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YEAR-END 2007 BUSINESS TAX PLANNING



MACRS Deductions. If you buy equipment or other assets for your business this year, you can recoup part of the cost through depreciation deductions. Generally, depreciation deductions are computed under the Modified Accelerated Cost Recovery System (MACRS).

Basic premise: You may deduct the equivalent of a half-year's worth of depreciation for business assets placed in service before the end of the year—no matter how late in the year it actually occurs. This tax break is called the “half-year convention.” For instance, using the IRS tables for the half-year convention, you can deduct 20% of the cost of new computers placed in service in late December.

However, if the cost of business assets (other than real estate) placed in service during the last quarter of the year—October 1 through December 31—exceeds 40% of the cost of assets placed in service during the entire year, depreciation deductions must be calculated under the “mid-quarter convention,” which is generally less favorable.

TAX TACTIC: *Postpone purchases to 2008 if you will trigger this tax trap. Alternatively, if your business needs assets in the last quarter, you may want to maximize Section 179 benefits (see below).*

Section 179 Expensing. Under Section 179 of the tax code, your business may elect to “expense” (i.e., currently deduct) the cost of qualified assets up to an annual limit. However, the deduction cannot exceed the taxable income for the year. Furthermore, the deduction is reduced on a dollar-for-dollar basis for purchases over an annual threshold.

New rules: The new small-business law increases the maximum Section 179 deduction for 2007 to \$125,000. (The inflation-indexed limit was originally scheduled to be \$112,000.) In addition, the phase-out threshold for the Section 179 deduction is generally increased from \$450,000 to \$500,000. The limits for recent years are shown below.

TAX TACTIC: *Because there is now more leeway under Section 179, you can buy additional assets before year-end. Significantly, amounts expensed under Section 179 do not count toward the last quarter tax trap (see above).*

Travel and Entertainment. The IRS allows an employer to deduct 100% of its business travel expenses and 50% of business-related entertainment and meal expenses incurred in 2007. However, the travel and entertainment (T&E) tax rules are fraught with twists and turns.

In particular, be aware of the following points in mind as you look to increase deductions at the end of the year.

- If you use the standard mileage amount in lieu of deducting actual car expenses, you can deduct 48.5 cents per business mile traveled this year (plus related tolls and parking fees). You can generally switch from using the standard mileage method in the prior year to the actual expense method this year, but not the other way around.
- Under the “luxury car” rules, the deduction limit for a passenger vehicle placed in service in 2007 is \$3,060 (\$3,260 for light trucks and vans). **Note:** These figures are based on 100% business use and must be adjusted accordingly. For example, if you use a new car 80% for business, your first-year deduction is limited to \$2,448 (80% of \$3,060).
- You can only deduct entertainment expenses that are “directly related to” or “associated with” your business. For instance, if entertainment follows or precedes a substantial business meeting, it may qualify as associated-with entertainment. You might want to plan year-end entertainment with clients around such meetings.
- If you give clients business gifts during the holiday season, the deduction is limited to only \$25 per recipient. However, if you give gifts of tickets to sporting events, concerts or plays, you may deduct the cost as entertainment (subject to the 50% limit).

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TAX TACTIC: *The IRS often challenges T&E deductions, so make sure you comply with all the recordkeeping rules. An employer may avoid complications by establishing an “accountable plan.” Contact your tax adviser for details.*

Manufacturing Deductions. A 2004 tax law created the “manufacturing” deduction for certain domestic producers of goods. The deduction may be claimed by C corporations or allocated to shareholders or partners in pass-through entities. It is also available to sole proprietors.

New rules: Previously, the deduction was equal to 3% of the lesser of taxable income from qualified production activities or taxable income. The maximum deduction percentage increases to 6% in 2007. It is scheduled to top out at 9% in 2010.

The annual deduction is limited to 50% of the W-2 wages paid during the year. This 50% limit applies only to wages paid in connection with a qualified production activity.

TAX TACTIC: *The manufacturing deduction has a wider application than many taxpayers think. It may apply to businesses that are not traditionally viewed as manufacturers. Obtain professional guidance with respect to your situation.*

Business Credits. A business may be able to claim certain tax credits for expenses incurred during 2007. The credits are combined in a general business credit on your company’s return.

New rules: The Tax Relief and Health Care Act of 2006 extends and enhances two key business credits that had technically expired after 2005.

1. **Research credit:** The research credit is generally equal to 20% of your qualified research activities. However, a business may elect to claim an alternative incremental credit based on a stated percentage of average expenses over a four-year period. The new law increases the stated percentages and creates an alternative simplified credit for 2007.
2. **Work Opportunity Tax Credit:** For 2007, the 2006 law combines the two credits—the Work Opportunity and Welfare-to-Work tax credits—for hiring workers from disadvantaged groups. The new small-business law also broadens the groups to include disabled veterans and more high-risk individuals and extends the credit into 2011.

TAX TACTIC: *As things stand now, the research credit is scheduled to expire after 2007 (although it may be extended again). To be on the safe side, your business may wish to incur qualified expenses before the end of the year.*

Miscellaneous.

- As a general rule, business bad debts can be deducted in the year they become worthless. To support your claims for unrecoverable debts, keep detailed records of collection efforts, including letters, phone calls, e-mails and collection agency activity.
- If the cost of your goods is rising, consider a switch to the LIFO (Last In, First Out) method of inventory accounting. The change can result in a larger deduction for the cost of goods sold. This will result in a lower taxable income for your company.
- Arrange charitable donations before 2008. Deductions are generally limited to 10% of an employer's taxable income, but any excess may be carried over for five years. **Note:** Certain tax breaks for charitable gifts of food and books will expire after 2007.
- Repairs made by your company before year-end are deductible on its 2007 return. However, capital improvements to the business premises must be capitalized. Try to implement separate plans for repairs and major renovations.
- Any loss claimed by an S corporation shareholder is limited to the basis in the stock plus outstanding debt. Therefore, shareholders might make a capital contribution or lend money to the corporation before year-end. This increases your basis for loss deduction purposes.
- Owners of commercial buildings may benefit from making energy-efficient improvements this year. The improvements must be certified as meeting certain environmental standards. **Note:** This tax break is scheduled to end after 2007.

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This year-end planning letter is published for our clients, friends and professional associates. It is designed to provide accurate and authoritative information with respect to the subject matter covered.

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