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# Client Information Bulletin

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## Overview of Key New Law Provisions *Roundup of tax breaks in new "extender" law*

**A**t long last, Congress passed the **Tax Relief and Health Care Act of 2006** in the waning days of December. As expected, the new legislation retroactively extends numerous tax law provisions that had officially expired at the end of 2005. In general, the extensions are retroactive to the beginning of 2006 and will now expire at the end of 2007 (unless further legislation is enacted).

The following is a brief summary of several key provisions included in the new tax law.

- ◆ Individual taxpayers may claim an above-the-line deduction for qualified higher education expenses in lieu of one of the education tax credits. The maximum deduction is \$4,000.
- ◆ A taxpayer may elect to deduct state sales tax in lieu of deducting state and local income taxes. The deduction amount is based on a state-by-state table (plus the sales tax on certain high-cost items may be added to the amount).
- ◆ The tax credit for qualified research and development (R&D) costs is extended. It also increases the value of the alternative incremental credit and adds a new simplified credit.
- ◆ The Work Opportunity Tax Credit (WOTC) and the Welfare-to-Work (WTW) Tax Credit are both

extended without modification through 2006. For 2007, the WTW credit is combined with a modified WOTC.

- ◆ The above-the-line deduction for teacher classroom expenses is reinstated. The maximum deduction remains at \$250.
- ◆ Generally, the write-off period for depreciable real estate is 39 years. The new law extends the use of a special 15-year depreciation period for leasehold and restaurant improvements.
- ◆ The availability of Archer Medical Savings Accounts (MSAs) is extended. Individuals may make tax-deductible donations to an Archer MSA to pay for health care expenses. The distributions are tax-free to the extent they are used to pay for qualified health care expenses.

- ◆ A business may be able to claim an expanded deduction for scientific property and computer equipment donated to educational institutions or other qualified charitable organizations. The deduction is equal to the donated property's basis plus half the difference between basis and fair-market value.

- ◆ Numerous tax incentives for energy-saving purchases that were originally scheduled to expire at the end of 2007 are extended through 2008.

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◆ The new law contains several provisions designed to improve Health Savings Accounts (HSAs). Significantly, it repeals the annual plan deductible limitation on HSA contributions.

Finally, the new law includes a package of other tax provisions designed to provide additional tax relief and greater clarity to taxpayers. Consult with a tax professional to determine the impact of the new law on your situation.

## The Tax Benefits of Being a "Homebody"

### Vital rules for deducting home-office expenses

If you operate a business from home, you may be able to deduct home-office expenses on your tax return. **Basic rules:** You can deduct home-office expenses on your tax return if you use part of your home "regularly and exclusively" as either the principal place of your business; or a place to meet or deal with patients, clients and customers in the normal course of business. In addition, you can deduct expenses attributable to a detached structure—such as a garage or shed—that is used in connection with your business (e.g., to store inventory).

If you are an employee, the home office must be used for the convenience of the employer. While these basic rules are simple enough, a few of the key terms require further explanation.

**Regular and exclusive use:** You must use a specific area of your home for business reasons only. The specific area can be a room or even an identifiable space within a room. This space doesn't have to be permanently enclosed, but this approach strengthens your tax position.

If you use the office portion of the home occasionally or sporadically for personal reasons, the personal use taints the home office and, therefore, deductions are lost. Conversely, if a home is a principal place of a business and a specific area is used for inventory or product storage, the area qualifies for depreciation deductions if it is

used regularly—but not necessarily exclusively—for business.

**Principal place of business:** If you are self-employed and work exclusively from home, it is obvious that your home office is your principal place of business. But this determination is not always so clear-cut. For instance, you may perform some business functions at home, but spend most of your time visiting clients, customers or patients at other locations.

The law seesawed back and forth in the 1990s, but the IRS now concedes that you will qualify for home-office deductions if you perform administrative and management functions at home and you have no other fixed business location for these functions. Administrative and managerial activities may include:

- ◆ Billing and invoicing;
- ◆ Keeping books and records;
- ◆ Ordering supplies;
- ◆ Setting up appointments; and
- ◆ Researching and writing reports.

