

Puget Sound

Builder + Designer

Digest

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Stock Plans**
By Leo Smith, AIA

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Audit Prevention
Defenses**
By Hans Kasper,
MS-CPA, PS



Ken Cornett

Estate Homes, Inc.
and Estate Homes Design, Inc.
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Tax Planning and Audit Prevention Defenses

By Hans Kasper, MS-CPA, PS, Bothell, Washington

As an ex-IRS agent and a CPA, I know that there is a proper path to take when performing tax planning to save taxes and when preparing an income tax return using appropriate audit prevention defenses.

Tax Planning

Proper income tax planning will reduce taxes and increase cash flow. You can achieve this goal by scheduling one or two appointments per year with your tax accountant who utilizes an all-inclusive, tax-planning checklist. Some of the areas that I see missed the most in tax planning are:

- Section 105 plans that allow for the business deduction of all of your medical insurance and medical expenses;
- Section 125 plans that allow for all of the Section 105 expenses, but also include childcare and other fringe benefits;
- The filing of your tax returns on a cash basis rather than an accrual basis;
- The deduction of office in the home expenses; and
- The tax-free sale of rental and investment property using a Section 1031, like-kind exchange agreement.

Congress designed the Section 105 Medical Reimbursement Plan for the small business owner. It allows as a business deduction 100% of health insurance premiums and out-of-pocket medical, vision, and dental expenses not covered by insurance. The Plan is best suited for sole proprietors such as realtors and single-owner corporations with a limited number of full-time employees and will reduce your income and self-employment taxes.

Those businesses with a greater number of full-time employees will benefit more from a Section 125 Benefit Reimbursement Plan. This Plan includes the Section 105 benefits as a pre-tax deduction from compensation, but also can include childcare benefits up to \$5,000 per year and other fringe benefits. Section 125 plans save income taxes and social security taxes for the employee and social security taxes for the employer.

Many small business owners are afraid that an Office-in-the-Home deduction will trigger an audit. I have even heard accountants say this. If it were true that Congress did not want you to have such a deduction, then they would not have written it into the law. Therefore, if you know what the law is, then you can abide by the law, make it work for you, and live without fear of it.

Here is what the law states: If you use a portion of your home exclusively for business including the storage of inventory, supplies and tools, then you can take an office-in-the-home deduction. This also includes buildings that are separated from your home. The deduction includes a portion of your real estate taxes, mortgage interest, utilities, homeowner dues, repairs, depreciation, and home insurance. These expenses generally reduce your taxes by 30% to 40% of the office-in-the-home deduction. In addition, I have never seen an audit that was caused by the deduction of the office-in-the-

Estate Homes, Inc. Profile

Company: Estate Homes, Inc.

Principal: Ken Cornett

Type of Construction: Custom & remodeling

Active in: South King County to Camano Island

Member of: Master Builders Association of King & Snohomish Counties, NAHB, NKBA and AIA

Favorite Building Product: Natural Stones

The Puget Sound housing market is:
"Medium" and over the next 12 months
will "Hold Steady or Improve" because
"interest rates will remain low."

home expenses.

Since September 11, 2001, Congress has allowed even more small businesses to convert their tax reporting method from the accrual basis to the cash basis. The purpose of this change is to reduce taxes and put cash back into those businesses that qualify—service-based businesses and those business that have no inventory with less than \$10 million in revenue who are not retailers, manufacturers, or wholesalers.

The election to make the change must be filed before the due date of the tax return to which the election applies. Tax savings can be significant if the right facts and circumstances apply.

Section 1031 like-kind exchanges apply to the sale of business and investment property including business equipment that is not inventory. The trade-in of a vehicle is a like-kind exchange. Two steps are required to make the exchange fully or partially tax-deferred: an independent intermediary (facilitator) who acts as a trustee of the cash between the sale and the purchase dates (the seller cannot touch the proceeds of the sale) and an exchange agreement between the seller and the intermediary. Yes, that is right—an exchange can also include the exchange of one property for another and the sale of one property and the purchase of another.

Transactions can include multi-property exchanges and reverse exchanges (the purchase of the new property can take place before the sale of the old property). By law, the replacement properties must be identified with 45 days from the date of sale and closed on within 180 days from the date sale of the relinquished property. To be totally tax-deferred, the replacement properties must be of an equal or greater value than the relinquished property. Just think about saving all of those capital gains taxes the next time you sell a property.

As you can see, a small amount of time spent on tax planning can reap some big tax savings.

Audit Prevention Defenses

While an audit may not be totally preventable, the proper preparation of your tax return can avoid unnecessary audits by taking the steps to eliminate audit potential through the implementation of a well-designed defense.

To pull your return for an audit, the IRS computer looks at your tax return and gives it a score—called a Diff Score—which quantifies the probability of your return producing significant additional tax revenues during an audit. Among the returns that will raise a red flag are those that have:

- Numerous or large even dollar amounts—\$40,000.00—the defensive play is to round the amount up or down by one dollar or to attach a written explanation supporting the deduction,

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· Large dollars amounts in expense areas that normally do not have large dollar amounts—office expense \$45,031.00—the defensive play is to provide a supporting schedule that breaks large amounts into many small ones,

· Unusual tax deductions—legal expenses for the protection of income—the defensive play is to include a factual description of the facts be-

cost of living analysis for the year of the audit. When they take that amount, subtract gifts that you have received and the bank transfers, and it is more than the amount of income that you have reported on your tax return—well, you are dead meat again. Only this time, they are shipping the audit file up to the I.D. section (the investigation division) for a fraud review. If they pass on the

If you have those (supporting documents for an audit), then you win, and if you do not, then they win; and nine times out of ten - they win. The only way you can beat them is to keep good records and documentation.

hind the deduction with copies of prior court cases and legal citations that support your position,

· Big travel and entertainment deductions or vehicle expenses—possible personal expenses—the defensive play is to provide a supporting schedule that breaks large amounts into small ones.

HOWEVER, should you be selected for an audit, let me tell you how they are going to work the wallet right out of your pocket. What they are going to do is ask you for the supporting documentation of your deductions, and they are going to go for the details.

If you have those documents, then you win, and if you do not, then they win; and nine times out of ten—they win. The only way you can beat them is to keep good records and documentation. This means that you know what good records and documents are and have retained those items. Without them, your wallet is theirs.

Congress gave the IRS a law and here is how it reads: The taxpayer is required to prove expenses (good documentation) and the IRS is required to prove income. This is how the IRS proves income: Every deposit to your bank accounts less transfers between accounts is income unless you can prove otherwise. So what are you going to do? That is right—you are going to keep good documentation! For those of you who do not even reconcile your bank accounts—well, you are dead meat.

But wait, there's more! They can take this to a completely new level. The courts have given them even more power. They can make you prepare a

fraud case, then the auditor is allowed to assess you with penalties (some up to 25% of the tax). If they keep the file and go after you, well, I think you can picture how much that might cost you in criminal defense fees even if you win.

Therefore, the proper preparation of your income tax return is your first-line of defense to prevent an audit and the retention of supporting documentation is your best insurance in case an audit should occur.

Hans Kasper has a Bachelors and a Masters degree in accounting, is a Certified Public Accountant and acts as a Section 1031 Facilitator. His office is located at 22118 - 20th Ave. SE, #122, Bothell, WA 98021. Phone: 425-485-7853; Email: hkasper@hkmscpa.com; Web site: www.hkmscpa.com

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