TAXPRO MONTHLY

Issue 9
Volume 28
September 2007

www.natptax.com

Inside This Issue

Tax Court Denies Claim of . . .

NOL and Theft Loss for Bad Investment Advice

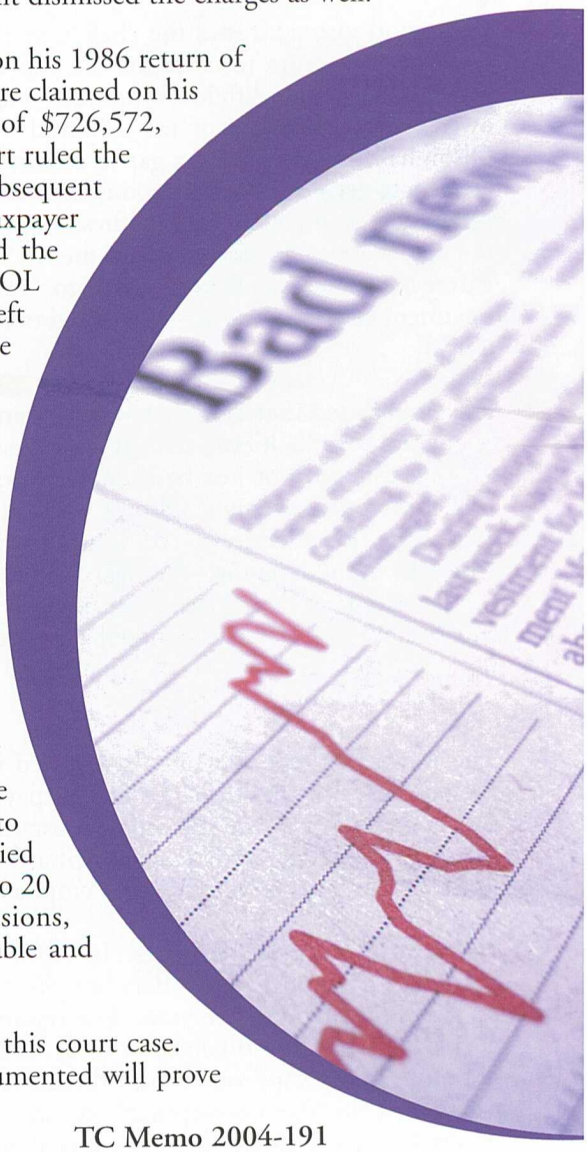
A taxpayer/investor claimed he suffered a theft loss because the brokerage firm "stole his money from him by supplying him with alcoholic beverages and allowed him to make unwise investments that benefited them directly." In 1978, 1979, and 1980, the taxpayer would go to the brokerage firm early in the morning where he started drinking and invested around $500,000 to $1 million in speculative securities. Most of his funds were exhausted during 1980. The taxpayer and wife later sued the brokerage firm in or around 1985 for liability of securities fraud, negligence, and breach of fiduciary duty. The U.S. District Court dismissed the lawsuit due to it being barred by the statute of limitations and failure to properly plead fraud. A later Court of Appeals in the Ninth Circuit dismissed the charges as well.

The taxpayer then proceeded to claim a theft loss on his 1986 return of $800,000. Net operating loss (NOL) carryovers were claimed on his 1997, 1998, and 1999 returns in the amount of $726,572, $726,572, and $703,308 respectively. The tax court ruled the taxpayer was not allowed a theft loss nor the subsequent NOL carryover. The tax court explained that the taxpayer had the burden of proving the NOL existed and the amount available for carryover. To prove the NOL existed, the taxpayer first had to prove that a theft occurred based on the law of the jurisdiction where the alleged theft took place. The taxpayer was not able to prove theft based on the limited records he presented. Even if the theft had been proven, the taxpayer did not prove what portion of the NOL was available for carryover.

In proving what portion of the NOL is available for carryover, the taxpayer needs to show the carryback was properly handled. This can be done in two different ways; either the taxpayer can elect to forgo the NOL carryback under IRC §172(b)(3), or he or she can apply the NOL carryback to applicable carryback years, even if this does not result in a refund because the statute of limitations has expired. The taxpayer needs to prove how much of the NOL carryover was applied going forward; this means keeping records for up to 20 years, under current NOL carryover provisions, depending on how much of a carryover is available and how long it takes to consume it.

Documented proof is important as we can see in this court case. The NOL carryback and carryover properly documented will prove the amount available for carryover in open years.

TC Memo 2004-191



NATP
National Association of Tax Professionals

Please Route: _____ _____ _____ _____ _____

Return To: _____ *Noteworthy:* _____

By Michele Knight, CPA, CEA, and NATP Member

Starting a small business is a wonderful feeling. No more bosses, no more red tape, no more endless forms and paperwork…but, then again, no more paycheck, no more expense reimbursements, no more corporate office to answer questions. You may have heard the warnings or experienced the shock of owing considerable taxes at year end. This article aims to help you and your clients lower their year-end tax bill. Whether you are starting your own business or counseling a client on starting theirs, read on!

