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CERTIFIED PUBLIC ACCOUNTANTS

Report

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Work-related education

When can you deduct your expenses?

Given today's high unemployment rate and cutthroat job market, many people are viewing higher education as a means to gain a competitive edge. If you're heading back to the classroom to improve your marketability, you may be wondering whether the expense qualifies for education-related tax breaks.

Depending on your income level and other factors, you may qualify for education tax credits (such as the Hope credit or Lifetime Learning credit) or the tuition and fees deduction. Here, however, we'll focus on deducting the cost of education as a business expense.

The education must relate directly to your trade or business and expenses must be reasonable, not "lavish or extravagant."

What's deductible?

If you're employed, qualifying education costs may be deducted on Schedule A as unreimbursed employee expenses. These are considered miscellaneous itemized deductions that are deductible only to the extent that the total of such deductions exceeds 2% of your adjusted gross income. If you're self-employed, education expenses may be deducted on Schedule C.

It's important to remember that education expenses are deductible only if they qualify as ordinary and necessary business expenses. So if you're currently unemployed (with one exception, discussed on the next page) — or otherwise not actively engaged in a trade or business — these expenses aren't deductible.

Under IRS regulations, you can deduct the cost of education that:

- Maintains or improves skills required in your employment or other trade or business; or
- Meets legal or employer requirements for retaining your employment, compensation or job status.

What types of expenses might you deduct? For starters, the cost of courses that review new developments in your field or the cost of courses needed to meet continuing professional education (CPE) requirements. Even courses that lead to a degree can be deductible, provided they otherwise satisfy regulatory requirements.

Education expenses that fall into one of the above categories aren't automatically deductible, however. The education must also relate directly to your trade or business and expenses must be

reasonable, not "lavish or extravagant." For example, expenses may be considered extravagant if you travel to an exotic location for education or if you stay in a five-star hotel. Also, education expenses aren't deductible if you're entitled to reimbursement from your employer (whether you apply for it or not).

What's *not* deductible?

IRS regulations specifically exclude expenses for the following types of education, which are considered to be personal and, therefore, aren't deductible:

- Education required to meet the minimum requirements for your employment or other trade or business, and
- Education that qualifies you for a *new* trade or business.

Suppose, for example, that a college instructor with a bachelor's degree must obtain a graduate degree to continue to hold her position on the faculty. Graduate courses are required to meet the minimum requirements for the job and, therefore, aren't deductible. On the other hand, a high school teacher required only to have a bachelor's degree can deduct the cost of graduate courses (provided the other criteria for deductibility are met).

Education that qualifies you for a new trade or business isn't deductible, regardless of whether you actually intend to enter that new trade or business. So, for example, a corporate executive who attends law school at night can't deduct the expense even if he has no intention of practicing law and the courses help him improve his skills in his current job.

What if you're unemployed?

As already noted, education expenses are deductible only if they qualify as business expenses. If you're unemployed, it's difficult to meet this requirement because you aren't actively engaged in a trade or business.

There's an exception, however, for temporary absences from work. The IRS generally considers anything more than one year to be permanent or "indefinite," but this time frame isn't set in stone. The key is to show that you were previously involved in a trade or business, that you're actively seeking to return to it (rather than a new trade or business), and that the absence is temporary rather than indefinite. Unfortunately, this can be difficult to prove in the current job climate.

School yourself

The rules regarding deductibility of work-related education expenses are confusing. Before you go back to school, it's a good idea to consult your tax advisor to find out whether your expenses are deductible and, if so, to ensure that you substantiate them properly.

What about an MBA?

Whether you can deduct the cost of obtaining an MBA depends on your particular circumstances. The courts have allowed people to deduct MBA expenses when they were able to show that the education helped them maintain or improve the skills they were already using in their employment or trade of business.

So, for example, if you're already in a management job, MBA expenses may be deductible if the coursework will help you perform your current job tasks. They're not deductible, however, if the degree will qualify you to move into a management position.

The icing on the cake

A QPRT allows you to save estate taxes on your home while still living in it

If you haven't yet considered a qualified personal residence trust (QPRT), now may be a good time to do so. A QPRT allows you to transfer your home to your children or other family members at a deeply discounted gift tax value.

By doing so, you can remove the home's value and any future appreciation from your taxable estate. And — here's the icing on the cake — you can continue to live in your home indefinitely. This can be an excellent strategy if your property's value is depressed and you expect it to increase. There are certain rules you must follow, but the outcome could be quite delicious.

How it works

A QPRT is an irrevocable trust to which you transfer your primary residence or a vacation home, reserving the right to occupy the home for a specified term.

When selecting a QPRT term, you'll need to strike a balance between maximizing tax benefits and minimizing mortality risk.

