

# Client Tax Letter

Tax Saving and Planning Strategies from your Trusted Business Advisor<sup>SM</sup>

## Deductions for Dining Out



meals with wine, and the tab comes to \$100 with tax and tip. If Nora pays the bill, she can take a \$50 tax deduction.

The IRS explicitly frowns on so-called “taking turns” deductions. Thus, if the potential client is Nora’s neighbor and they dine together every month, alternating as to who pays the bill, the IRS won’t allow either

party to take tax deductions.

However, that may not always be the case.

**Example 2:** Nora and her neighbor dine together throughout the year, discussing possible ideas for the latter’s garden, and Nora picks up the tab every other time, paying a total of \$600. Eventually, the neighbor hires Nora to landscape her garden; Nora ultimately earns \$2,000 from that job, reported as taxable income. Can Nora take a \$300 (50% of \$600) tax deduction, despite the alternate bill paying? Our office can help you determine the answer to such difficult questions.

### Beyond reasonable doubt

The IRS also asserts that meal outlays that are “lavish or extravagant” won’t

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### Expensive Education

*The three most expensive U.S. colleges are in New York state: Columbia (\$51,008 in tuition and fees for 2014-15), Sarah Lawrence (\$50,780), and Vassar (\$49,570).*

Champagne and caviar on the IRS?

Typically, the answer is no. Nevertheless, there are times when you can go out to eat—perhaps to the best restaurant in town—and recoup some of your costs through tax savings.

### Business as usual

Perhaps the most obvious way to deduct dining costs is to buy a meal for someone with whom you do business or would like to do business. The good news is that everything counts: food, drinks, tax, and tip. The bad news? Meal costs typically are considered entertainment expenses, which generally have a 50% cap on deductions.

**Example 1:** Nora Peters has dinner with a potential client for her landscaping business. They both have full-course

## Trusted Advice

### Meal Plans

- In order to support a deduction for buying someone a meal, you must be present.
- The purpose of the meal must be the active conduct of business, you must engage in business during the meal, and you must have more than a general expectation of getting income or some specific business benefit in the future; or the meal must be associated with the active conduct of business and come directly before or after a substantial business discussion.
- You should keep a record of all these meal expenses. Note the “who, where, when, and how much” details along with an explanation of the business purpose of your mealtime conversation.

qualify for a tax deduction. Unfortunately, the agency doesn't provide a dollar limit or any tangible guideline, only that the cost must be “reasonable,” considering the “facts and circumstances.” Merely dining at a deluxe restaurant or a pricey resort won't automatically rule out a 50% deduction.

One way to approach this issue is to put things into perspective.

In a major city with a steep cost of living, spending \$100 on a dinner for two may not be considered lavish, if there's a valid business purpose for the excursion. Conversely, spending hundreds of dollars on a meal with someone who has only a peripheral connection to your company and little chance of providing meaningful revenues in the future, might not pass muster.

One U.S. Commerce Department website provides an example of spending \$200 for a business-related meal. If \$110 of that amount is not allowable because it is lavish and extravagant, the remaining \$90 is subject to the 50% limit. Thus, the tax deduction could be \$45 (50% of \$90).

### Going solo

You should be aware that the 50% limit also applies to business meals away from home, not just to meals where you're entertaining someone.

**Example 3:** Ron Sawyer travels from his Dallas home to Tucson on a sales trip. He does no entertaining but spends \$140 eating his meals in restaurants. Ron's meal deduction is \$70 (50% of \$140).

### Filling out a foursome

Generally, you can't claim a 50% deduction for buying your spouse a meal. There are exceptions, though, if including your spouse at the table serves a business purpose, rather than one that's personal or social.

**Example 4:** Tim Walker invites a customer to dinner. The customer is visiting from out of town, so the

customer's spouse is also invited because it is impractical to entertain the customer without the spouse. Tim can deduct 50% of the cost of the meal for the customer's spouse. What's more, if Tim's wife joins the group because the customer's spouse is present, the cost of the meal for Tim's wife is also deductible.

