

This Issue:

- ◆ Corporation's Rent Payments
- ◆ Depreciating Leasehold Improvements
- ◆ Reporting Rental Income
- ◆ "Simple" Retirement Plan
- ◆ Record Keeping Requirements
- ◆ Gifts to Clients
- ◆ Corporation Carryover

Depreciating Leasehold Improvements

The cost of leasehold improvements placed in service after 1986 is recovered over the IRS-assigned class life for that property, regardless of the term of the lease. The improvement is depreciated using the straight-line method over 27.5 years for residential property and 39 years for commercial property. A lessor may not use the shorter lease term, even if the improvements may not be acceptable for use by future tenants. If the lease ends before the recovery period for the improvements, the lessee may have a reportable gain or loss if the improvement is left behind. The remaining basis of the improvement may be deductible as a loss if the improvement is not retained. If the lessee is paid an amount exceeding the remaining basis for terminating the lease, a gain would result.



Corporation's Rent Payments to Shareholder

When a corporation pays rent to a shareholder for the use of real estate, the shareholder must report the income on his/her personal tax return. This treatment



helps avoid double taxation on dividends, as well as payroll taxes on wage payments. The rent must be fair and reasonable in an arm's-length transaction; otherwise, the excess will be reclassified by the IRS and taxed to the shareholder as a dividend or wages.

Be aware that any home-office expenses associated with the rental of a personal residence are disallowed during any period in which the taxpayer uses the residence to perform services as an employee of the corporation.

Reporting Rental Income

Most income from real estate rental activities is not subject to self-employment tax. However, if significant services are provided, the activity is conducted as a business for profit. The sole proprietor then must report the income and expenses on Schedule C or F and must pay self-employment tax on the net profit. Examples include hotel rooms, boarding houses, and farm rentals where the owner materially participates in the activity.

The rental of personal property may be subject to self-employment tax if the individual is in the business of renting personal property. For example, stores that rent machinery and car rental services would use Schedule C and would pay self-employment tax. Individuals not in the business of renting personal property would report income and expenses directly on Form 1040.

“SIMPLE” Retirement Plan

If you would like to offer your employees the opportunity to share in the responsibility for funding their own retirement, you will want to take a closer look at the Savings Incentive Match Plan for Employees (SIMPLE). Designed specifically for companies with 100 or fewer employees, the SIMPLE plan offers several attractive features. A SIMPLE plan is similar to a 401(k) plan in that the employee can elect to defer compensation tax free, and the employer can make tax-deductible matching contributions to the plan for the employee's benefit. Unlike 401(k) plans, SIMPLE plans are not subject to the nondiscrimination, or the “top-heavy” plan requirements of other qualified plans. In addition, eligible employees do not have to elect to participate.

An employer can establish a SIMPLE plan for himself or herself even if no other employees choose to participate. A SIMPLE plan can be either an Individual Retirement Account (IRA) for each employee or part of a 401(k) plan. Qualified distributions from SIMPLE plans are taxed like traditional IRAs.

Record Keeping Requirements

A little reminder: The Internal Revenue Code requires you to retain all your financial records relating to positions taken on your tax return for three years. However, we recommend you keep all your tax and financial records for no less than six years. You should keep all records relating to large purchases - for example, a house or large capital improvements (such as an addition) - for at least six years after the sale of the property.



Fortunately, the IRS is now permitting the use of independently prepared bank statements that list the payee as adequate support for your position. This can be a big space saver for those who have been saving cancelled checks. Many banks no longer provide cancelled checks (unless specifically requested) but provide their customers with photocopies of their checks on 8 ½ x 11 paper. Many of you will find that the storage of these records is far more convenient than the storage of cancelled checks.

Gifts to Clients

Generally, only 50% of the cost of business meals and entertainment can be deducted. From a tax standpoint, it may now be more advantageous to woo your clients or business associates by giving them gifts instead. The cost of gifts is deductible - as much as \$25 a recipient.

Tickets to the theater or a sporting event may be treated as a gift as long as you do not accompany the customer to the performance. If you attend the event with a customer; however, you must consider the cost of the tickets as an entertainment expense.

Corporation Carryovers

Corporations contemplating electing the S corporation status should make sure any carryover items are completely used up before the election is made. In general, an S corporation cannot use any carryovers such as net operating loss and charitable contribution carryforwards from years the corporation was a C corporation. Unfortunately, the clock continues to tick during the time the corporation is an S corporation, resulting in a loss of the carryover if S corporation status is not terminated before the end of the carryover period.

Padgett Business Services — Building success stories, one entrepreneur at a time.



Padgett Business Services is dedicated to meeting the tax, government compliance, profit & financial reporting and payroll needs of businesses with fewer than 20 employees in the retail and service sector of the economy. This publication suggests general business planning concepts that may be appropriate in certain situations. It is designed to provide complete and accurate information to the reader. However, because of the complexities of the tax law and the necessity of determining whether the material discussed herein is appropriate to your business, it is important you seek advice from your Padgett office before implementing any of the concepts suggested in this newsletter.

PENALTY NOTICE: As required by U.S. Treasury regulations, you are advised that any written tax advice contained herein was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.