



2009

Small Business

advisor

TIMELY TALK ABOUT BUSINESS, TAXES AND TRENDS

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# Taking Your Business Home

The economic downturn has many businesses struggling to stay afloat. With so much at stake, some owners have moved their businesses into their homes to save money. If you are considering this option, then you need to be aware of the rules that apply when deducting home office expenses.

Generally, a self-employed individual will qualify for a home office deduction if the office is a place where the taxpayer meets with customers, patients or clients, or is used on an exclusive and regular basis for administrative or management activities of his or her trade or business, and there is no other fixed location of the business where the taxpayer conducts substantial administrative or management activities of the business. Even if a taxpayer conducts administrative activities at a fixed location outside the home, he or she is still eligible to claim a deduction as long as the administrative activities conducted at the outside location aren't substantial. Space in the home used to store inventory for a wholesale or retail business also qualifies as business use of the home.

Deductible home office expenses fall under two basic categories: direct and indirect expenses. Expenses that

are directly attributable to the home office, such as painting the office, repairs to the office space, etc., are 100% deductible to the business. The second category is indirect expenses that are attributable to the entire home, for which only a fraction of the total amount is allocated to the home. These include home mortgage interest, property taxes, insurance, certain utilities and depreciation. If the home is rented, substitute rent paid for interest, taxes and depreciation. The fraction used to allocate business portions of the indirect expenses is determined by dividing the business use square footage by the total square footage of the home.

The home office deduction is, however, limited to the gross income of the business derived from the use of the home for that business, and where the gross income is less than the expenses, certain expenses can be carried forward for the same trade or business in the subsequent years but cannot be used against a positive income from another business. Carryover never includes home interest, taxes and casualty losses because they are allowed without regard to the gross income limitation.

If the self-employed taxpayer owns the home, there is a negative aspect to the home office deduction that can create unexpected consequences when the home is sold. First, the allowable home office depreciation is

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The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

# Luxury Car Rules

Unfortunately, if you deduct actual expenses for the business use of your car, you will probably find your write-offs for depreciation restricted due to so-called luxury car limitations. And most any cars (including trucks or vans) fit the IRS definition of a "luxury vehicle," regardless of their cost. If a vehicle is four-wheeled, used mostly on public roads, and has an unloaded gross weight of no more than 6,000 pounds, the car is considered a "luxury vehicle."

To see how this works, let's hypothetically say you and an associate each bought a car in 2009. Your car costs \$50,000 while your associate's costs \$25,000. You both use your vehicles 75% for business. Cars are in the 5-year life depreciation category and generally the first-year depreciation for 5-year life items is 20%. However, your depreciation deduction for the year (including any choice to expense part of the car's cost) will be subject to the first-year "luxury vehicle" limitation, which for 2009 is \$2,960 or \$10,960 if a special bonus allowance is claimed.

## Vehicle Depreciation Comparison

1. Vehicle Cost	\$50,000	\$25,000
2. 50% Bonus Depreciation	25,000	12,500
3. 20% First-Year Depreciation	5,000	2,500
4. Total Depreciation if Not Limited (3 + 4)	30,000	15,000
5. Luxury Auto Limit	10,960	10,960
6. Allowable Depreciation (lesser of 4 or 5)	10,960	10,960
7. Depreciation Deduction (75% business)	8,220	8,220

As you can see, both you and your associate's depreciation for the first year is the same amount because of the luxury auto limits. Thus, your associate will be able to deduct the same amount as you, even though his car had a much lower cost than yours.

To stimulate the economy, Congress has temporarily allowed businesses to recover the costs of capital expenditures made in 2008 and 2009 faster than the

# May Limit Vehicle Write-Offs



ordinary depreciation schedule would allow, by permitting these businesses to immediately write off 50% of the cost of new, depreciable property (e.g., equipment, tractors, wind turbines, solar panels, and computers) acquired in 2008 and 2009 for use in the United States. This bonus depreciation provision also applies to new cars but is limited to a maximum of \$8,000. So, in our example above, the annual depreciation before applying the business use factor will be equal to \$10,960 (\$2,960 + \$8,000).

Thus, your first-year depreciation (you used the vehicle 75% for business) will be \$8,220 ( $10,960 \times .75$ ).

