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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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# Home Office Deductions

If you are self-employed (or considering becoming self-employed) and working out of an office in your home, there are strict rules that apply to deducting expenses related to a home office. If you are able to meet these requirements, the expenses related to your home office will qualify for the more favorable treatment as above-the-line business expenses.

Expenses related to the home office include both direct and indirect expenses. Direct expenses include the costs of painting or repairing the home office, depreciation deductions for furniture and fixtures used in the home office, etc. Indirect expenses of maintaining the home office include the properly allocable share of utility costs, depreciation, insurance, etc., for your home, as well as an allocable share of mortgage interest, real estate taxes, and casualty losses.

If your home office is your principal place of business, the costs of traveling between your office and other work locations in that business are deductible transportation expenses, rather than nondeductible commuting costs. An additional benefit includes the ability to deduct the cost of computers and related equipment used in your home office.

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If you are in the business of selling retail or wholesale products, you can deduct home office expenses related to the space in your home, if it is your sole fixed business location, when it is used regularly to store inventory or product samples.

Finally, deductions related to your home office are subject to limitations based on the income attributable to the business conducted in the home office. So, you must be careful not to deduct ineligible expense items.

With proper planning, you will be able to benefit from the maximum deductions available related to your home office. Please call us if you would like to discuss this issue in further detail. We can review the specific requirements that will apply to eligible deductions for your business and any applicable limitations.

# Tax Calendar

**October 15**—Personal returns that received an automatic six-month extension must be filed today and any tax, interest, and penalties due must be paid.

—Partnerships that received an additional six-month extension must file their Forms 1065 today.

**October 31**—The third quarter Form 941 (Employer's Quarterly Federal Tax Return) is due today and any undeposited tax must be deposited. (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 November 13 to file the return.

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

**December 17**—Calendar-year corporations must deposit the fourth installment of estimated income tax for 2007.

# Honda FCX Eligible for Tax Credit

American Honda Motor Company, Inc.

The IRS recently acknowledged Honda's certification that one of its vehicles meets the requirements for classification as a qualified fuel cell vehicle. Purchasers of the 2005 and 2006 Honda FCX, which operates on hydrogen, are eligible for a $12,000 qualified fuel cell motor vehicle credit. These are the first fuel cell powered vehicles to be certified as eligible for the credit.

To qualify for the credit, the taxpayer must acquire their Honda FCX by purchase or lease and not for resale. In addition, the original use of the vehicle must commence with the taxpayer.

# No Prorating for 2007 HSA Contributions

If you were planning to contribute to a Health Savings Account (HSA) but thought it was too late in the year to maximize your deductible contribution, think again. That would have been the case in 2006 when prorating your HSA contribution for the number of months you were eligible to participate was required. Beginning in 2007, an individual eligible during the last month of the tax year is treated as having been eligible for the entire year. Thus, the maximum annual contribution (up to $5,650 in 2007) plus any catch-up contribution for someone age 55 or older (up to $800 in 2007) does not have to be prorated based on the number of months of eligibility.

As with most tax benefits, there are specific conditions that apply in order to receive that tax break. If, except for death or disability, you become ineligible during a 12-month testing period (which generally runs through November of 2008), contribution amounts for the months you would have been ineligible in 2007 will be added to your 2008 income. In addition, a penalty of 10% of that amount will be assessed. So, there is still time to participate in an HSA in 2007 and receive a meaningful tax break; just follow the rules.

# Tax Implications of Investment Strategies

Taxes are not specifically an issue in investment strategy decisions. However, the tax implications of those investment strategy decisions must be considered in evaluating the suitability of the various alternatives. Tax payments resulting from portfolio gains will reduce the net return on your investments, so every effort should be made to minimize your tax liability.

The type of account, taxable or tax deferred (e.g., qualified retirement plan), could affect the investment strategy in a number of ways. Qualified retirement plans, because of their tax-deferred nature, tend to favor the following strategies:

1. More frequent turnover (securities transactions within the portfolio) can be tolerated. Recognition of gains is not an issue in a qualified plan account; therefore, a strategy that allows frequent buying and selling (turnover) of the underlying investments would not have a detrimental effect because of associated tax liabilities.
2. More active management might be appropriate for a qualified plan, whereas passive investments, such as index funds, might be held in taxable accounts.
3. Large-cap investments, which are more likely to be dividend-paying companies, may be better suited for qualified plan accounts because the income is not currently taxed.
4. Portfolio rebalancing (e.g., shifting funds from small cap to large cap stocks) is best accomplished using assets in a qualified plan to minimize the recognition of taxable income.

Taxable accounts tend to favor the following strategies:

1. Buy-and-hold strategies are most appropriate to limit gain recognition and to limit gains to assets that qualify for preferential long-term gain treatment.
2. Passive investments, particularly index funds that have minimal taxable distributions, are more appropriate for taxable accounts.
3. International funds, which frequently have associated foreign tax payments, are more appropriate for taxable accounts so the foreign tax credit can be claimed.
4. Small-cap growth stocks are more appropriate because of the minimal dividend income generally associated with these types of investments.

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A topic of continuing discussion among investment professionals is where to hold fixed-income investments and, correspondingly, where to hold equity investments. Generally, sufficient fixed-income investments need to be in taxable accounts to provide liquidity. Those investments will be either tax-free or taxable bonds, depending on the after-tax yield as determined by your marginal tax rate. The need for current income will also affect whether additional fixed-income investments are held outside of qualified plans. Beyond the liquidity amount and provision for current income, the remainder of the fixed-income portfolio can be held in a qualified plan.

Similarly, for stocks, that part of the portfolio that is intended to be long-term, low turnover, passively managed investments can be held in the taxable accounts. More aggressive parts of the portfolio that call for active management and potentially high turnover can be held in qualified plans.

# Don’t Buy a Tax Liability with Your Mutual Fund

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Many taxpayers make adjustments to their investment portfolio during the final quarter of the year to take profits, recognize tax losses, reallocate their assets, and for myriad other reasons. When making purchases of mutual funds near year-end, taxpayers should exercise caution not to purchase a tax liability.

Mutual funds must pay out their gains and income to shareholders at least annually to avoid taxation at the fund level. Income and balanced funds typically make taxable distributions to shareholders either monthly or quarterly. However, equity funds normally make one annual distribution at or near the fund’s year-end. These taxable distributions to shareholders reflect the income and net gains realized by the fund for the period.

An equity fund that appears to have a minimal or negative overall return for the year may actually make taxable distributions to shareholders because of gains the fund recognized on appreciation that occurred in prior years. From an investor’s standpoint, distributions do not result in additional return on their investment; instead, distributions are already reflected in the fund’s per share value, so after a distribution is made, the per share value is reduced accordingly.

Because of the income distributions mutual funds must make, the timing of a share purchase in a particular fund can affect your tax liability. Purchasing shares just before the record date (i.e., the date that determines which shareholders will receive the distribution) is essentially purchasing a tax liability. This is because the price of the shares just before the distribution includes the income that is about to be paid out.

When the distribution is made, the price per share falls although the total investment value remains the same (i.e., if income is reinvested, the shareholder now owns more shares with a lower value per share; if income is distributed, the cash received plus the share value equals their investment before the distribution). Thus, mutual fund investors should pay particular attention to when they invest. This is especially true for equity funds that make only one distribution each year. So, be sure to check with the mutual fund company to determine the status and nature of any forthcoming dividends when purchasing equity mutual funds late in the year to avoid an unexpected tax liability.





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