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Borrowing Money to Finance an Education?

Article Highlights

- Education Loans
- Home Equity Loans
- Tapping Retirement Accounts

College is just around the corner for many, and paying for tuition and college expenses may require borrowing money. If you are in this situation, here are some tax implications to consider before taking out a loan.

There are two possible types of loans that can generate a tax deduction for the interest paid: home equity loans and education loans. Each has its own special rules and limitations:

- **Education Loan** – An education loan can be almost any type of loan as long as it is a single purpose loan; i.e., proceeds are only used for qualified educational purposes. The most commonly thought of education loan is a government-guaranteed student loan, but one could even use a credit card if the card was only used for qualified educational purposes. Probably not a good choice, however, since the interest on credit cards is so high.

  Interest in this category is an above-the-line deduction—meaning you don't have to itemize your deductions to claim this benefit, provided the student was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. However, the maximum interest deduction per year is $2,500, and the deduction phases out for higher income married taxpayers with an AGI between $130,000 and $160,000. For singles, the phase-out range is between $65,000 and $80,000. (These are the 2014 ranges; call for the values for other years.)

  While loans from relatives or a qualified employer plan are also potential borrowing sources, the interest paid on these loans will not qualify as deductible education interest.

- **Home Equity Loan** – If you itemize your deductions and have sufficient equity in your home, you might consider borrowing the needed cash from your home. Generally, homeowners can take $100,000 of equity debt on their home and still deduct the interest paid on the loan against the regular tax. Unfortunately, the interest on equity debt is not deductible against the Alternative Minimum Tax (AMT), so consider other alternatives first if you are subject to the AMT. However, even if you are subject to the AMT, your best option may still be taking equity from your home. You may lose the benefit of the interest deduction, but the low interest rate on home loans is still in your favor.

Generally, the borrowed funds must be used for qualified expenses within a reasonable period of time, usually 90 days before or after borrowing the funds. A home equity line of credit can be used to meet these requirements by paying education expenses as they become due, provided the loan is not also used for another purpose.

If you are considering tapping a retirement account to pay for education expenses, explore all other options first. Retirement account distributions are generally taxable and subject to early withdrawal penalties if you are under retirement age, generally 59 1/2.

Please call this office to discuss your education loan options, especially if you are considering tapping a retirement account.

Can You Take a Home Office Deduction?

Article Highlights:

- Home Office Deduction
- For Self-Employed Individuals
- Employee Home Office Issues
- Safe Harbor Home Office Deduction

If you run your small business out of your home, you may want to “write off” many of your household expenses. But how do you know what is deductible and what is not?

Generally, expenses related to the rent, purchase, maintenance and repair of a personal residence are not deductible. However, if you use part of your home for business purposes, you may be able to take a deduction for the business use of your home on your self-employed business schedule. This deduction is commonly referred to as the home-office deduction, but it need not necessarily be an “office” to qualify.

Expenses that can be deducted include the business portion of real estate taxes, mortgage interest (but not principal payments), rent, utilities, insurance, painting, repairs and depreciation. Expenses that are for both the business-use and non-business-use areas of the home (example: real estate tax) are prorated, generally in the ratio of the square footage of the office area to total square footage of the home, unless an expense is exclusive to the office (example: painting only the office area). As an alternative, the IRS provides a safe harbor deduction as explained below.

In order to claim a deduction for the business use of your home, you must use part of your home **exclusively** in your trade or business on a **regular**, continuing basis. You must be able to provide sufficient evidence to show the use is regular. Exclusive use means there can be no personal use (other than de minimis) at any time during the tax year. Use of only a portion of a room is acceptable as long as the taxpayer shows that section is totally for business. In addition, one of the following must apply:

- It is the ***<u>principal place of business</u>*** for a trade or business of the taxpayer;
- It is used for ***storing inventory for a wholesale or retail business*** for which the taxpayer’s home is the only fixed location of the business;
- It is a place where the ***taxpayer meets with customers, patients or clients*** (just telephone contact with clients isn’t enough to meet this test);
- It is used as a ***licensed day care center***; or
- It is in a ***separate structure*** not attached to the taxpayer’s home.