This may seem unfair, but there is an alternative that can help. Certain sports utility vehicles (a Suburban for example) exceed 6,000 pounds unloaded gross weight and have special rules.

For more information on how to maximize your business vehicle deductions, please give us a call.

## *(Taking Your Business Home Continued...)*

never excludable under the \$250,000 (\$500,000 for joint filers) exclusion of gain for primary residences and will end up being recaptured as taxable income upon sale. Worse yet, if the office is located in a separate structure, then the home sale is treated as two sales (the sale of the home portion and the sale of the office portion). Any gain from the office portion would not qualify for the home gain exclusion and would be taxable.

For example, a married couple sells a home that includes a home office in a separate structure that is 20% of the total home square footage. The home, originally costing \$150,000, is sold for \$500,000. If the home office had never been claimed, or if the office had not been in a separate structure, the entire home gain, except recaptured depreciation, could be excluded from income. However, in this case, \$70,000 (20% of the gain) becomes taxable income. (For this example, to keep it simple, we haven't taken into account improvements, selling costs, or depreciation.)

If you would like to learn more about how the business use of your home might affect your taxes, please give this office a call.

# Converting a Rental to a Home

A \$250,000 (\$500,000 for joint filers) exclusion is available to offset the gain from the sale of a taxpayer's principal residence. This exclusion can be used repeatedly, provided the eligibility requirements are met, but generally not more than once every two years.

This often tempts owners of rental properties to sell their current home their principal residence – to utilize the exclusion, and then occupy one of their rental properties until the requirements are met to be eligible for the exclusion again. If the taxpayer owned multiple rentals, the same process could be applied to each property, allowing the individual to benefit from the exclusion numerous times.

When the rental is not a place in which the taxpayer would want to live during the qualification period, the rental can be swapped through a tax-deferred exchange for a more suitable one, which the property owner must rent out for a reasonable period of time before occupying it to meet the exclusion qualifications. These types of transactions became so popular that Congress passed two laws to make it more difficult to achieve this tax-saving strategy.

Generally, to qualify for the gain exclusion, a taxpayer must own and use the home as a primary residence for two of the five years prior to the sale. However,

if the home was acquired by means of a tax-deferred exchange, Congress increased the ownership requirement from two years to five years, thereby requiring the taxpayer to wait five years before being able to qualify for the home sale gain exclusion for the exchanged property.

Beginning in 2009, Congress added yet another roadblock to this strategy by making the gain attributable to nonqualified periods nonexcludable. "Nonqualified use" is when the home isn't used as the taxpayer's principal residence. Luckily, this restriction was not implemented right away. Instead, it was phased in by only counting periods of nonqualified use beginning in 2009, and grandfathered in periods before 2009 as qualified use. However, over time, this new law will diminish the benefits from this strategy.

Keep in mind that even when a home qualifies for the home gain exclusion, the gain attributable to the depreciation allowable after May 5, 1997 on the home, and prior rental in case of an exchange, is not excludable and will be taxable.

Although these laws have complicated the benefits of converting a rental property to a primary residence prior to sale, with careful planning the strategy is still a viable one and can provide shelter from rental gains. Please call this office for more information.

## Writing Off Equipment Purchases in 2009 Can Be Tricky

Generally, assets (equipment) other than real property, leasehold improvements and certain farm structures acquired by a small business can be written off using three provisions of the tax law or combinations of the three. Choosing the right provision or a combination of provisions can have a significant impact on your taxes in 2009 and future years, so careful planning is required for any significant purchases made in 2009. The three write-off methods are outlined below so you can better understand the tax implications of using them.

- **Section 179 Expense Deduction** – This is a provision that permits a business to write off any portion of the cost of a newly-purchased asset in the first year it is placed in service. The first-year write-off cannot exceed the greater of the taxable income from all of the taxpayer's active trades or businesses or the annual cap, which for 2009 is \$250,000 (\$125,000 for married taxpayers filing separately). Any amount which can't be deducted in one tax year because of the taxable income limit may be carried over to the next year and added to the cost of qualifying property in that year. There is also an investment limit of \$800,000, which is rarely encountered by small businesses.

Should the asset be taken out of service before the end of the normal useful depreciable life of the asset, then the Section 179 deduction will be recaptured in that year to the extent it exceeds the otherwise allowable MACRS depreciation.

