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JUNE 2004

Client Bulletin

BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

Structuring Loans to Family Members

SPECIAL TAX ISSUE

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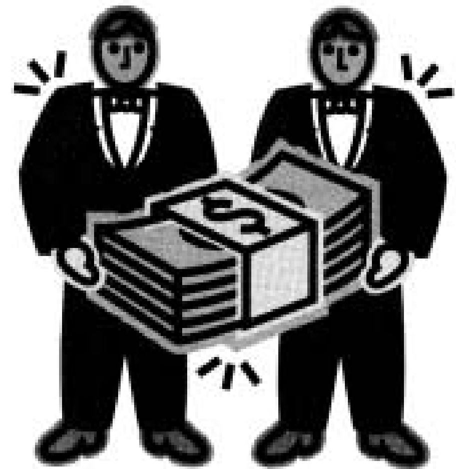
In today's challenging economy, more and more family members are seeking financial help in the form of loans from parents and other relatives. While there is nothing inherently wrong with helping a family member, there are important practical and tax matters that you should consider before making an intrafamily loan.



Treat the decision to lend seriously

Give careful thought to whether you honestly want to loan money to your son, daughter, or other family member. You'll also want to consider how much you can comfortably give. Don't put your own financial future at risk by lending money you can't afford to lose. Saying "no" may not be easy, but doing so now can help avoid a more difficult situation down the road.

Put it in writing

Should you decide to lend money to a family member, make the deal as businesslike as possible. While it may seem overly formal to document a loan to a family member, without one, the Internal Revenue Service (IRS) could argue that there was no loan at all—that the money you gave was really a gift. What's more, should the borrower be unable to repay all or some of the loan and you want to write it off as a nonbusiness bad debt, documentation showing that the loan actually existed could be critical.

Did You Know?

It is believed that the Romans introduced the serrated edges of today's coins as a way to discourage the practice of shaving off thin slices of precious metals.

Set an interest rate

Many families choose to make no-interest or below-market-interest loans to family members. According to the Internal Revenue Code, a below-market loan is one that has an interest rate lower than the applicable federal rates (AFR) established by the IRS as the minimum for loans between family members. AFR rates are based on the type and term of the loan and are set monthly by the federal government.

For a demand loan (a loan payable in

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full at any time on the lender's demand), if the lender does not charge interest at least equal to the AFR, he or she is considered to have received "imputed" interest. This means that the lender owes tax on the amount he or she *would* have received if the AFR had been used. And, for gift tax purposes, the lender is treated as if he or she gave the borrower a taxable gift of the imputed interest amount each year the loan is in force.

There are, however, two important exceptions to the imputed interest rules. The first exception is known as the $10,000 gift loan exception. This means that the below-market imputed interest rules do not apply to individual loans with an aggregate outstanding amount of not over $10,000 on any given day. However, this exception does not apply if the loan proceeds are used to purchase income-producing assets.

A second exception protects even larger low- or no-interest loans. For below-market gift loans up to $100,000 between individuals, the amount of interest added to the lender's taxable income is limited to the borrower's net investment income. In cases where the borrower's net investment income is less than $1,000, the lender will not be required to include any imputed interest from the loan in his or her taxable income.

For example, if you gave your child an interest-free loan to buy a home or start a business, you wouldn't pay any tax on imputed interest as long as he or she doesn't earn net investment income over $1,000. If your child's investment income exceeds $1,000, the imputed interest income rules apply. For gift tax purposes, foreign interest is treated as a taxable gift.

Tread carefully

Clearly, loaning money to family members is not something you should do casually. It can damage personal relationships and cause income, gift, and estate tax planning problems. Given the complexity of the imputed interest rules and the related exceptions, it's wise to seek professional advice in structuring loans to family members.

Deducting Business Car Expenses

Operating a car for business can be expensive, so it's important to take advantage of the available tax breaks. If you use a car for business purposes, here's what you need to know.