In most cases, when you transfer property to a trust for the benefit of your family but keep an interest in that trust, you must pay a gift tax on the full market value of the property. The U.S. tax code provides an exception for QPRTs, however: Under a QPRT, the home's value is its fair market value minus the present value of your retained interest (computed using the federal Section 7520 rate).

At the end of the trust's term, the home is transferred to your children or other beneficiaries, either outright or in trust. You can continue to live in the home even after the term ends, but to preserve the QPRT's tax benefits you must pay the trust beneficiaries fair market rent.

Choose your own term

Another benefit is that you can make the trust's term as long or as short as you'd like. A longer term reduces the gift's size, enhancing your tax benefits. But a longer term is riskier because, if you die during the term, the home's fair market value will be included in your estate as if the QPRT had never existed. When selecting a term, you'll need to strike a balance between maximizing tax benefits and minimizing mortality risk.

Because a QPRT is a grantor trust, you remain responsible for mortgage payments (if applicable),

real estate taxes, insurance and other expenses during the trust term. You can deduct any mortgage interest and real estate taxes on your individual income tax return just as if you still owned the home outright.

Abide by the rules

A QPRT must adhere to a number of technical requirements. For example, the trust instrument must prohibit the trust from holding any assets other than the personal residence and certain cash and insurance policies. It must also provide for mandatory distributions of any trust income — for example, a vacation home's rental income — to the grantor at least annually during the trust term. Finally, the QPRT can't make distributions to anyone other than the grantor during the trust term.

IRS regulations also state that QPRT status is lost if the home ceases to be used as a personal residence or is sold (unless the trustee uses the proceeds to purchase a new personal residence within two years).

Consider the downsides

Before you adopt this strategy, you need to be aware of a QPRT's capital gains tax ramifications. If the home's value has appreciated significantly, your children may be hit with a high capital gains tax bill should they decide to sell the home. If instead the home is transferred to them at your death, they'll receive a step-up in basis, generally to the home's value on your date of death. This likely will considerably reduce any capital gains tax liability if they sell the home.

Also keep in mind that a QPRT can be more complicated if you haven't paid off the mortgage before you transfer the home to the QPRT. Transferring property subject to a mortgage will reduce the size of the initial gift, but, each time you make a mortgage payment, it will be considered an additional gift that must be valued for gift tax purposes. Consider remaining personally liable on the mortgage, as opposed to transferring the liability to the QPRT.

Act now while the going's good

QPRTs are most effective when interest rates are high. But even with today's low interest rates, this strategy can reduce a home's value for gift tax purposes by 50% or more. Work with your tax advisor to learn more about how you can employ a QPRT to remove your home's value and any future appreciation from your taxable estate. ◎

How to maximize deductions for LLC and LLP losses

Limited liability companies (LLCs) and limited liability partnerships (LLPs) are popular business structures because they combine the tax advantages and flexibility of a partnership with the liability protection of a corporation. But until recently, they had one big disadvantage: The IRS treated owners as *limited* partners for purposes of the passive activity loss (PAL) rules.

Fortunately, both the U.S. Tax Court and the U.S. Court of Federal Claims have ruled that LLC and LLP owners should be treated as *general* partners,

making it easier for them to deduct losses. If you're an LLC or LLP owner, the key is to establish that you "materially participated" in the business.

PAL 101

Congress established the PAL rules in 1986 to discourage abusive tax shelters. The rules prohibit taxpayers from offsetting losses from passive business activities (such as limited partnerships or rental properties) against nonpassive income (such as wages, interest, dividends and capital gains). Disallowed losses may be carried forward to future years and deducted from passive income or recovered when the passive business interest is sold.

Congress established the PAL rules in 1986 to discourage abusive tax shelters.

There are two types of passive activities: 1) trade or business activities in which you don't materially participate during the year, and 2) rental activities, even if you materially participate (unless you're a qualified real estate professional).

Material participation in this context means participation on a "regular, continuous and substantial" basis. Under the tax regulations, unless you're a limited partner, you're deemed to materially participate in a business activity if you meet *one* of the following seven tests:

1. You participate in the activity at least 500 hours during the year.
2. Your participation constitutes substantially all of the participation for the year by anyone, including nonowners.
3. You participate at least 100 hours and as much or more than any other person.
4. The activity is a "significant participation activity" — that is, you participate more than 100 hours and otherwise qualify as a material participant — and your participation in all significant participation activities for the year totals more than 500 hours.
5. You materially participated in the activity for any five of the preceding 10 tax years.
6. The activity is a personal service activity in which you materially participated in any three previous tax years.
7. Regardless of the number of hours, based on all the facts and circumstances, you participate in the activity on a regular, continuous and substantial basis.

The rules are more restrictive for limited partners, who can establish material participation only by satisfying tests 1, 5 or 6.

