

## **March, 2004**

### **When You Owe Tax**

In earlier articles, this newsletter has addressed how to pay the IRS. As you know, you can now pay using a credit card. There is a charge for that imposed by the credit card company, not by the IRS. You can also have the office help arrange an installment agreement if you need additional time to pay the tax you owe. But that is not the topic of the day.

Rather, this article is to remind you now, during tax season, that the IRS very much wants to see you neither owe tax nor receive a refund. In other words, the optimum outcome is that you have paid the IRS sufficient tax during the year to cover your liability. Many taxpayers do this through payroll tax withholding, the amount of money withheld from their paychecks for federal taxes paid directly by the employer to the IRS. Others, primarily sole proprietorships, and those with partnership and/or significant investment income, need to pay estimated tax.

### **Do you need to revise the Form W-4 you provide to your employer?**

If your 2003 tax return shows that you do owe more than a minor amount of tax, might the office suggest that you retain its services to either help adjust your payroll withholding or set you up on a program of estimated taxes. If you receive a W-2 and you owe tax at year-end, this probably is an opportunity to adjust the number of exemptions you claim on the Form W-4. The W-4 is the form you provide to your employer, giving instructions on how much federal tax to withhold. The larger the number of exemptions claimed on the W-4, the less the withholding will be. If you receive a large refund, how about considering increasing the number of exemptions claimed on your W-4 so that you have more take home pay which you can use during the year, instead of waiting for that tax time refund. Again, recall that the IRS wants a break-even position. Getting a large refund at the end of the year, while pleasant, is not, as such, good. It means that you had too much withheld during the year. Why make an interest free loan to Uncle Sam?

### **Are you required to pay estimated taxes?**

If you find that your 1040 has the dreaded Form 2210 attached, then you are not paying enough in estimated taxes. Estimated taxes are paid 4 times during the year, by using the Form 1040-ES. Estimated taxes for the current year are usually pegged to the amount of tax liability for the preceding year, but there are variations permitted. If the office tells you to make estimated payments, please do so. Failure to follow through results in the penalty for underpayment of estimated tax, the Form 2210.

The office knows, when you come in to have your tax return done, the last thing you want to do is to think about the next year. But proper planning now and a check on the W-4 and the need for estimated taxes will not only benefit your cash flow but will make next tax season more pleasant than ever.

### **More Than One Way to Deduct Education Expenses**

Sometimes, the tax law is like a quilt. It is composed of various pieces of fabric. If you don't like one of the squares, look next to it. So it is with the Internal Revenue Code.

In the middle of last year, the United States Tax Court decided in *Zhang v. Commissioner* that the cost of an MBA degree for this taxpayer was not deductible as a business expense. It might have been helpful if Mr. Zhang had looked over the entire quilt.

### **Why was the deduction denied?**

Can the cost of an MBA degree be deductible? The court holds that, in the right circumstances, the answer is a resounding yes. The court states: In general, expenses which are ordinary and necessary in carrying on a trade or business are deductible in the year in which they are paid. Such expenses may include educational expenses paid in carrying on the trade or business of being an employee. To be deductible, such expenses must be for education which (1) maintains or improves skills required by the taxpayer in his employment, or (2) meets the express requirements of the taxpayer's employer, or of applicable law or regulations, imposed as a condition to the retention by the taxpayer of an established employment relationship, status, or rate or compensation. However, expenses which fall into either of these categories are nevertheless not deductible if the education (1) is required in order to meet the minimum educational requirements for qualification in the taxpayer's employment, or (2) qualifies the taxpayer for a new trade or business.

In the present matter, the court found that the MBA degree "in this case served to improve petitioner's "general understanding and competency", rather than to improve specific skills required in petitioner's employment. The judge drew support for this decision from two previous cases. In *Menas v. Commissioner*, the court held that courses in an M.B.A. program were not directly related to the skills used by an Internal Revenue Service agent. The decision in *Coughlin v. Commissioner* was similar. Courses required for a bachelor's degree in business administration provided only an increase in "general understanding and competency" and did not have a direct relation to the taxpayer's employment as a method and controls analyst for an insurance company. While the M.B.A. program did focus on "business administration", it was nonetheless a generalized field of study which provided an education in a number of areas not necessarily applicable to petitioner's employment prior to or after the year in issue."