Self-employed individuals fit into many categories. The most common forms of self-employed are sole proprietors and partners, however independent contractors and members of LLCs that are taxed as a partnership or disregarded entity are usually considered self-employed as well. If you are self-employed, you will not receive a W-2 at year end; therefore, you must report your income on Schedule C, *Profit or Loss from Business,* of the 1040 U.S. Individual Income Tax Return or on a Form 1065, *U.S. Return of Partnership Income.*

The primary difference between those who receive a W-2 and those who file as self-employed individuals is the self-employment tax, a.k.a. FICA. An employee receiving a paycheck will notice that 7.65% of their wages are withheld from each check, broken out as 6.2% for Social Security and 1.45% for Medicare. An additional 7.65% is matched by their employer and sent to the Internal Revenue Service on a periodic basis on the employee's behalf. Self-employed individuals owe the entire 15.3% of their profits, since there is no employer involved to provide a matching contribution.

While this may seem to be a downfall, self-employed individuals can take advantage of many other tax deductions. According to the IRS, taxpayers with small businesses may take deductions for any expenses that are both ordinary and necessary. Ordinary expenses are common and accepted in a given industry. Necessary expenses are helpful and appropriate for a line of work but do not have to be indispensable to be deductible. The IRS divides expenses into four categories: business expenses, cost of goods sold, capital expenses, and personal expenses. For the purposes of

this article, I am grouping expenses into simply business or personal categories, but you should also consider whether an expense qualifies as cost of goods sold or a capital expense.

I offer a simple test to my clients to help them start determining which expenses are deductible. Instead of repeating the IRS definitions, I help them base their decision on the answer to one question, "Would you have incurred the expense if you were not in business?" This helps a new business owner draw the line between business and personal expense. For example, a business owner purchases groceries whether they are in business or not, however an individual would almost never pay merchant service fees if they hadn't opened up an online business.

Once you understand the nature of business expenses, it's time to look at the details. Schedule C shows 20 lines of expenses, while the partnership return only shows 12 lines. Both have a line item for "other expenses" which is linked to a schedule listing whatever expenses a business has that do not fit into the detailed lines. Every year I chuckle that common expense categories such as bank charges and continuing education do not appear on the return and must be reported under other expenses, but the tax forms have a specific line item for depletion (an expense category rarely used, except in the case of a company with stocks of natural resources).

When it comes to specific self-employment expenses, I find that certain categories are more complicated than others. Let's start with the simple categories. Advertising, insurance, interest, legal and professional services, rent, repairs and maintenance, and supplies tend to be straight forward, as long as you keep in mind the "would you have incurred this expense if you weren't in business" guideline.

Other categories aren't so simple. While I can't go into the details of each expense in this article, I want to highlight a few to give each reader food for thought.

- Auto expenses can be an enormous benefit to the self-employed individual, and they have a choice between two methods of calculation called the standard mileage rate or the actual expenses.
- Office expenses need to be carefully considered to determine whether expenses are fully deductible in the current year, should be capitalized and depreciated over a period of years, or in the case of a home office, deducted on Form 8829, *Expenses for the Business Use of Your Home*. As a side note, home office deductions were once a red flag to the IRS, but I believe that the trend is shifting with the growth of the Internet and the ease of working from home. As long as you have a portion of your home that is used exclusively and regularly for administrative or management activities for your trade or business, I do not see a problem with taking a legitimate home office expense.
- Most meals and entertainment expenses are only 50% deductible, because the tax law takes into consideration that you would've eaten a meal whether you were in business or not.
- When recording employee paychecks, be careful to deduct the full amount of wages, not just the amount the paychecks were cut for. This is a commonly missed deduction, because business owners forget that they can deduct the gross wages, and not just the net pay.

And lastly, the most important lesson I can spread about self-employment expenses... document, document, document. Not only will it protect your deductions in the event of an audit by the IRS, but I have seen a direct correlation in the quality of a business' recordkeeping and their tax liability. When I am asked what the best method is for saving money on taxes, the answer is simple – document! Owning a small business has been a rewarding experience for my husband and me, and keeping our taxes low is just a wonderful perk!

Biography

Michele Knight co-owns Knight Accounting and Technology, LLC with her husband David in Dillon, Colorado. She graduated from St. Michael's College in Vermont with degrees in Accounting, Business Administration, and Economics. She enjoys helping individuals and small business owners with tax preparation, tax planning, and financial management. Her greatest satisfaction comes from helping small business owners lower their tax bills and grow their businesses. She is a frequent author for Thompson Tax and Accounting publications, and consults on Sarbanes Oxley projects. For more tax resources, please visit *www.cpamichele.com*.