

# Tax Tips

For Small Business

Summer 2005

**Abby Diamond, CMA**  
Certified Management Accountant  
*"A cut above the rest for your financial success"*

P.O. Box 6  
Hull, MA 02045  
(781) 706-7316  
AbbyDiamondCMA@comcast.net  
wwwAbbyCMA.com

## Selling a Home You Used for Business?

Proper reporting saves you money

If you plan on selling your home, you might assume you won't have to pay tax on the profit. Usually that's a fair assumption considering the generous \$250,000 (\$500,000 if a joint return is filed) exclusion-of-gain tax break on the sale of a principal residence. However, when you have a home office, or have taken the home office deduction in the past, you may have an extra bit of planning to do in order to guarantee the full benefit of the exclusion.

Fortunately, the IRS recently simplified complicated rules for those taxpayers who have a home office and take depreciation deductions. Prior to issuing corrective regulations in December 2002, the IRS required that, if you used your residence for both personal and business purposes, you would be treated as having sold two separate properties for purposes of using the home sale gain exclusion—a personal residence and a business building. The profit you realized on the sale of your home would be entitled to the \$250,000 or \$500,000 exclusion, but any profit on the sale of the business part of your property would be taxed.

The new rules no longer require most taxpayers who claim the home office deduction to allocate gain between business and residential portions of their home if the business use occurred within the same dwelling unit as the residential use. Now, the amount of depreciation you deducted as a home office expense is the only portion reportable as taxable gain.

For example, assume you used a spare room exclusively as a home office. The spare room occupies one-twelfth of your home and



you took \$10,000 in depreciation for that room over the years. Assume further that you purchased your home for \$240,000 and just sold it for \$600,000. Before the new IRS rules, one-twelfth of the sale, or \$50,000, would be attributable to the business portion, with a tax basis of \$10,000, generating a \$40,000 taxable gain. Now, more of your profit may be covered by the \$250,000 or \$500,000 exclusion. Under the new rules, only \$10,000 of your former depreciation deductions are taxed, while the rest of your profit, \$360,000, would be all tax-free.

If you have plans to move or set up your home office in a separate structure, however, you need to think carefully about the tax implications. In cases where your home office is not in the same building in which you reside, the old rules continue to apply and you may find that you'll lose out on a significant portion of your home sale exclusion when it comes time to sell.

## Employer Options for Health Costs

### New reimbursement plan offers tax-favored benefits

If you are looking for a way to reduce your employee benefit costs, you may want to consider using a health reimbursement arrangement (HRA). An HRA is an employer-funded health benefit account for individual employees that may be used to pay their medical expenses and health insurance premiums. This type of plan is generally more economical and more flexible than other health benefit plans. It also has more features that provide favorable treatment for federal income tax purposes.

Under an HRA, the contributions you make and the amounts your employees receive are generally excluded from the employee's income. In addition, any excess amounts at the end of the year can be carried over to future years without being lost.



In order to receive favorable tax treatment, an HRA must meet the following requirements:

- The plan is paid for only by you and is not provided by an employee salary-reduction election or under an employee benefit cafeteria plan;
- The plan reimburses the medical expenses of the covered individual and his or her spouse and dependents; and
- The plan reimburses a covered individual up to a maximum dollar amount for any given period of coverage. Any unused portion of the maximum dollar amount at the end of that period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods.

## Like-Kind Exchanges of Business Property

### Use caution if you later convert property to your residence

When exchanging business or investment property for property of a "like-kind," no gain or loss is recognized on the exchange. Therefore, no tax is paid at the time of the exchange on any appreciation in the value of the property. The like-kind exclusion is sometimes combined with the

exclusion of tax on the gain from the sale of a principal residence. In effect, this combination can allow taxpayers to avoid paying tax on the gain from the sale of their business or investment property.

The *American Jobs Creation Act of 2004*, enacted on October 22, 2004, addressed this issue of combining like-kind exchanges with the exclusion of gain on the sale of a principal residence. As of that date, the exclusion for gain on the sale of a principal residence may no longer apply if the taxpayer acquired the principal residence in a like-kind exchange within the past five years. In effect, this requires the taxpayer to hold the exchanged property for a full five years before selling it and taking full advantage of the exclusion of the gain. While this change may reduce the attractiveness of combining like-kind exchanges with the principal residence exclusion, it doesn't completely eliminate it.