When combining the three write-off provisions, the Section 179 allowance must be taken first and reduces the basis of the property before the application of the other two provisions. There are no adverse alternative minimum tax (AMT) implications to using the Section 179.

- **Fifty Percent Bonus Depreciation** – For 2009, a small business can take a 50% bonus depreciation write-off in the year the asset is placed in

service. Only new property qualifies. Bonus first-year depreciation automatically applies to qualified property, unless the taxpayer "elects out." The election out applies to all assets in the same class, i.e., 3-, 5-, 7- or 10-year class of property for 2009.

There is no AMT depreciation adjustment associated with the 50% bonus depreciation. In addition, for property with a life of 10 years or less, the balance of the asset's cost may be depreciated using the 200% declining balance method instead of the 150% declining balance with the normal AMT adjustment.

- **Modified Accelerated Cost Recovery System (MACRS)** – The third provision is the normal depreciation allowance over the useful life of the equipment. Generally, the useful lives are 3, 5, 7, or 10 years depending upon the type and use of the equipment. MACRS provides accelerated depreciation (front-loaded) using the 200% declining balance method.

The following illustrates the three basic write-off provisions for \$60,000 of business equipment purchased in 2009 with a useful life of 5 years and shows the maximum and minimum amount available.

	<b>Sec. 179</b>	<b>50% Bonus</b>	<b>MACRS</b>
Sec. 179 Deduction	<60,000>		
50% Bonus Depreciation	0	<30,000>	
MACRS Depreciation (20%)	0	<6,000>	<12,000>
<b>Total First Year Write-Off</b>	<b>&lt;60,000&gt;</b>	<b>&lt;36,000&gt;</b>	<b>&lt;12,000&gt;</b>

This office can help plan a strategy that maximizes the benefits of the write-off for 2009 and subsequent years. Please call for assistance.



FOR SMALL  
BUSINESSES

**QUESTION:** I would like to hire an unemployed veteran, and I understand that there is some sort of credit available for doing so. Can you help?

**ANSWER:** Yes, the credit is 40% of first-year wages (but not exceeding \$6,000), for a maximum credit of \$2,400 (.4 x \$6,000). A qualifying veteran is one who has been discharged or released from active duty in the Armed Forces at any time during the five-year period ending on the hiring date, and who receives unemployment compensation for no less than four weeks during the one-year period ending on the hiring date. The veteran must have served for more than 180 days or been released from service due to a service-connected disability. You will need to obtain certification from your state workforce agency.

**QUESTION:** I am uncertain how well my business is going to fair this year and don't want to overpay my estimated tax because I need the cash. But I don't want to get stuck with penalties either. Do you have any suggestions?

**ANSWER:** There is a special break this year for small business owners that provides a "safe-harbor" estimate amount that will protect you from federal under-estimated tax penalties. To qualify, 50% of your gross income should come from a business with no more than 500 employees and your 2008 AGI should be less than \$500,000 (\$250,000 if filing married separate). If you qualify, your required annual payment for 2009 is the smaller of 90% of the tax shown on your 2008 tax return or 90% of the tax shown on your 2009 tax return.

If you don't qualify for this special break, the annual safe-harbor payment is the smaller of 90% of the tax shown on your 2009 tax return or 100% of the tax shown on your 2008 return. However, if your 2008 AGI was over \$150,000 (\$75,000 if filing married separate), the 2008 safe-harbor figure is increased to 110%.

Under any of the safe-harbor provisions, if you fail to make the required installment amount timely or pay less than the required amount for any of the "quarters," you may still be subject to penalty for the period the payment was late or underpaid.

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## Tax Calendar

September – December 2009

### September – December

– Time for your 2009 Fall and 2010 Tax Planning. Contact this office to schedule a consultation appointment.

### September 15, 2009

– The third installment of 2009 individual estimated taxes is due.

– This is the FINAL extended filing due date for your 2008 calendar year partnership returns (Form 1065), fiduciary returns (Form 1041), S corporation returns (Form 1120S), and corporation returns (Form 1120).

### October 15, 2009

– This is the FINAL extended filing due date for your 2008 individual income tax return.

### December 31, 2009

– This is generally the LAST day that you can pay tax-deductible expenses for the year. IRA contributions and some self-employed retirement plan contributions can be made after the close of the year.