**Convenience of employer:** An employee is entitled to deduct home-office expenses only if he or she is specifically required by the employer to maintain a home office. Thus, an industrious worker who brings work home nights and weekends usually doesn't qualify. It doesn't matter if the work at home results in a benefit to the employer—it must be an absolute condition of employment. In addition, keeping a home office must be justified by the nature of the job.

**Note:** Deductions are not available if the employee rents the home office to the employer—even if it is for the employer's convenience.



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Do you have any questions or comments about **Client Information Bulletin** or your individual situation? Please do not hesitate to contact our office. We would be glad to serve you in any way we can.



# Avoiding the New Crackdown on Private Annuities

## *New proposed regulations reverse tax treatment*

**T**he U.S. Department of the Treasury recently issued new proposed regulations that would eliminate certain income tax advantages of selling appreciated property in exchange for a private annuity. However, some taxpayers may still realize tax benefits under the new rules.

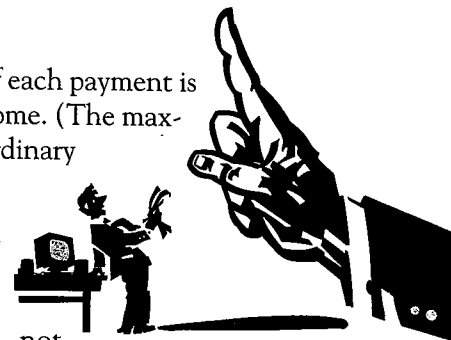
**Background:** Unlike a regular annuity, a private annuity does not involve a financial institution. Generally, you transfer appreciated property to someone who likely would have inherited it anyway, such as your children or grandchildren. In exchange, they make an unsecured promise to make periodic payments to you (the “annuitant”) for the rest of your life. The payment amounts are determined by special IRS life-expectancy tables.

Part of each payment you receive is a tax-free return of investment, part is capital gain and part is ordinary income. (In the case of depreciable real estate, some of the income may be recaptured depreciation, taxed at 25%.)

The amount excluded from tax is determined by the “exclusion ratio” (your basis in the contract divided by the expected return). The capital gain portion is the difference between your basis in the property and the present value of the property. Any long-term capital gain is taxed at a maximum rate of only 15%. The balance of

the taxable portion of each payment is taxed as ordinary income. (The maximum tax rate on ordinary income is 35%.)

Upon your death, the obligation to make payments ends, even if you have not received full fair-market value. In any event, the property is removed from your taxable estate.



Under a long-standing ruling, the IRS allowed the gain from a private annuity to be taxed ratably over the annuitant’s life expectancy. Thus, the tax could be spread out over time. Now the IRS has reversed its direction in the new proposed regulations.

**How it works:** If an annuity contract is received for property instead of cash, the amount realized is the fair-market value of the annuity contract at the time of the exchange. In this case, the entire amount of the gain (or loss) is recognized at the end of the year of the transaction.

In other words, you are taxed on the appreciation in the property as if you had sold it for cash and then used the money to buy an annuity contract. All of the income—including the ordinary income portion—is currently taxable.

The new proposed regulations apply across-the-board to private and commercial annuities. These rules generally apply to transactions entered into after October 18, 2006, but there are certain exceptions.

**Key point:** The effective date for the new regulations is postponed six months for certain transactions that do not appear to the IRS to be abusive. This includes transfers that meet these requirements:

- ◆ The issuer of the annuity is an individual;
- ◆ The obligations under the annuity are not secured (either directly or indirectly); and
- ◆ The property transferred in the exchange is not sold or otherwise disposed of within two years of the initial exchange.