If you work as an employee you can claim this deduction only if the regular and exclusive business use of the home is required by and for the convenience of your employer and the employer does not rent that portion of the home. If the home-office deduction is challenged by the IRS, an employee will have to provide documentation from the employer that the employer requires the employee to have a home office as a condition of employment.

“Exclusive use” means a specific area of the home is used only for trade or business. “Regular use” means the area is used regularly for trade or business. Incidental or occasional business use is not regular use. In addition, employees must deduct the office as a miscellaneous itemized deduction, which has three additional limitations: the employee must itemize deductions (can't take the standard deduction), this type of miscellaneous deduction is reduced by 2% of AGI (income), and it is not deductible at all to the extent the taxpayer is subject to the alternative minimum tax (AMT). Non-business profit-seeking endeavors, such as investment activities, do not qualify for a home office deduction, nor do not-for-profit activities, such as hobbies.

Example: An attorney uses the den in his home to write legal briefs or prepare clients' tax returns. The family also uses the den for recreation. The den is not used exclusively in the attorney's profession, so a business deduction cannot be claimed for its use.

As an alternative, where taxpayers (either self-employeds or employees) meet the qualifications for deducting business use of the home, they can elect a simplified deduction rather than itemizing expenses. This simplified method is referred to as the "safe-harbor" method and allows a deduction of $5 per square foot with a maximum square footage of 300. Thus, the maximum deduction is $1,500 per year. This method can be used in any year in lieu of the regular method.

If you have questions regarding how the home office deduction might apply to your unique situation, please give this office a call.

Child Care Credit Available to Student-Parents

Article Highlights:

- Student Parents May Qualify for Child Care Credit
- Determining the Artificial Income for Credit Computation
- How the Credit Is Determined

If your family is among the many families that incur child care expenses so that a parent can attend school, you may be eligible for a child care tax credit. Generally, the child care credit is only available to couples where both parents work, but a special provision of the tax law permits married parents attending college to also get the credit, if they meet certain criteria, even if the student-parent has no income.

Normally, the child care credit is based on care expenses for children under the age of 13 (limited to $3,000 for one child and $6,000 for two or more) and further limited to the lesser of (1) the taxpayer's earned income, (2) the spouse's earned income, or (3) the actual child care expenses. If one of the spouses does not have an income, then no credit would be available, thus penalizing families where one parent is attending school full time with no earned income. To correct this inequity, the tax law includes a special provision for spouse-students.

Artificial Income		
Months	1-Child	2-Children
5	1,250	2,500
6	1,500	3,000
7	1,750	3,500
8	2,000	4,000
9	2,250	4,500
10	2,500	5,000
11	2,750	5,500
12	3,000	6,000

To qualify for this tax break, the student-parent must be a full-time student for some part of five months during the year (the months don't have to be consecutive). For each month the student-parent qualifies as a full-time student, their earned income is *considered* to be the greater of $250 ($500 if the care is for two or more children) or their actual earned income for that month. If the student-parent is a full-time student for the entire year, the artificial income would be $3,000 for one child and $6,000 for two or more, permitting the student-parent the maximum allowable child care credit. This phantom income is used only for computing the child care credit and doesn't become income that is taxed.

The actual credit is based upon the taxpayer's income (AGI). For incomes between zero and $43,000, the credit ranges from 35% to 21%. For incomes above $43,000, the credit is 20%. The credit will reduce both income tax and the alternative minimum tax, but it is not refundable.

For example, a couple has two children under the age of 13. One spouse works full time and earns $45,000 a year. The other spouse attended college full time for nine months during the year and was not employed. Their annual child care expenses for the two children are $5,000. The student-spouse's artificial income (from the chart) is $4,500. The couple's child care credit is computed based upon the artificial earned income $4,500, since it is less than the actual expenses of $5,000 and the expense limitation is $6,000 for two children. Assuming the couple met all the other care qualification criteria, their credit would be $900 (20% of $4,500).

This article focused on the special full-time student provisions of the child care credit. There are also special provisions that apply for the care of a disabled spouse. If you have questions regarding these special provisions or any provision of the child and dependent care credit, please call.

