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RECOGNIZING HOME-BASED BUSINESS TAX AVOIDANCE SCHEMES

Facts About Home-Based Businesses

In order to deduct expenses related to the business use of your home, you must carry-on a “bona fide” business, as well as meet other specific requirements. Even then, your deduction may be limited. To qualify to claim expenses for the business use of your home, you must meet both of the following tests:

- ◆ Your use of the business part of your home must be:
 - Exclusive,
 - Regular, and
 - For your trade or business,

AND

- ◆ The business part of your home must be one of the following:

Your principal place of place business,

A place where you meet and deal with customers in the normal course of your trade or business, or

A separate structure you use in connection with your trade or business.

Home Based Business Tax Avoidance Schemes

Scam home-based businesses and tax avoidance promotions have gained popularity over the last few years for a variety reasons, including:

- ◆ The desire of individuals to reduce the amount of taxes they pay.
- ◆ Unscrupulous promoters selling tax avoidance and audit assistance packages.
- ◆ Taxpayers being advised they can deduct all or most of their home and other personal assets as business expenses.

Personal Expenses or Business Expenses?

Most taxpayers with home-based businesses accurately report their income and expenses, while still enjoying the benefits that a home-based business can offer. However, some individuals have received advice that they can operate any type of unprofitable “business” out of their home and claim personal expenses as business expenses. Nondeductible personal living expenses cannot be transformed into deductible business

expenses, regardless of how convincing the information in marketing materials may seem.

The following are a few examples of items that are generally not deductible as business expenses.

- ◆ Deducting all or most of the cost and operation of a personal residence. For example, placing a calendar, desk, file cabinet, telephone or other business item in each room does not increase the amount that can be deducted. Taxpayers should also be aware of depreciation recapture rules when assets are later sold.
- ◆ Paying children a salary (e.g. for answering telephones, washing cars, etc.)
- ◆ Deducting education expenses from salaries paid to children wrongfully claimed as employees.

Treasury Unveils Budget Proposals To Close Loopholes; Stop Abusive Tax Avoidance

Treasury has just announced a series of legislative proposals included in President Bush's FY 2005 Budget "to close loopholes, halt several abusive tax avoidance transactions and simplify the Tax Code." In addition, more money would be earmarked for taxpayer compliance.

Comment. Treasury's announcement only included certain compliance, enforcement and simplification proposals. The expectation is that the full budget proposals will include several other significant initiatives, such as making the tax cuts enacted since 2001 permanent and allowing tax-friendly lifetime savings accounts.

Comment. "We are committed to restoring confidence in the tax system by ending the proliferation of abusive tax avoidance transactions and simplifying the tax code," Treasury Assistant Secretary for Tax Policy Pam Olson said. "Curbing the use of abusive tax avoidance transactions by corporations and individuals is our top enforcement priority," IRS Commissioner Mark Everson added.

Tax Shelter sanctions

The president's budget proposals would make over a dozen changes to put more teeth into IRS efforts to curb the use of tax shelters. These include:

- ◆ Penalties for failure to disclose potentially abusive transactions;

Comment. "Penalties for non disclosure by taxpayers and promoters are either nonexistent or insufficient," admits Treasury.

- ◆ Uniform disclosure rules for potentially abusive transactions.

Comment. This and the previous provision were first introduced in 2002 by the Bush Administration. With increased focus on shelters lately, odds are better for passage this year.

- ◆ Injunction actions against promoters repeatedly disregarding the registration and list-maintenance requirements;
- ◆ A separate penalty for failure to report an interest in a foreign financial account;

- ◆ Curbing abusive income-separation transactions that purport to generate an immediate tax loss for one taxpayer and the conversion of current taxable income into deferred capital gain for another.
- ◆ Eliminating obstacles to disclosure by extending the exception to the practitioner privilege to noncorporate tax shelters and extending the statute of limitations;
- ◆ Increasing penalties for false or fraudulent statements made to promote abusive tax avoidance transactions;
- ◆ Eliminating abusive transactions involving foreign tax credits; and
- ◆ Halting abusive leasing transactions with tax-indifferent parties, such as a municipal transit authority or foreign government.

More loophole closing

In addition to shutting down use of tax shelters, the Bush Administration is taking aim at some other abuses by individuals and small businesses. These provisions would:

- ◆ Require charitable deductions to reflect accurately the value of the donated property, especially in the case of patents, intellectual property, and motor vehicles;
- ◆ Prevent misuse of tax-exempt casualty insurance companies to improperly accumulate investment income tax-free;
- ◆ Address the tax consequences of changing beneficiaries of a section 529 college savings plan to avoid transfer taxes;
- ◆ Tighten the deduction limitation for interest paid to related parties;
- ◆ Prevent avoidance of U.S. tax on foreign earnings invested in U.S. property; and
- ◆ Modify tax rules for individuals who give up U.S. citizenship or green card status.

IRS Procedure

The budget proposals also aim to fix some rules that the IRS believes hamstrung it from moving cases forward more quickly. These include:

- ◆ Curbing frivolous submissions, such as bogus offers-in-compromise (OICs), fraudulent offers to enter into installment agreements, and requests for collection due process hearings made only for delay;
- ◆ Terminating installment agreements when taxpayers fail to file returns or make tax deposits;
- ◆ Streamlining collection due process cases;
- ◆ Permitting the IRS to enter into installment agreements that do not guarantee full payment of a liability over the life of the agreement;
- ◆ Making counsel review of accepted OIC's more efficient without diminishing oversight over the offers that are accepted;
- ◆ Making payment of financial management services (FMS) fees for levies more efficient; and
- ◆ Authorizing private collection agencies to support the IRS's collection activities.

IRS Resources

The FY '05 budget earmarks \$300 million for IRS compliance activities. The total IRS budget would be boosted by 4.8 percent to \$10.70 billion.

IRS Audits 800 of Its Own
Employees

The IRS recently targeted 800 of its continuing efforts to enforce employee tax compliance. Commissioner Mark Everson plans to take additional steps, including education, outreach, as well as audits, to ensure that IRS employees are meeting tax filing payment requirements.