### Taking the deduction

For self-employed individuals and business owners, taking 50% deductions for business meals may be straightforward. For employees, though, those deductions might be harder to obtain. Unreimbursed expenses are included in miscellaneous itemized deductions, which are deductible only to the extent they exceed 2% of adjusted gross income (AGI).

**Example 5:** Lynn Knox, who is an employee, spends \$500 on business meals in 2015 and is not reimbursed. When she prepares her tax return for the year, she includes \$250 as a miscellaneous itemized deduction. Her AGI is \$100,000, so her 2% threshold is \$2,000. If Lynn's miscellaneous deductions add up to \$2,400, she is entitled to deduct the \$400 excess. Without her business meals, Lynn's miscellaneous deductions would have been only \$2,150, generating a \$150 deduction, so Lynn effectively gets a \$250 deduction for her \$500 of business meal expenses. If Lynn's miscellaneous deductions were under \$2,000, she would have no tax benefit from her business meals. ■

## Grandparent Aid for College Costs

Many grandparents would like to help their grandchildren with the steep costs of higher education. That's often a laudable goal, but some methods of providing this assistance might be more effective than other tactics.

### Grand gifts

The simplest tactic is to give money to youngsters before or during their college years. In 2015, the annual gift tax exclusion is \$14,000 per recipient.

**Example 1:** Cora Smith has three grandchildren. She can give each

of them \$14,000 this year for their college funds. Cora's husband, Rob, can make identical gifts to each of their grandchildren. Such gifts will have no adverse tax consequences. (Larger gifts may reduce this couple's gift tax exemption

and, ultimately, their estate tax exemption.)

In addition to all of these \$14,000 gifts, the Smiths can pay the college tuition for any of their grandchildren. No matter how large these outlays might be, Cora and Rob will not owe any tax or suffer any reduction in their transfer tax breaks.

### Axing aid

Such grandparent gifts may have their disadvantages, though. They could result in reduced financial aid.

**Example 2:** Over the years, Rob and Cora have made gifts to their grandson Doug. Counting investment buildup, Doug has \$50,000 worth of assets when he fills out the Free Application for Federal Student Aid (FAFSA) for his first year of college. The FAFSA assesses Doug's assets by 20%, when calculating the expected family contribution (EFC), so the \$50,000 could reduce his financial aid by \$10,000: the 20% assessment times \$50,000 of Doug's assets. Tuition payments by Rob and Cora for Doug's schooling could result in even larger aid cutbacks.

For some grandparents, this won't be a major concern. The student's immediate family might have such extensive assets and such substantial income that need-based financial aid won't be possible. However, today's college costs are so high that aid might be available, even to well-off families. The possible impact on financial aid should be discussed with the student's parents.

In addition, it should be considered that assets given to grandchildren will come under the youngsters' control once they come of age, usually on or before age 21. Grandparents need to be comfortable with the idea that money in a grandchild's account may or may not be used for education or other worthwhile purposes.

### Grandparents to parents

Instead of making gifts directly to grandchildren, grandparents can give assets to their own children who are the student's parents. This plan will have less impact on financial aid.

**Example 3:** Assume that Cora and Rob have made gifts to their daughter Elly, Doug's mother, rather than making gifts directly to Doug. Such gifts have increased Elly's assets by \$50,000. A parent's assets are assessed at no more than 5.64%, on the FAFSA, so the additional assets held in Elly's name would reduce possible aid by \$2,820: 5.64% of \$50,000.

Therefore, giving money to the student's parent would be better than giving money to the student, if financial aid is a concern, and, assuming the parents are more financially prudent, less chance exists of the transferred assets being squandered.

### Focusing on 529 plans

If concerns about the security and intent of the gifted funds still exist, they may be addressed by contributing to a 529 college savings plan, instead. Such plans have many advantages.

**Example 4:** Cora Smith creates three 529 accounts, naming a different grandchild as the beneficiary for each one. Now Cora has control over how the money will be invested and how it will be spent. Any investment earnings will be tax-free and distributions also will be untaxed if the money is used for the beneficiary's college bills. Cora can even reclaim the funds in the 529 if she needs money, paying tax and (with some exceptions) a 10% penalty on any earnings.