Know the Rules before You Break Open Your Retirement Piggy Bank

Article Highlights:

- Early Withdrawal Penalties
- Reduction in Retirement Savings
- Exceptions from the Early Withdrawal Penalty

If you are looking for cash for a specific purpose, your retirement piggy bank may be a tempting source. However, if you are under age 59½ and plan to withdraw money from your Traditional IRA or qualified retirement account, you will likely pay both income tax and a 10% early distribution tax (also referred to as a penalty) on any previously untaxed money that you take out. Withdrawals from a Simple IRA before you are age 59½ and during the "2-year period" may be subject to a 25% additional early distribution tax instead of 10%. The 2-year period is measured from the first day that contributions are deposited. These penalty rates are what you'd pay on your federal return; your state may also charge an early withdrawal penalty in addition to regular state income tax.

So before making any withdrawals from an IRA or other retirement plan, including 401(k) plans, 403(b) tax sheltered annuity plans, and self-employed retirement plans, carefully consider the resulting decrease in your retirement savings and the increase in tax and penalties.

There are a number of exceptions to the 10% early distribution tax depending on whether you take money from an IRA or a retirement plan. But even if you are not subject to the 10% penalty, you will still have to pay taxes on the distribution. The following are some exceptions that may help you avoid the penalty.

- **Withdrawals from any retirement plan to pay medical expenses—**Amounts withdrawn to pay unreimbursed medical expenses that would be deductible on Schedule A during the year and that exceed 10% of your AGI are exempt from penalty. This is true even if you do not itemize.

- **Withdrawals from any retirement plan as a result of a disability**—You are considered disabled if you can furnish proof that you cannot perform any substantial gainful activity because of a physical or mental condition. A physician must certify your condition.
- **IRA withdrawals by unemployed individuals to pay medical insurance premiums -** The amount that is exempt from penalty cannot be more than the amount you paid during the year for medical insurance for yourself, spouse, and dependents. Unemployment compensation must have been received for at least 12 weeks.
- **IRA withdrawals to pay higher education expenses—**Withdrawals made during the year for qualified higher education expenses for yourself, spouse, or children or grandchildren are exempt from the early withdrawal penalty.
- **IRA withdrawals to buy, build or rebuild a first home**—Generally, you are a first-time homebuyer for this exception if the you had no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the distribution is being used to buy, build, or rebuild. If you are married, your spouse must also meet this no-ownership requirement. This exception applies to the first $10,000 of withdrawals used for this purpose. If married, both you and your spouse can withdraw up to $10,000 penalty-free from your respective IRA accounts.
- **IRA withdrawals annuitized over your lifetime**—To qualify, the withdrawals must continue, unchanged, for a minimum of 5 years and after you reach age 59½.
- **Employer retirement plans withdrawals—**To qualify, you must have separated from service and be age 55 or older in that year (age 50 for qualified public service employees such as police and firefighters); or elect to receive the money in substantially equal periodic payments after separation from service.

You should be aware that the information provided above is an overview of the penalty exceptions and there may be additional conditions, not listed, that must be met to qualify for a particular exception. You are encouraged to contact this office before tapping your retirement funds for uses other than retirement. Distributions are most often subject to both tax and penalties that can take a significant bite out of the distribution. However, with carefully planned distributions, both the tax and penalties can be minimized. Please call for assistance.

Misclassifying Workers Can Be Costly!

Article Highlights:

- Independent Contractor Cost Savings
- Penalties For Misclassification
- Primary Determining Factors
- Additional Determining Factors
- Requesting the IRS to Make the Determination

Most business owners and executives tend to be financially conservative and preserve the cash of the business. This conservative approach frequently carries over to hiring activities, with many employers choosing to hire independent contractors/freelancers as opposed to full-time employees. In doing so, they eliminate the cost of company benefits such as vacation, sick pay, health insurance and retirement funding. Another big benefit is eliminating the employer's matching share of Social Security and

Medicare payroll taxes, not to mention the savings on unemployment taxes and worker's compensation insurance.

Eliminating all those costs associated with employees and hiring independent contractors may save a lot of money, but it can also be a minefield. Just because you pay a worker like an independent contractor does not necessarily make him one. And if you are subsequently challenged on that classification by the IRS or your state taxing authority, and lose, you will pay back all those savings plus penalties and interest. The company's retirement plan could also be in jeopardy of losing its qualifying status if workers who should have been eligible to participate have been excluded from the plan. The line between independent contractor and employee is not always clear, but the following are some guidelines that can be used in making the determination.

