proprietorship and the old law firm partnership now was simply the law firm corporation.

Wrong, ruled the court. First, the court noted that federal law clearly treats a corporation as a new, separate, and distinct entity from a partnership. Second, the court noted that the law in the state of Maine applies the same rule: that corporations are separate legal entities.

Thus, Mr. Farris, the individual, was subject to the self-rental rule and had to pay the additional taxes.¹⁷

Here are important points for you to take from this case:

- Renting to an entity, such as your business, in which you materially participate will not produce passive rental income for use against passive losses from other properties.
- The corporation is a separate legal entity from the predecessor proprietorship or partnership.
- If you own rental property, you want to make sure that you know exactly how the passive loss rules are hitting your properties.
- When you make changes to your rental property portfolio, you should know exactly how those changes affect the passive loss rules that apply to you. ■

In coming issues

- Maximum benefits from the real estate closing statement
- Who is filing your 5500?
- Last and best tax shelter ever.
- New 2008 economic stimulus benefits for your business