What's more, a 529 account owned by a grandparent won't be reported on the grandchild's FAFSA, so it will not have any initial impact on financial aid. It's true that eventual distributions from

a grandparent's 529 will be reported on a subsequent FAFSA and will substantially reduce financial aid. That won't be a concern for families who are not receiving need-based aid. If the student is receiving aid, distributions from the grandparent's 529 plan can be postponed until the last FAFSA has been filed.

**Example 5:** Doug Franklin will start college in the 2015-2016 school year, so he files his first FAFSA in January 2015. Doug receives some need-based aid, so his grandmother Cora lets the 529 account continue to grow, untaxed. Doug files a new FAFSA every year until January 2018, when he submits the form for his senior year. Subsequently, Cora can tap the 529 account to pay Doug's remaining college bills. Doug won't be filing any more FAFSAs for financial aid, so Cora's 529 distributions won't be reported. The bottom line is that grandparents have many tactics they can consider if they wish to give grandchildren a financial assist on the path towards a college degree. ■

### Did You Know?

**A**mong individuals age 80 and older, more than three-quarters live in their own homes. Pre-retirees also hope to "age in place." A recent survey of people 45 and older found that 73% strongly agreed that they would like to stay in their current residences as long as possible.

Source: Harvard.edu

## Tax-Free Income From Renting Your Home

From Canton, Ohio, where the Pro Football Hall of Fame Weekend takes place in August, to Los Angeles, which has Haunted Hayrides to celebrate Halloween throughout October, cities small and large host special events throughout the year. Moreover, oceanfront communities attract millions of tourists in the summer while mountain regions offer winter sports each winter.

What is the common denominator? If you live in an area popular with tourists, for a season or a month or even a day, you can rent your home for a sizable amount. According to some reports, homes in the Augusta, Georgia area rent for as much as \$20,000 for the week of the Masters Golf Tournament in April.

Moreover, income from such rental activity is legitimately tax-free: you don't have to report it on your tax return. You can't deduct any expenses incurred for the rental, but you still can take applicable mortgage interest and property tax deductions for your home with no reduction for the profitable rental period.

### Fortune's fortnight

As you might expect, you have to clear some hurdles to qualify for this tax-free income. Perhaps most important, you must rent the home for no more than 14 days during the year. If you go over by even one day, tax-free taxation will vanish. In that case, you will have to report your rental income, and you may take appropriate deductions, but the process can become very complicated.

In addition to the 14-day limit, the IRS says that you must use the "dwelling unit as a home." This means that you must use the property for personal purposes more than (a) 14 days or (b) 10% of the days it is rented to others at a fair price, whichever is greater.

**Example 1:** Jan Harrison lives in Charlotte, North Carolina, throughout the year but rents her home for a week when the Bank of America 500 race is in town. She moves in with her sister and then goes home after the weeklong rental ends. Jan lives in her home well over 300 days in the year, so claiming the tax-free rental income won't be a problem.

You also can claim this tax break for a vacation home as long as there

are at least 15 days of personal use and you keep rentals under 15 days a year. With either a primary residence or a second home, keep careful records to show that you observed the 14-day rental limit.

### Proceed prudently

Tax-free income is certainly welcome, but it shouldn't be your only concern. Keep in mind that you are letting other people occupy your home, perhaps during a time when parties may occur. Make sure you have a formal rental agreement in place and that you collect the rent upfront, along with a deposit for possible property damage. Check with your homeowners insurance agent to see if you need special coverage, and check with local officials to find out if you need a permit for a short-term rental.

If you decide to use a service to handle the rental and save you some aggravation, ask what fees you'll owe. In addition, ask if the rental income will be reported to the IRS. Such reports may complicate what can be a straightforward tax benefit; our office can explain the possible problems and solutions. ■

## Deducting Foreign Business Travel

As the world shrinks, business owners may find themselves traveling to foreign destinations. Often, such trips are vital, leading to personal visits with suppliers and potential customers. Ideally, you'll be able to deduct all your travel costs, but that may not be the case if you venture beyond the 50 states and Washington, D.C.

