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Check 21—Proving Tax Deductions Without Cancelled Checks

- ◆ Check 21 eventually will do away with cancelled checks entirely. Banks may replace cancelled checks with “substitute checks” October 24, 2004. The following sample client letter may be sent to explain how Check 21 affects what proof clients must retain to be entitled to a tax deduction or credit or otherwise prove payment for tax purposes.

Re: Check 21—Proving tax deductions without cancelled checks

Dear Client:

The *Check Clearing for the 21st Century Act* (Check 21) became effective on October 28, 2004. The bottom line on what this means for most consumers is that in time you won't be seeing any of your checks ever again after you send them off as payment with a bill or other statement. Instead, Check 21 allows your bank to truncate each of your checks and create a new electronic negotiable instrument called a substitute check. After doing this, your bank generally will be allowed to destroy your original check as long as it has updated its “customer agreement” to do so.

How does Check 21 change the way I am able to prove an expense to the IRS to be entitled to a tax deduction or credit?

The short answer is that, for most taxpayers, Check 21 means you will need to keep your past bank statements in good order. The IRS reports it will accept bank statements that contain images of cancelled checks and/or substitute checks. To be used as proof, an account statement must show the check number, amount, payee's name, and the date the check was posted. A check image isn't required if the account statement itself covers all these items.

To keep track of your payments more easily for tax purposes, you should also maintain a careful check register. That way, you'll know where to look if you are audited.

Important Details

Banks are not being forced to jump on board to the new electronic Check 21 system. However, most have already done so and the rest are predicted to follow soon. If you receive cancelled checks with your account statement, Check 21 for the time being will mean that you might begin to receive a mixture of cancelled original and substitute checks. If you receive image statements (pictures of several checks on a single page), you also may notice that some of the pictures are of substitute checks.

Check 21 says you can use a substitute check as proof of payment because it is legally the same as the original check. The IRS, therefore, must accept your substitute check as proof of payment.

The IRS has indicated that it generally will accept image statements of substitute checks as proof of payment. However, as has been IRS policy for image statements of cancelled original checks, if an IRS auditor is suspicious that the image statement is not genuine, you may be requested to order the actual substitute check from your bank. This should be rare, however, and only if you are audited. Your record keeping obligations under the tax law are satisfied in the meantime by keeping your bank statements.

Of course, dealing with bank statements instead of cancelled checks is not as easy. Instead of separating your cancelled checks that involve a tax-return matter in a neat pile each month, you will need to devise other ways of keeping track. Some people circle tax-related payments in their check register, then review the entire register for the year at tax time (while making sure they have all bank statements in one place, too). Others circle tax items directly on their monthly bank statement; still others record tax payments in a separate notepad or computer file.

Online banking

What if you do all your banking and bill paying online? The same rules apply.

As a precaution, however, we suggest that you download and print out your bank statements at the end of the year. That way, even if you are audited several years from now, you'll have a record that's easy to access.

Company Vehicles

There are several things to keep in mind when purchasing vehicles for your company. These items are as follows:

- ◆ Company vehicles should be in the company name.
- ◆ Company vehicles should be covered by a company auto insurance policy.
- ◆ Any loans attached to company vehicles should be in company name.

If you have a company vehicle that is in your personal name, you should take the following steps to rectify the situation:

- ◆ Prepare minutes for corporate book stating that the company is purchasing a vehicle from individual.
- ◆ Contact Georgia Motor Vehicle Department-transfer tag and title from personal name to company name.
- ◆ If there is an existing lien on vehicle and lien is in individual name—contact lien holder and advise them that you are putting vehicle in company name but will still personally be guaranteeing loan.

There are risks involved when company vehicles are not titled personally and not in the company name.

- ◆ If the vehicle is titled personally but listed under a company auto insurance policy, the insurance company could deny coverage and benefits.
- ◆ Personally titled vehicles could allow the company veil to be pierced and you could personally be sued.
- ◆ The IRS could disallow any deductions associated with personally titled vehicles.

Sales Tax Deduction Option

The American Jobs Creation Act of 2004 gives taxpayers the option to claim state and local sales taxes instead of state and local income taxes when they itemize deductions. This option is available for the 2004 and 2005 returns only.

IRS Publication 600, *Optional State Sales Tax Tables*, helps taxpayers determine their sales tax deduction amount in lieu of saving their receipts throughout the year. Taxpayers use their income level and number of exemptions to find the sales tax amount for their state. The table instructions explain how to add an amount for local sales taxes if appropriate.

Taxpayers also may add to the table amount any sales taxes paid on:

A motor vehicle, but only up to the amount of tax paid at the general sales tax rate; and

An aircraft, boat, home (including mobile or prefabricated), or home building materials, if the tax rate is the same as the general sales tax rate.

For example, the State of Washington has a motor vehicle sales tax of 0.3 percent in addition to the state and local sales tax. A Washington state resident who purchased a new car could add the tax paid at the general sales tax rate to the table amount, but not the 0.3 percent motor vehicle sales tax paid.

Taxpayers will claim the deduction on line 5 of Schedule A, checking a box to indicate whether the amount represents sales tax or income tax.

While this deduction will mainly benefit taxpayers with a state or local sales tax but no income tax - in Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming - it may give a larger deduction to any taxpayer who paid more in sales taxes than income taxes. For example, you may have bought a new car, boosting your sales tax total, or claimed tax credits, lowering your state income tax.

Taxpayers may download Pub. 600 from the IRS Web site, or order it by calling (toll-free) 1-800-TAX-FORM (1-800-829-3676). The IRS has mailed Pub. 600 to all taxpayers who received a Form 1040 tax package.

What does this mean if you live in Douglas County with a 7% sales tax rate? A family of three earning \$45,000 a year is entitled to a deduction of \$936.25 for sales tax. If that family also purchased a motor vehicle during the year, then they are entitled to add the state (4%) sales tax paid on that purchase to their deduction. To claim the deduction you must file itemized and you may not deduct the state income tax withheld from your paycheck.

OTHER TIPS:

- ◆ New Law Encourages Tsunami Relief Contributions - Contributions made to qualified charities to help victims of the Tsunami can be deducted for tax year 2004 even if they are made in January 2005, under a new law enacted on Jan. 7.
- ◆ Combat Pay - Some military personnel receiving combat pay get larger tax credits because of two law changes. The new law counts excludable combat pay as income when figuring the Child Tax Credit and gives the taxpayer the option of counting or ignoring combat pay as income when figuring the Earned Income Tax Credit. Counting combat pay as income when calculating these credits does not change the exclusion of combat pay from taxable income.
- ◆ Child Tax Credit - Taxpayers with a credit amount more than their tax could get a refund of the difference, up to 10% of the amount by which their 2004 taxable earned income exceeds \$10,750. This percentage was raised to 15% for 2004, meaning a larger refund for many of these taxpayers.

**Please call if you have any
Questions 770-920-2890**