Track your hours

If you're an LLC or LLP owner, you need to track the time you spend on business activities. Under recent court rulings, you can establish material participation — and maximize your deductions for business losses — under *any* of the seven tests listed above. In addition, if your spouse also participates in an activity, you can combine your hours to meet the material participation standards. ◎

tax TIPS

Don't skimp on S corporation salaries

S corporation owners often take modest salaries as a tax-saving strategy. By distributing most of the corporation's profits in the form of dividends rather than wages, the company and its owners can avoid payroll taxes on these amounts.

Although S corporations may be tempted to pay little or no salary to their shareholder-employees, this is a dangerous tactic. The IRS has targeted S corporations, assessing unpaid payroll taxes, penalties and interest against companies whose owners' salaries are unreasonably low.

To avoid an unexpected tax bill, S corporations should conduct an analysis — using compensation surveys, company financial data and other evidence — to establish and document reasonable salaries for each position.

Now's the time for giving

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 established a $5 million gift and estate tax exemption and a maximum tax rate of 35% for this year and next. Absent additional legislation, the exemption will drop to $1 million, and the top tax rate will increase to 55%, in 2013. It's difficult to predict what Congress will do between now and then, so consider making large gifts now to take advantage of the high exemption amount.

Even if Congress extends the current law, there are advantages to making gifts early, especially gifts of assets expected to appreciate. That's because future appreciation is removed from your estate and sheltered from gift and estate taxes.

A caveat: If the exemption does fall back to $1 million in 2013, the IRS might attempt to "claw back" previous gifts in excess of $1 million and subject them to estate tax, even though they were exempt from gift taxes when made. Most experts believe this outcome is unlikely, but if it happens, you'll be no worse off for having made the gift, and you may be better off if the assets appreciate after the gift is made.

Consider a charitable IRA rollover

The Tax Relief act extended the charitable IRA rollover through the end of 2011. This strategy allows those 70½ or older to transfer up to $100,000 directly from an IRA to a qualified charity without triggering income taxes on the distribution. (The rollover can be used to satisfy minimum distribution requirements for the year.)

Seniors who want to make charitable contributions often withdraw funds from their IRAs, donate the money to charity and offset the income with a corresponding charitable deduction. A direct rollover offers similar tax savings for those who don't itemize or are constrained by income limits on charitable deductions.

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Developments Affecting California Taxpayers

IRS announces second offshore voluntary disclosure program: On February 8, the IRS announced it is starting a second initiative designed to bring offshore money back into the U.S. tax system and help taxpayers with undisclosed income from offshore accounts get current with their taxes. Details of the program, called the 2011 Offshore Voluntary Disclosure Initiative (OVDI), were released in the form of 53 frequently asked questions (FAQs).

- Taxpayers that fully comply with the offer will avoid criminal prosecution and will be able to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues.
- The program covers years 2003 – 2010.
- Taxpayers must file amended income returns and pay taxes, interest, and related penalties for each year covered by the program. The amended returns must detail the previously unreported income from the foreign accounts or entities.
- A penalty in the amount of 25% (or in limited cases 12.5% or 5%) will be assessed on the highest aggregate balance in the taxpayers foreign bank accounts/entities or value of foreign assets during the covered period.
- Taxpayers with foreign accounts but no unreported income may simply file a delinquent FBAR and attach an explanation as to why the form is being filed late. Formal entry into the program is not required. FBARS for these types of accounts for 2009 and previous years must be filed by August 31, 2011 to avoid late filing penalties.

Small Business Health Care Credit: Beginning in 2011, qualified small employers can claim a tax credit when they provide at least half of the premiums for single health coverage for their employees. The credit is available for small employers — those with 10 or fewer full-time equivalent employees (FTE) and paying annual average wages of $25,000 or less. The credit is completely phased out for employers that have 25 or more FTEs or that pay average wages of $50,000 or more per year. Small businesses can claim the credit for 2010 through 2013 and for any two consecutive years after that. For tax years 2010 to 2013, the maximum credit is 35% of premiums paid by eligible small businesses and 25% of premiums paid by eligible tax-exempt organizations. Beginning in 2014, the maximum tax credit will increase to 50% of premiums paid by eligible small business employers and 35% of premiums paid by eligible tax-exempt organizations.

Jobs credit for small California employers: A tax credit of $3,000 for each additional qualified full-time employee hired is available to small businesses with 20 or less employees beginning January 1, 2009. The credit is not subject to the 50% limitation for business credits. The total amount of credit available to be claimed by all taxpayers is capped at $400 million. At the end of March 2011, less than $40 million of the credit has been used. The credit is claimed on a timely filed original return received by the Franchise Tax Board on or before a cut-off date specified by the Franchise Tax Board. Taxpayers claiming the credit on an original return received by the Franchise Tax Board after the cut-off date is met will be notified that the credit has been denied.

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Did You Know … The Kentucky Derby is the oldest continually held sports event in the United States (1875); the second oldest is the Westminster Kennel Club Dog Show (1876)

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