### The seven-day rule

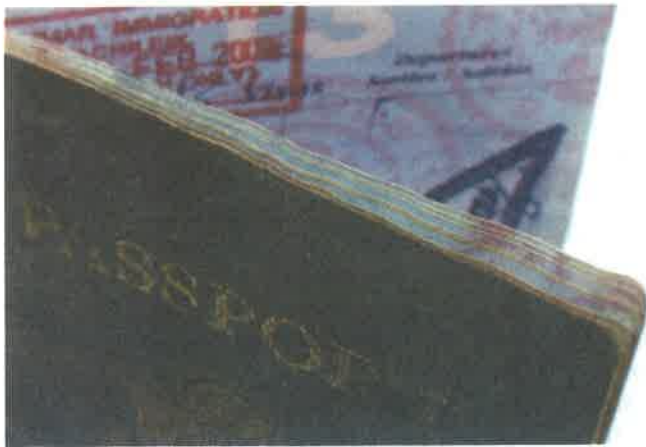
If you travel outside the U.S. for a week or less, your trip will be

considered entirely for business, even if you combine business and nonbusiness activities. Then, you can deduct all of your travel costs. A week, for this purpose, is seven consecutive days, not counting the day you leave the U.S.

**Example 1:** Denise Edwards has a clothing import business in Chicago. She travels to San Francisco on Tuesday, then flies to Hong Kong on Wednesday. After spending Thursday and Friday in business discussions,

Denise spends Saturday through Tuesday sightseeing. She flies back to San Francisco on Wednesday and returns to Chicago on Thursday.

Here, Denise was not outside the U.S. for more than a week. (The day she departed from San Francisco does not count as a day outside the U.S.) Therefore, she can deduct all of her travel costs. She also can deduct the cost of her stay in Hong Kong for the days she worked there but not her costs for her sightseeing days.



### More than one week

Business trips longer than one week trigger another set of rules. As long as 75% or more of the trip's total days are business days, you can deduct all your travel costs. Days traveling to and from your destination count as business days, for the purpose of reaching the 75% mark. Again, your costs for nonbusiness days are not tax deductible.

If your trip is primarily for business, but you fail both the one week and the 75% tests for the travel, calculating your deduction

becomes more complicated. You can only deduct the business portion of your cost of getting to and from your destination and must allocate your travel time on a day-to-day basis between business days and nonbusiness days.

**Example 2:** Henry Jackson owns a restaurant supply business in Boston. He flies to Berlin on March 7 for a conference and spends time there on business until March 17. That day, Henry flies to Brussels to see friends and tour the local museums. On March 24, he returns to Boston from Brussels.

As the IRS looks at Henry's itinerary, it appears that Henry could have returned to Boston on March 17, after completing his business. Thus, 11 days of the trip (March

7–17) count as business days while the other seven days (March 18–24) are nonbusiness days.

With this reasoning, 7 out of 18 days of the trip were nonbusiness days, so  $\frac{7}{18}$  of what it would have cost him to travel roundtrip between Boston and Brussels is not tax deductible.

Assume Henry's total airfare costs were \$2,000, whereas roundtrip airfare between Boston and Brussels would have been \$1,500. Henry must subtract  $\frac{7}{18}$  of this roundtrip fare ( $\$1,500 \times \frac{7}{18} = \$583$ ) from his actual travel expenses. Because Henry spent \$2,000, subtracting \$583 gives him a \$1,417 deduction for his airfare. He can deduct his costs while in Berlin on business but not his costs while in Brussels for other purposes.

As you can see, calculating foreign business travel deductions can be complex. If you will be outside the United States for business, our office can help you set up a schedule for optimal tax benefits. ■

## Reasonable Compensation for S Corporation Owners

For regular C corporations, "reasonable compensation" can be a troublesome tax issue. The IRS doesn't want shareholder executives to inflate their deductible salaries while minimizing the corporation's nondeductible dividend payouts.

For S corporation owners, the opposite is true. If owner employees take what the IRS considers "unreasonably low" compensation, the IRS may recast the earnings to reflect higher payroll taxes, along with interest and penalties.

### One pocket to pick

Eligible corporations that elect S status avoid corporate income taxes. Instead, all income flows

through to the shareholders' personal tax returns.

