PREZIOSI NICHOLSON & ASSOCIATES, CPAS

1101 Wheaton Avenue, Suite 100 Millville, NJ 08332 (856) 794-8400 Fax (856) 794-8411

TAX AND BUSINESS *Alert*™

April 2012

50% Disallowance Rule for Meals and Entertainment

When you pay for business meals and entertainment, keep in mind that generally only half of otherwise allowable meal and entertainment expenses are deductible on your federal tax return. This includes 50% of all business meal and entertainment expenses, including those incurred while attending professional seminars and traveling away from home. If a hotel includes meals in its room charge, a reasonable allocation must be made to determine the portion of the expenditure subject to the 50% disallowance.

Taxes and tips related to meals or entertainment are included in the amount that is subject to the 50% limit. Also subject are expenses for cover charges to clubs, room rental for a dinner or cocktail party, and amounts paid for parking at an entertainment location. However, transportation costs incurred getting to and from the entertainment activity are not subject to the 50% disallowance. In addition, when a self-employed taxpayer uses a per diem method for travel expenses, the federal meal and incidental expense rate is treated as an expense for food and beverages and, thus, is subject to the 50% disallowance.

If an employee adequately accounts for these expenses and the employer properly reimburses the expenses under an accountable plan arrangement, the employer is also subject to the 50% limitation on its reimbursement. An *accountable plan* is a reimbursement or other expense allowance arrangement that requires employees to substantiate covered expenses and return unsubstantiated advances. The employee has nothing to report since the reimbursement offsets the expenses incurred.

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Conversely, an employer gets a 100% deduction if meal expense reimbursements or allowances paid for or to an employee under a nonaccountable plan are treated as compensation to the employee. Of course, the employer must then

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The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

Tax Calendar

April 17—Besides being the last day to file (or extend) your 2011 personal return and pay any tax that is due, 2012 first quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due today. So are 2011 returns for trusts and calendar-year estates, partnerships, and LLCs, plus any final contribution you plan to make to an IRA or Education Savings Account for 2011. SEP and Keogh contributions are also due today if your return is not being extended.

—If you need to file a 2011 gift tax return, it also must be filed or extended by this date.

—If you paid cash wages of $1,700 or more in 2011 to a household employee, you must file Schedule H by this date. You may also have to report any federal unemployment tax paid and any income tax you withheld for your household employees.

April 30—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through March 31 exceeds $500.

—Most employers must file Form 941 (Employer's Quarterly Federal Tax Return) to report Medicare, social security, and income taxes withheld in the first quarter of 2012. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until May 10 to file the return.

June 15—Second quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due today.

Taxpayer Advocate's Report

National Taxpayer Advocate Nina E. Olson has released her annual report to Congress, identifying the combination of the IRS's expanding workload and declining resources as the most serious problem facing taxpayers. The result, the report says, is inadequate taxpayer service, erosion of taxpayer rights, and reduced tax compliance. The Advocate expressed her continuing concern that the IRS's expanding use of automated processes to adjust tax liabilities is causing harm to taxpayers and

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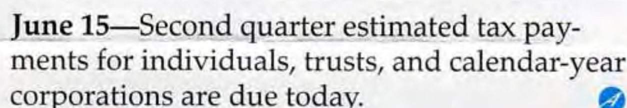
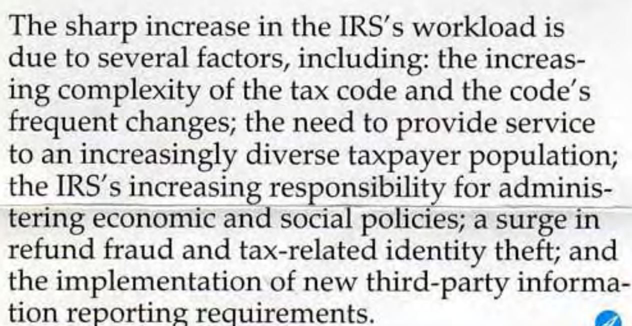


once again recommended that Congress enact a comprehensive Taxpayer Bill of Rights.