Note that even an IRS Agent was audited by the IRS and the cost of the MBA degree was not allowed. It is possible, of course, that in your case your education is deductible because it does maintain or improve skills required in your employment. If so, the education could be deductible on Schedule C, for sole proprietorships, or on Schedule A, for employees.

### **Other ways to deduct education expense**

But the tax quilt also provides some other choices. Under Code Section 25A, you are entitled to a Hope Scholarship Credit or a Lifetime Learning Credit for education. If Mr. Zhang could not deduct the MBA as ordinary and necessary, he could have qualified under the Lifetime Learning Credit which, in 2003, would have saved him \$2,000 in tax (the credit base in 2003 is 20% of up to \$10,000 in expenses).

And there is another patch of the quilt. Instead of the Lifetime Learning Credit, Mr. Zhang could have claimed a deduction under Internal Revenue Code Section 222, which would have given him a deduction in 2003 of \$3,000. If he were in the 25% bracket, he would have saved \$750.

Moral: There is more than one way to salvage a tax deduction or tax credit. The office has the knowledge to provide you the benefit you are entitled to, even if it means examining the entire quilt.

### **Changes To Your 2003 Tax Return**

Congress passed several laws during 2003 that will impact the appearance of your individual tax filing. The Form 1040 for 2003 will look slightly different from the 2002 version of the form. Two new lines have been added to the form and one line has been deleted. In addition, the rules and requirements for some of the credits have been changed, and the change in the tax rates will have a noticeable effect on your final tax amount.

#### Qualified Dividends - New Line 9b

Your Form 1099-DIV will hopefully summarize the amount of qualified dividends that will be reported on Line 9b which is subject to a reduced rate. These rates are at a maximum of 5% and 15% depending on your marginal rate. The previous article, "Lower Taxes on Dividends" dealt with the tax effect of this change.

#### Post-May 5 Capital Gain Distributions - New Line 13b

The top tax rate for net capital gains on sales and other qualified dispositions (including installment payments) transacted after May 5, 2003, is generally subject to a reduced tax rate of 15% (5% for gains that would be taxed regularly at 10% or 15%). The eligible amount is reported on this line.

### Self-Employed Health Insurance - Line 29

In previous years, only a portion of self-employed health insurance was reported as an adjustment to income. The remainder was deducted on Schedule A if total medical expenses exceeded 7.5% of adjusted gross income. Beginning with tax year 2003, 100% of self-employed health insurance premiums are deductible on this line.

### Child & Dependent Care Credit - Line 45

For 2003, the amount of expenses eligible for this credit has increased from the previous year. Now you can use up to \$3,000 of expenses or \$6,000 for two or more qualifying persons. The credit percentage ranges from 35% down to 20%, depending on your adjusted gross income.

### Lifetime Learning Credit - Line 47

The maximum credit has doubled to \$2,000 for tax year 2003. Up to \$10,000 of qualified expense can be used to calculate the credit

### Child Tax Credit, Line 49

If you are not sure whether or not you received the \$400 advance payment for the 2003 Child Tax Credit you may verify this information with the IRS. You can contact them at (800) 829-1040 or go to [www.irs.gov](http://www.irs.gov) for more information. The credit on Line 49 should be adjusted for the receipt of this advance payment if you received it.

Some of the changes are obvious when you read the instructions for the forms, but others are not so obvious. For example, one of the most significant changes for individuals is the reduction in tax rates used to calculate your line 41, tax liability. There are now tax rates of 10%, 15%, 25%, 28%, 33% and 35%. These rates are significantly lower than those used in 2002.

Very Truly Yours,

Krebs & Co., CPA's, Inc.  
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