Defining business miles

The IRS defines business use as the miles you drive your car between two business locations. If, for example, you travel between your office and the office of a customer or between two jobs, your travel is considered a deductible business expense. If you have a regular place of business, the cost of traveling between your home and a temporary work site is deductible, regardless of the distance traveled. Commuting from your home to your regular place of business is not deductible. However, for self-employed workers who work from a home office, the cost of driving from home to other work locations is a deductible business expense.

Computing qualified expenses

There are two methods you can use to compute deductible expenses: the standard mileage rate or the actual cost method. With the standard mileage rate, you claim a flat amount for each business mile you drive. This rate is set by the IRS and adjusted annually. The standard mileage rate for 2004 is 37.5 cents a mile, up from 36 cents in 2003. To use this method, multiply the number of business miles driven during the year by the standard mileage rate.

To use the actual expenses method, calculate all vehicle expenses, including gasoline and oil, tires, battery, repairs, driver's license and car registration fees, car insurance, and depreciation. To arrive at the deductible amount, multiply your total actual costs by the percentage of business use for the vehicle based on business miles as a percentage of total miles.

Note that business-related tolls and parking fees are deductible in full regardless of which method you use.

New for 2004

Previously, taxpayers using more than one vehicle at a time for business could not use the standard mileage rate. The IRS has announced that beginning in 2004 taxpayers who use no more than four vehicles for business purposes during the tax year may use the standard mileage rate.

Which method is best for you?

It's important to consider carefully whether to deduct the standard mileage rate or your actual costs. The method you choose for deducting business auto expenses for the year you place the car in service affects your options in later years.

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If you choose to use the standard mileage method in the first year, you can switch to the actual cost method in later years. However, the reverse does not apply. When you use the actual cost method in the first year, you cannot switch to the standard mileage for that car in any subsequent year.

Also, if you lease your car and choose the standard mileage method, you must use that method for the entire lease term.

While the standard mileage rate is generally easier to use and doesn't require as many detailed records, the actual cost method may result in a larger and/or accelerated deduction, particularly with a relatively expensive car. This is especially true in light of the liberalized depreciation rules of recent years.

Regardless of the method you use, certain recordkeeping requirements apply. The best way to keep track of the necessary information is to keep a log handy to record the date, your business miles, the destination, and the business purpose of your trip.

Whether you are considering the purchase of a vehicle for business use, have begun to use an existing vehicle for business purposes, or would like to be sure of the best tax treatment for your existing business vehicle, please call us so we can help you receive the best possible deduction.

Tax Breaks for Supporting Elderly Parents

Although supporting elderly parents can be financially draining, qualified taxpayers can get some financial assistance from Uncle Sam. Individuals who provide financial support for their parents may qualify for a dependency exemption on their tax returns. In addition, they may qualify for a medical expense deduction as well as a credit for dependent care expenses.

Understanding dependency

Although most filers are familiar with claiming dependency exemptions for themselves, their spouses, and their children, few are aware of the tax rules governing dependency exemptions for a parent or other relative. If you provide more than half the cost of supporting a parent or other qualified relative, you may be entitled to a dependency exemption. Support includes food, lodging, clothing, transportation, recreation, medical and dental care, and similar necessities. The dependent's own funds are not considered support unless they are actually used for support.

Qualifying for the deduction

The parent or relative must be a U.S. citizen, or a resident of the United States, Canada, or Mexico. Your parent need not live with you to qualify as a dependent. Certain relatives, however, must reside with you in order for you to take a dependency exemption. The dependent must not file a joint return with anyone, unless the return is filed only to receive a refund for taxes paid. Furthermore, the dependent's gross income must be less than the personal exemption amount which is $3,100 for 2004. (Note: this limit does not apply to your children who are less than age 19 or to full-time students under age 24.) Tax-exempt income doesn't count toward the personal exemption amount, nor does the tax-exempt part of Social Security.