The three primary characteristics the IRS uses to determine the relationship between businesses and workers are: Behavioral Control, Financial Control and the Type of Relationship.

1. ***Behavioral Control*** - Relates to facts that show whether the business has a right to direct or control how the work is done through instructions, training or other means.
2. ***Financial Control*** - Relates to facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job.
3. ***Type of Relationship*** – This factor relates to how the workers and the business owner perceive their relationship.

If you have the right to control or direct not only what is to be done, but also how it is to be done, then your workers are most likely employees. If you can direct or control only the result of the work done, and not the means and methods of accomplishing the result, then your workers are probably independent contractors.

Here are some additional factors to consider when making a determination:

- ***Sole Employer*** - An independent contractor is in business for him or herself and generally will have additional clients for whom services are provided. If you are the only client and he or she is not actively pursuing work from others, then it becomes an indicator favoring employee status.
- ***Work Schedule*** - Independent contractors generally set their own work schedule. Requiring the worker to maintain regularly scheduled work hours is an indicator of employee status.
- ***Materials & Supplies*** - Independent contractors generally provide their own materials and equipment and invoice their clients for labor and materials. If you provide all of the material and supplies, that is another indicator of employee status.
- ***Work Location*** – Another indicator of employee status is when a worker performs services only at your work location and does not maintain an office or facilities elsewhere.

If, after considering all the factors and issues, you feel you cannot reach a definitive determination, then you, as an employer, can request the IRS to make a determination on whether a specific individual is an independent contractor or an employee by filing a Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) with the IRS. However, the IRS does not issue determinations for proposed or hypothetical situations. A worker may also file Form SS-8 requesting an IRS determination.

A word of caution: if a worker that you classified as an independent contractor is subsequently determined to be an employee, you will be open to a lawsuit for back benefits or even other demands related to the worker's specific circumstances.

If you need more information about the critical determination of a worker's status as an independent contractor or employee, please give this office a call.

Tax Tips for the Well-Traveled Businessperson

Article Highlights:

- Acceptable Records
- Meals
- Spouse Expenses

Food and lodging expenses are generally deductible when away from home for business purposes. This may be particularly beneficial for self-employed individuals who travel extensively. Like everything involving taxes, there are rules to follow.

The IRS requires that lodging expenses (and other expenses of $75 or more) be substantiated by records or other evidence. Acceptable records include diaries, logs, receipts, paid bills and expense reports. The records should disclose the amount, date, place and essential character of each expense. Diaries and logs should be notated close to the time of the expense; newly created diary, log and calendar entries made months (or years) later when the IRS requests documentation in an audit are less likely to pass muster than those that were prepared when the travel and expenses occurred.

- Keep good records of your travel expenses.
- Document the business purpose and the expected business benefit.
- Retain your travel itinerary to document the business activity while away.

Travel expenses are deductible only if the individual is away from his or her "tax home" for more than one business day. "Tax home" usually means the individual's regular place of business.

Meal expenses are only deductible if the trip is overnight or long enough that there is a need to stop for sleep or rest in order to properly perform one's duties. The amount of the meal expenses must be substantiated, but instead of keeping records of the actual cost of meal expenses, a "standard meal allowance" ranging from $46 to $71 per day can generally be used, depending on where and when the individual travels. Generally, the deduction for unreimbursed business meals is limited to 50% of the cost that would otherwise be deductible.

Lodging expenses must be substantiated with actual receipts and are 100% deductible. Meals included in lodging expenses, such as room service or dining costs charged to a hotel room, must be separately identified, since meals have the 50% limitation noted above.

Taking the Spouse Along? – Generally, deductions are denied for travel expenses paid or incurred for a spouse, dependent or employee of the taxpayer on business unless the:

(1) The spouse or dependent is an employee of the taxpayer, **and**

(2) The ravel of the spouse, dependent or employee is for a bona fide business purpose, **and**

(3) The expenses would otherwise be deductible by the spouse, dependent or employee.