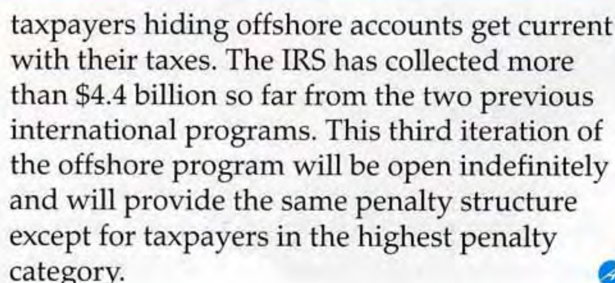
"The overriding challenge facing the IRS is that its workload has grown significantly in recent years, while its funding is being cut," Olson said in releasing the report. "This is causing the IRS to resort to shortcuts that undermine fundamental taxpayer rights and harm taxpayers—and at the same time reduces the IRS's ability to deliver on its core mission of raising revenue."



The sharp increase in the IRS's workload is due to several factors, including: the increasing complexity of the tax code and the code's frequent changes; the need to provide service to an increasingly diverse taxpayer population; the IRS's increasing responsibility for administering economic and social policies; a surge in refund fraud and tax-related identity theft; and the implementation of new third-party information reporting requirements.

IRS Reopens Offshore Voluntary Disclosure Program

The IRS has reopened the Offshore Voluntary Disclosure Program (OVDP) to help



taxpayers hiding offshore accounts get current with their taxes. The IRS has collected more than $4.4 billion so far from the two previous international programs. This third iteration of the offshore program will be open indefinitely and will provide the same penalty structure except for taxpayers in the highest penalty category.

Roth IRAs for Kids

If you have a child who works, consider encouraging the child to use some of the earnings for Roth IRA contributions. All that is required to make a Roth IRA contribution is having some earned income for the year. Age is irrelevant. Specifically, for 2012 your child can contribute the lesser of: (1) earned income or (2) $5,000.

By making Roth IRA contributions for just a few years now, your child can potentially accumulate quite a bit of money by retirement age. Realistically, however, most kids will not be willing to contribute the $5,000 annual maximum even when they have enough earnings to do so. Be satisfied if you can convince your child to contribute at least a meaningful amount each year. Remember, if you are so inclined, you can make the Roth IRA contribution for your child.

Here's what can happen. If your 15-year-old contributes $1,000 to a Roth IRA each year for four years starting now, in 45 years when your child is 60 years old, the Roth IRA would be worth about $33,000 if it earns a 5% annual return or $114,000 if it earns an 8% return. If your child contributes $1,500 for each of the four years, after 45 years the Roth IRA would be worth about $50,000 if it earns 5% or about $171,000 if it earns 8%. If the child contributes $2,500 for each of the four years, after 45 years the Roth IRA would be worth about $84,000 if it earns 5% or a whopping $285,000 if it earns 8%. You get the idea. With relatively modest annual contributions for just a few years, Roth IRAs can be worth eye-popping amounts by the time your child approaches retirement age.

For a child, contributing to a Roth IRA is usually a much better idea than contributing to a traditional IRA for several reasons. The child can withdraw all or part of the annual Roth contributions—without any federal income tax or penalty—to pay for college or for any other reason. (However, Roth earnings generally cannot be withdrawn tax-free before age 59½.) In contrast, if your child makes deductible contributions to a traditional IRA, any subsequent withdrawals must be reported as income on his or her tax returns.

Even though a child can withdraw Roth IRA contributions without any adverse federal income tax consequences, the best strategy is to leave as much of the account balance as possible untouched until retirement age in order to accumulate a larger federal-income-tax-free sum.