## Solo 401(k)

### Option increases retirement savings

As the sole owner of your business, you may wish to consider the implementation of an individual 401(k) retirement plan to accumulate retirement savings on a tax-deferred basis.

Self-employed taxpayers can contribute to a sole-owner 401(k) retirement plan as both an employer and as an employee. As an employer, you may contribute up to 25 percent of your total income to your retirement plan, and, as an employee, you may also contribute up to an additional \$14,000 in 2005.

Your maximum contribution to an individual 401(k) plan is the lesser of \$42,000 or the sum of the employer and employee maximums. This significant change provides you with an additional opportunity to maximize your yearly retirement plan contribution. As an added bonus, this type of plan, unlike other retirement plan options, allows participants to take out loans from plan assets.

# QUICK TIPS

**1** The maximum Section 179 deduction you can elect for property you place in service in 2005 increases to \$105,000 for qualified Section 179 property. This limit is reduced by the amount by which the cost of Section 179 property placed in service during the tax year exceeds \$420,000.

**2** If you started a new business in 2005, you may elect to deduct up to \$5,000 in start-up costs in the first year. Start-up costs in excess of the \$5,000 limit can be amortized over 180 months beginning with the month your new business begins operations. Prior to October 22, 2004, all start-up costs were amortized over 60 months with no first-year deduction.

**3** Outright sales of standing timber after December 31, 2004, will qualify for capital gain treatment. The requirement that the owner of timber must retain an economic interest in the timber in order to obtain capital gain treatment no longer applies to outright sales of timber.

**4** S corporations can now have up to 100 shareholders. Previously the limit was 75. For purposes of counting the number of shareholders to determine if the 100-shareholder limit is exceeded, all family members can elect to be treated as one shareholder.

**5** Beginning January 1, 2005, the standard mileage rates for the use of a car (including vans, pickups, or panel trucks) are:

- 40.5 cents per mile for all business miles driven;
- 14 cents per mile for all miles driven for medical or moving purposes; and
- 15 cents per mile for all miles driven for charitable purposes.



## Tips for the New Business Owner

Your choice of entity affects how you are taxed—and how much tax you'll pay

Before you start a new business, there are a number of preliminary decisions you need to make. First you need to determine the legal form in which you will operate the business. Should you operate an unincorporated sole proprietorship, a partnership, a limited liability company, a regular corporation, or an S corporation? Each form has advantages and disadvantages that you must weigh in combination with your own plans and personal situation.



Sole proprietorships, for example, are the easiest and cheapest business form to set up. Although they can be operated with few formalities, they offer no personal liability protection and don't allow many of the tax benefits that are available to corporate employees.

Partnerships offer many of the same advantages and disadvantages as the sole proprietorship, but they allow the business to be owned and operated by more than one person. In addition, the liability problem can be overcome to a certain extent by forming a limited partnership. Partners whose liability is limited cannot be involved in actively managing the business, and losses from limited partnerships may be restricted by the passive activity rules.

A limited liability company (LLC), which is approved for use in almost every state, offers what many see as the best alternative for the typical small business. LLCs with more than one member are taxed as partnerships, avoiding the corporate income tax, while the managing members' personal assets remain fully protected from business creditors. The LLC can also elect to be taxed as a corporation. Single-member LLCs are taxed as sole proprietorships by default. They can, however, elect to be taxed as a corporation.

S corporations also offer liability protection, without a separate corporate tax. Like partners and sole proprietors, however, more than two percent of S corporation shareholders are ineligible for tax-favored fringe benefits. Another potential drawback of S corporations results from limitations on the number and kind of permissible shareholders. These restrictions can limit an S corporation's growth potential and access to capital in some businesses.



The remaining choice is a C corporation. These entities do not have the shareholder restrictions that apply to S corporations, but they are subject to a double system of taxation. Put another way, the corporate profits are subject to income tax at the corporate level and are also taxed to the shareholders if distributed as dividends. But if profits remain in the business to further the company's growth, the tax consequence is usually lower than with an S corporation. There are many situations, however, in which the double tax can be substantially minimized. The biggest advantage to this form of operation is that shareholder-employees are entitled to tax-advantaged fringe benefits, such as medical coverage, disability insurance, and group-term life.