Strategy - The law allows a deduction for the single rate for lodging, and there is frequently no rate difference between one and two occupants for a room. Thus, virtually the entire lodging expenses for an accompanying spouse will be deductible. When traveling by car, the law does not require any allocation because the spouse is also traveling in the vehicle. Thus, if traveling by vehicle, the entire cost of the transportation would be deductible. This generally also applies to taxis at the destination. The only substantial cost that is not allowed is the costs of the spouse's meals that, even if they were deductible, would be reduced by the 50% rule. If traveling by air or rail, the cost of the spouse's tickets is also not deductible.

Have questions about business travel expenses? Give our office a call.

Customize QuickBooks' Reports, Make Better Business Decisions

QuickBooks simplifies and speeds up your daily accounting work, but you're missing out on valuable insight if you don't tailor your report data.

Do you remember why you started using QuickBooks? You may have simply wanted to produce sales forms and record payments electronically. Gradually, you expanded your use of the software, perhaps paying and tracking bills through it and keeping an eagle eye on your inventory levels. Certainly, you've run at least some of the pre-built report templates offered by all versions of QuickBooks since their inception.

QuickBooks' automation of your daily bookkeeping tasks has undoubtedly served you well. But that's merely limited use; now it's time to take advantage of QuickBooks' greatest strength: customizable reports.

One of the rewards for diligently entering all of your accounting information is a better grasp of your company's financial performance to date. That insight ultimately leads to better business decisions that can contribute to your future growth and success.

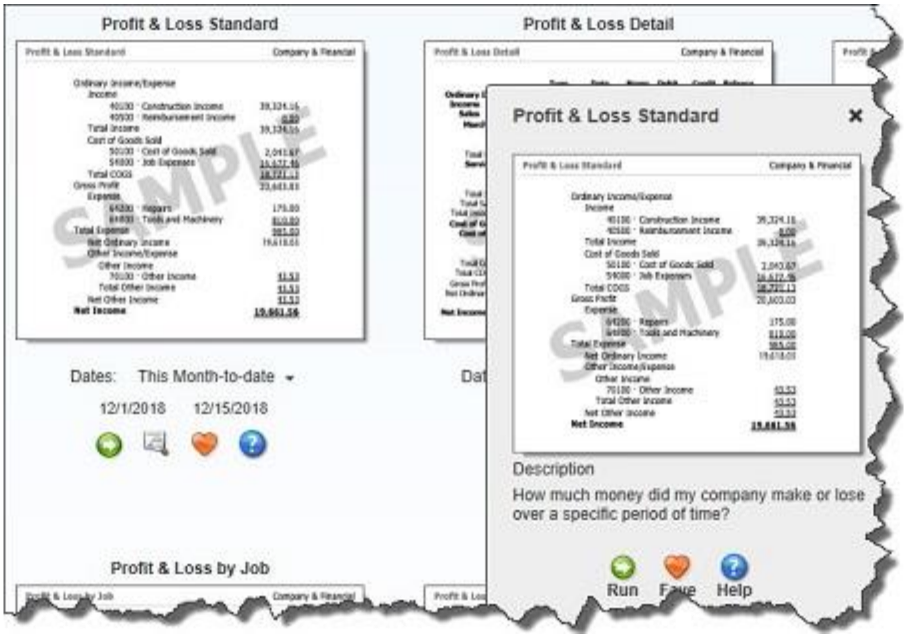

Figure 1: QuickBooks' Report Center can help you learn about what each report is designed to tell you. But smart customization requires deeper insight.

Making Reports Meaningful

Like many other tasks in QuickBooks, report customization tools aren't that difficult to master. What's challenging is:

- Understanding what each report is designed to tell you
- Determining which reports are most relevant to your business information needs, and
- Designing each to produce the critical insight you need in order to move forward.

The first of these is fairly clear. You can understand what many reports do by their titles, their content, and the descriptions QuickBooks offers. We recommend that you spend some time looking at the **Report Center** in QuickBooks to familiarize yourself with your options.

The second two challenges are a bit more formidable. It's our job to assist you in establishing a workflow in QuickBooks to keep accurate records and produce necessary transactions. But we want you to do more than just maintain the status quo. When you analyze and interpret what your reports are telling you, you can make smart business decisions.