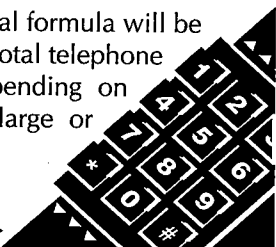
*This exception may protect small-business owners who might use a private annuity to shelter the transfer of a business interest from tax. If the private annuity is created before April 19, 2007, you may be able to preserve the income tax benefits.*

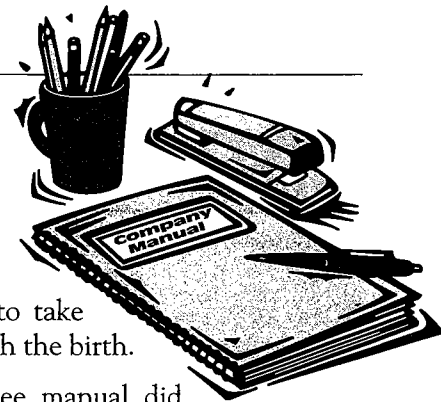
### ***Business Connection to Telephone Tax Refunds***

The IRS recently announced new rules enabling businesses to claim tax refunds for long-distance telephone charges. Previously, the IRS had established specific rules for individual taxpayers.

Under the new rules, a business may use an IRS-prescribed formula to estimate its telephone tax refunds. The formula reflects payments for long-distance charges billed after February 28, 2003, and before August 1, 2006. In lieu of using the formula to claim the refund, a business must produce documentation of actual tax expenses for the entire period.

**Note:** Refunds under the special formula will be capped at either 1% or 2% of total telephone expenses for the period, depending on whether your business is a large or small employer.





## Watch What You Say in Company Manuals

### *New case points out potential pitfalls*

It frequently happens to owners and managers of companies: You are named as a party to a lawsuit involving the business. That's a risk associated with your position. But you still might be taken aback if the suit is initiated by someone you trust—for example, one of your long-time employees.

Unfortunately, this type of lawsuit has become more prevalent as both employees and ex-employees increasingly take their gripes to the courts. For instance, you must be especially careful about what you say in your company's employee manual and how you say it.

**Caveat:** This is not to discourage your company from using an employee manual. On the contrary. It is important to document company policies from both a practical and legal viewpoint. For example, if your employees work at computers, implementing a strict policy for Internet usage and personal e-mail usage is critical in today's electronic world. But this must be done with the requisite care.

To give you a prime example, there's no reason to explain the "whys and wherefores" of a particular policy in the manual. These unnecessary embellishments could land you in court.

**New case:** During the time a husband and wife were both employed by a university, the wife became pregnant. According to the university's employee manual, the pregnancy entitled her to a paid maternity leave of six weeks. However, the policy did not include any pro-

visions for the husband to take time off in connection with the birth.

Nonetheless, the employee manual did include a "purpose" section, which the couple cited. This section stated the following: "Purpose: To permit parents who have care giving responsibilities to have time off to spend with a child newly added to the family."

In reliance on this purpose statement, the husband claimed he was entitled to a leave following the birth of his child, since he was a primary caregiver. Subsequently, the husband initiated a legal action against the university. The lawsuit alleged that the policy discriminated against biological fathers.

**Result:** The Eighth Circuit Court of Appeals did not agree with the husband. The Court opined that it was permissible to offer different benefits to women who were experiencing childbirth. But the Court did note that it was "troubled" by the language in the manual that admittedly ran counter to the "purpose" stated therein.

In this particular case, the employer managed to prevail in court. But the entire matter could have easily been avoided by matching the purpose statement in the manual to the actual content or by eliminating it altogether.

**Lesson to be learned:** *Be careful about publishing statements in your manual. Consult with an attorney on the exact wording of the content.*

## Facts and Figures

### *Timely points of particular interest*

➔**Completed Gifts**—To qualify for the annual gift-tax exclusion, the gift must be complete. You cannot retain rights of ownership. **New case:** After transferring an interest in rental property to her son, a taxpayer continued to receive monthly rent payments from a tenant. The Tax Court determined that there is an implied agreement the taxpayer would retain certain economic benefits. **Result:** The full value of the property was included in the taxpayer's estate.

➔**Deferred Compensation**—The IRS has issued new guidelines on reporting and withholding requirements for deferred compensation plans. In general, the guidance imposes reporting and withholding requirements for deferred compensation amounts taxable in 2005 and 2006. On the plus side, deferred compensation payments that are not taxable are exempted from the new reporting requirements. Consult with a professional tax adviser.

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