**Example 1:** Ivan Nelson owns a plumbing supply firm structured as an S corporation. Ivan's salary is \$250,000 a year while the company's profits are \$400,000. The \$650,000 total is reported on Ivan's personal tax return.

In 2015, Ivan pays 12.4% as the employer and employee shares of Social Security tax on \$118,500 of earnings. He also pays 2.9% Medicare tax on his \$250,000 of salary. As a result of recent tax legislation, Ivan—who is not married—owes an additional 0.9% Medicare tax on \$50,000, the amount over the \$200,000 earnings threshold (the

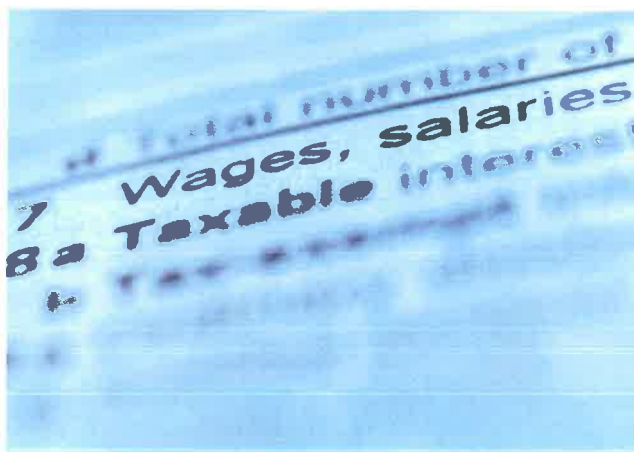
threshold is \$250,000 on a joint tax return). Altogether, Ivan pays well over \$20,000 in these payroll taxes.

### Going low

Often, S corporation owners have a great deal of leeway in determining their salary and any bonus. Holding down these earnings may reduce payroll taxes.

**Example 2:** Jenny Maxwell owns an electrical supply firm across the street from Ivan's business. Jenny's company also is an S corporation. She reports the same \$650,000 of income from the business but Jenny classes only \$75,000 as salary and \$575,000 as profits from the business. Thus, she pays thousands

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of dollars less than Ivan pays for Social Security and Medicare taxes.

### Proving your payout

As mentioned, the IRS might target S corporation owners suspected of lowballing earned income. Therefore, all S corporation shareholders should take steps to justify the reasonableness of their compensation.

If you own an S corporation, consider spelling out your salary level in your corporate minutes. Where possible, give examples and quote industry statistics that show your compensation is in line with the amounts paid to executives at similar firms.

Other explanations also might help. Depending on the situation, you might say that business is slow, in the current economy, so the minutes will report that you are keeping your salary low to provide working capital

for the company. If your business is young, the minutes could explain that you're holding fixed costs down, so the company can grow, but you expect to earn more in the future. In still another scenario, you might say that you are nearing retirement

and making an effort to rely more on valued employees, so a modest level of earnings reflects the actual work you're now contributing.

As illustrated above, holding down S corporation compensation can result in sizable payroll tax savings. Our office can help you establish a reasonable, tax-efficient plan for your salary and bonus.

### Calculating coverage

Beyond compensation, health insurance also may affect the payroll tax paid by an S corporation owner. Special rules apply to anyone owning more than 2% of the company's stock.

If the company has a health plan and pays some or all of the costs for coverage of such a so-called "2% shareholder," the payments will be reported to the IRS as taxable income. However, that amount will not be subject to payroll taxes, including those for Medicare and

Social Security. The company can take a deduction for these payments, effectively reducing corporate profits passed through as taxable income for the shareholder.

In addition, the S corporation shareholder may be able to deduct the premiums paid by the company—this deduction can be taken on page 1 of his or her personal tax return, which may provide other tax benefits. However, such an "above-the-line" deduction cannot be taken in any month when the shareholder or spouse is eligible to participate in another employer-sponsored health plan. Also, this deduction can't exceed the amount of the shareholder's earned income for the year.

This can be a complicated issue, especially if your state law prevents a corporation from buying group health insurance for a single employee. If you own an S corporation, our office can help you decide the best way to hold down payroll tax as well as income tax from your health plan. ■