So if we haven't gone over this with you already, we encourage you to schedule some time with us so you can get the maximum benefit from your QuickBooks reports.

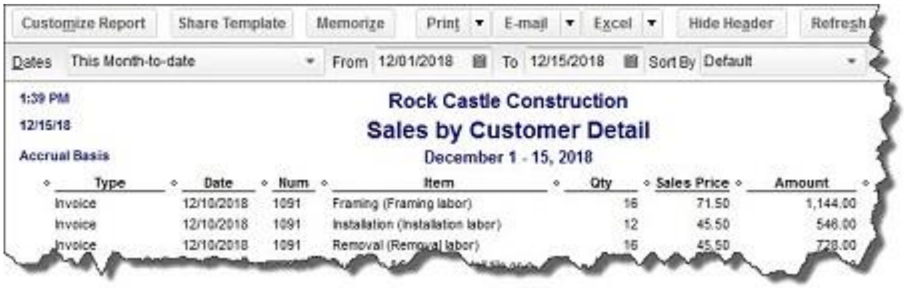

Figure 2: You can't miss QuickBooks' customization link when you open a report. But the trick is knowing how to best use its options for your business.

A Simple Set of Steps

Let's take a look at a report you may already be generate: **Sales by Customer Detail** (**Reports | Sales | Sales by Customer Detail**). QuickBooks comes with a commonly-used set of default columns in its reports. This particular report contains column labels like **Type** (invoice, sales receipt, etc.), **Item and Quantity**, and **Sales Price**.

You can easily change the date range that's offered as a default up below the toolbar. But to get to QuickBooks' powerful customization tools, click **Customize Report**. A window with four tabs opens. They are:

Display. Options in this window help you specify the columns you want to appear in your report. In the lower left corner, there's a list titled **Columns** that contains every possible column label for that report. If you scroll down, you'll see a check mark in front of the default columns. Click on any of those to uncheck them, and click in front of any that you'd like to add.

Other options here include how your data should be totaled and sorted. Some reports let you choose between cash and accrual basis.

Filters. This is the difficult one – and the tool that will provide the most insight. Filters determine which subsets of related data you'll see (accounts, items, customer types, zip codes, etc.) by including only those that meet certain conditions. Here's where we can really help you answer critical business questions that will lead you to smart decisions.

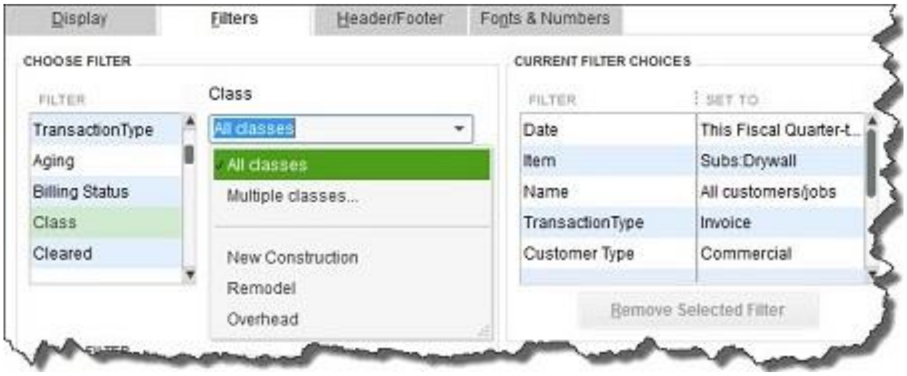

Figure 3: In this example, you've created a filter that will find all commercial drywall jobs that have been invoiced in the current fiscal quarter. You could narrow this report further by, for example, class, state, and paid status.

Header/Footer and **Fonts & Numbers.** You can tailor the design and layout of your reports here.

Well-formulated reports can help you spot cash flow problems, maintain the right inventory levels, see which jobs are the most profitable, and compare your estimates to actual costs. You'll also be able to identify your best customers, your most sought-after items, and your most successful sales reps. Careful customization of your reports – and thorough analysis of their data – will make the answers to your constant questions about your company's future direction much clearer. We can help you take full advantage of these powerful tools.