Filing a multiple support agreement

In some cases, several siblings join together to support an elderly parent. If you and your siblings together contribute more than half your parent's support, but no one of you provides more than 50% of that support, you can file a "multiple support agreement." A multiple support agreement allows any one of you who furnished over 10% of the dependent's support to claim the one available exemption, if the others agree. Each contributor signs a Form 2120 and attaches the form to his or her tax return. The person who claims the exemption can alternate from year to year.

Deducting medical expenses

If you pay more than half your parent's support, you may be able to deduct any medical expenses you pay on his or her behalf, even if your parent earned too much for you to claim a dependency exemption. You may add your parent's qualifying medical expenses (including health insurance premiums) to your own medical expenses and deduct the expenses which exceed 7.5% of your adjusted gross income (AGI).

Qualifying for the dependent care credit

A dependent care tax credit is available for individuals who, in order to be able to work, pay someone to care for a mentally or physically disabled parent. The credit is a percentage, based on your AGI, of the amount of dependent care expenses you pay. Expenses for care of a disabled dependent also may qualify for a medical deduction. You must choose to take either the itemized deduction or the dependent care credit, but not both.

Golden Business Ideas

Nurturing employee growth

Losing experienced employees is expensive—the cost of recruiting and retaining employees can be a significant hit to your bottom line. Here's how one company eases the problem:

Each employee meets periodically with his or her mentor, who is assigned by the company based not on title or tenure but on people skills and knowledge about the company and its industry. Together they map out the employee's career path in the company, determining the training necessary to achieve the goals that are set.

Tip: Don't select an employee's manager as a mentor; it's a potential conflict.

Headhunter paradise

Trade shows may be excellent places to find new products, suppliers, customers—and employees. The next time your company has a booth at a trade show, take advantage of the opportunity and put up a help-wanted sign.

Challenge: Don't reject this idea until you try it!

The old adage "You learn from your mistakes" contains more truth than you imagine.

Take advantage of those times when an "error" turns out to be a breakthrough. That may not occur often, but when it does, the rewards can be substantial—albeit unexpected.

Try this: Instead of following all the "rules" you've collected from years of experience, break one of them just a little bit. Be sure, of course, you can handle the consequences of the broken rule. It might help to think of the rule-breaking as entertainment gambling: You go into a casino with $50—win or lose, it's just entertainment.

If you can make it work for you, consider encouraging those you supervise to do the same. It may open some unexpected doors to innovation.

Tax Calendar

JUNE 2004

June 10

Employees who work for tips. If you received $20 or more in tips during May, report them to your employer. You can use Form 4070.

June 15

Individuals. If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due. If you want additional time to file your return, file Form 4868 to obtain two additional months to file. Then, file Form 1040 by August 15. If you are a participant in a combat zone, you may be subject to special rules for filing and payment of taxes.

If you are not paying your 2004 income tax through withholding (or will not pay in enough tax during the year that way), pay the second installment of your 2004 estimated tax. Use Form 1040-ES.

Corporations. Deposit the second installment of estimated tax for 2004.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

JULY 2004

July 12

Employees who work for tips. If you received $20 or more in tips during June, report them to your employer. You can use Form 4070.

July 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

Partnerships. File a 2003 calendar year return (Form 1065). This due date applies only if you were given an automatic three-month extension. Provide each partner with a copy of Schedule K-1 or a substitute K-1. If you need an additional three-month extension, file Form 8800.

Electing large partnerships. File a 2003 calendar year return (Form 1065). This due date applies only if you were given an automatic three-month extension. If you need an additional three-month extension, file Form 8800.

August 2 (normally July 31)

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2004. Deposit any undeposited tax. (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 August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $100.

If you maintain an employee benefit plan with a calendar year-end, file Form 5500 or 5500EZ for calendar year 2003.

The CPA. Never Underestimate The Value.

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