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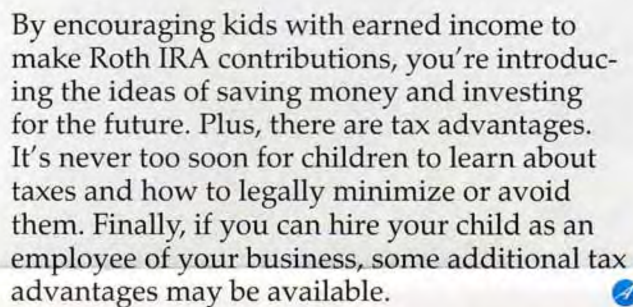
What about tax deductions for traditional IRA contributions? Isn't that an advantage compared to Roth IRAs? Good questions. There are no write-offs for Roth IRA contributions, but your child probably will not get any meaningful write-offs from contributing to a traditional IRA either. That is because an unmarried dependent child's standard deduction will automatically shelter up to $5,950 of earned income (for 2012) from federal income tax. Any additional income will probably be taxed at very low rates. Unless your child has enough taxable income to owe a significant amount of tax (not very likely), the advantage of being able to deduct traditional IRA contributions is mostly or entirely worthless. Since that is the only advantage a traditional IRA has over a Roth IRA, the Roth option almost always comes out on top for kids.



By encouraging kids with earned income to make Roth IRA contributions, you're introducing the ideas of saving money and investing for the future. Plus, there are tax advantages. It's never too soon for children to learn about taxes and how to legally minimize or avoid them. Finally, if you can hire your child as an employee of your business, some additional tax advantages may be available.

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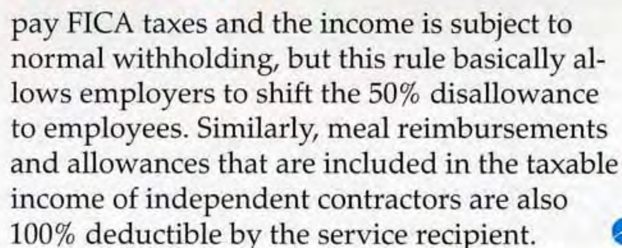

pay FICA taxes and the income is subject to normal withholding, but this rule basically allows employers to shift the 50% disallowance to employees. Similarly, meal reimbursements and allowances that are included in the taxable income of independent contractors are also 100% deductible by the service recipient.

Tax Ramifications of Owning a Second Home

Many taxpayers own or plan to purchase a second home. If you are among these taxpayers, you may be viewing your second home either for personal pleasure or as an investment for tax benefits and appreciation. Perhaps you are somewhere in between. But, regardless of how you view your second home, planning for its tax implications will enable you to either own the property in the most tax-efficient way possible or, if your purchase is somewhat tax driven, maximize the allowable deductions the property generates. A second home can fall into one of three categories for tax purposes, depending on how it is used: personal residence, vacation home, or rental property.

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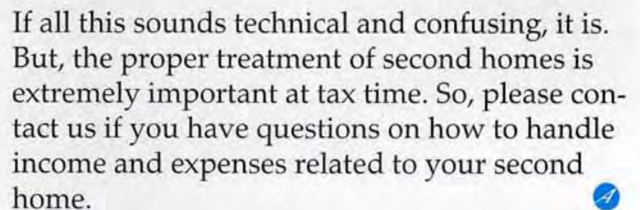
A property used for personal purposes more than 14 days during the year, or more than 10% of the rental days if that number is greater, is considered to be a residence. If this residence is rented for fewer than 15 days during the calendar year, it is considered to be a *personal* residence. As such, the downside is you are not entitled to deduct any rental expenses, but on the plus side, rental income received is not taxable. However, interest expense (to the extent it is qualified residential interest) and real estate taxes are fully deductible subject to the overall limitation on itemized deductions.

If the property is used as a residence (see above) and is rented more than 14 days during the calendar year, it is considered to be a vacation home, and the reporting of income and deductions is subject to limitations. In this situation, interest, taxes, and casualty losses are normally fully deductible. Other property-related expenses are deductible to the extent of rents received, but only after first considering the interest, taxes, and casualty losses previously mentioned.

Where personal use does not exceed 14 days (or 10% of rental days, if greater) and the property is rented for at least 15 days, the second home is considered to be rental property. For second homes classified as rental property, interest, taxes, casualty losses, and other operating expenses are fully deductible. However, these expenses must be prorated for any period of personal use. In addition, the property is subject to the passive activity loss rules and at-risk limitations, meaning net losses may have to be deferred to a future tax year and not currently recognized.



If all this sounds technical and confusing, it is. But, the proper treatment of second homes is extremely important at tax time. So, please contact us if you have questions on how to handle income and expenses related to your second home.

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