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Client Information Bulletin

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Can You Deduct All of Your Mortgage Interest?

Spelling out the roundup of key tax rules for personal returns

If you are like most established individuals, the biggest asset you own is the home where you live year-round or most of the time. Of course, you don't exactly "own" your home if you are still making mortgage payments to the bank. So it stands to reason that one of the biggest tax deductions on your personal tax return is the one for mortgage interest.

How much mortgage interest can you deduct? Answer: It depends. Here is a quick review of the current rules.

Acquisition debts: You may fully deduct the mortgage interest paid on loan proceeds used to buy, build or substan-

tially renovate a home if the loans are secured by either your principal residence or one other home (e.g., a vacation home). **Key limit:** The total principal amount of the acquisition debts cannot exceed \$1 million.

Home equity debts: When it is permitted by state law, you also may fully deduct the interest on home equity loans secured by a qualified residence. But the total amount of such loans is limited to \$100,000. Also, these amounts cannot exceed your equity in the residence (the home's value less other loans). With a home equity loan, you can use the loan proceeds any way that you see fit.

Any mortgage debt existing prior to October 14, 1987, known as “grandfathered debt,” is treated as acquisition debt regardless of the amount. The mortgage interest on post-October 13, 1987, acquisition debt is deductible on debts up to \$1 million; the interest on home equity debt on debts up to \$100,000.

If a grandfathered debt is refinanced, it is treated as acquisition debt up to the amount of the existing debt. This amount is treated as grandfathered debt only for the remaining term of the original debt. Any excess may be treated as acquisition debt or home equity debt, but the total debt cannot exceed the fair-market value of the home.

Points: You may be required to pay “points” up front when you take out a mortgage. The points are currently deductible as mortgage interest only if paid to purchase, build or improve a home. For example, if you pay points on a home equity loan used to buy a new car, the points must be deducted over the loan period. But if the proceeds are used to finish your basement, the points are currently deductible.

Of course, when you refinance an existing mortgage, any points you are required to pay must be deducted over the life of the loan.

Caution: There is another major tax limit to contend with. If your adjusted gross income (AGI) for the year exceeds a specific threshold (\$150,500 on your 2006 return), your total itemized deductions (other than those for medical expenses, casualty and theft losses, gambling losses and investment interest) are reduced.

The reduction generally is equal to 3% of your AGI above the threshold. However, in no case can the overall reduction exceed 80%.

Note: *Mortgage lenders are required to report the mortgage interest you pay each year. But don't automatically assume that the figure provided by the lender is correct. Check to make sure that all the qualified interest you paid in 2006 is reflected on the forms you have received.*

Pinpoint New Per Diem Rates for Business Travel

Using IRS-approved method of substantiation

The IRS pays close attention to deductions claimed for business travel expenses. As a result, both employers and employees must meet strict record-keeping requirements or face the consequences. Fortunately, you can obtain some relief by using IRS-approved per diem allowances in lieu of accounting for every expense.

The per diem rates are actually the allowances approved for travel by U.S.

government employees. However, a business owner cannot use either type of per diem allowance if he or she owns 10% or more of the company.

There are two basic per diem rates. The first rate is based separately on the employee's travel destination. The second rate depends on the annual “high-low” rates established each year for certain areas.

Starting point: As long as employees properly account for their business travel expenses, including the cost of meals and lodging, employer-paid reimbursements are tax-free to the employees and deductible by the company. But this can lead to a record-keeping nightmare. With a per diem allowance, employees don't have to keep receipts for all of their travel expenses. The employer simply pays the government-approved allowance -- no muss, no fuss.

Employees don't even have to report the payments on their tax return. However, they still must substantiate the time, place and business purpose of their business travel.

In addition to adjusting the allowances for each specific travel destination, the government establishes a flat rate for certain high-cost areas. The list of high-cost areas includes industry centers like New York and Chicago. In addition, other areas may be included on a seasonal basis, such as Miami in the winter or Nantucket in the summer. All the locations that are not listed as high-cost areas automatically fall into the low-cost category.

New rates: The IRS recently announced new per diem rates for the 2007 tax year.

It has increased the approved per diem rate for high-cost areas to \$246 (\$188 for lodging plus \$58 for meals and incidental expenses). That represents a substantial \$20-per-day increase from over a year ago. In recent years, the annual increase has been only a few dollars.

The IRS-approved per diem rate for all other destinations is \$148 (\$103 for lodging and \$45 for meals and incidental expenses). This represents a \$7-per-day increase from the \$141 rate established a year ago. Note: These new rates may be used for business travel expenses incurred after September 30, 2006.

To reduce the paperwork burden, you might use the high-low method for employees who travel extensively, especially if they generally are traveling to major cities. On the other hand, you can require other employees to use the specific-location method if they frequently travel to low-cost areas. Finally, you can have those employees who travel infrequently keep detailed records of their actual expenses.

End of the line: Consult with your professional tax advisers for the particulars that apply to your company's situation.

New Training Methods for the Workplace

Implementing ideas to improve employee performance

After reducing the size of its staff, a company may look more productive “on paper.” But that leaves fewer workers to handle the workload. As a result, more companies are relying on technological advances to pick up the slack. This is not always as easy as it seems.

To rectify this situation, the remaining workers have to work smarter. That doesn’t simply mean working faster. It does mean working in teams, making quick effective decisions without going to a higher management level, recognizing problems and devising solutions, and pushing available technologies to the limit.

How can this be accomplished? Of course, it helps to hire qualified employees in the first place. But even the best and brightest employees may have some catching up to do. It may be necessary to implement a new training program for employees.

Of course, training methods have changed just as fast as everything else in the workplace. Here are four ways to keep workers up-to-date.

1. Classroom teaching can be an effective way to train workers, especially in more basic skill areas. Community colleges are often a good resource for companies. Almost all of them have evening classes, while many also hold classes early in the morning.

Frequently, these schools will work with your company to create specific courses for your employees and schedule them at

off-hours. In some cases, the courses are given right on the business premises.

2. Consider audio and video tapes and similar media that enable employees to improve their skills in the car or at home. Besides providing flexibility, media may hold an employee’s attention better than a classroom lecture.

Also, a video may demonstrate skill techniques, present information in a dramatic and meaningful way or highlight information by means of charts and graphs in ways that might not be easily done in a classroom. It can even bring an employee into a new facility before it is completed.

3. Computer-based training may also help employees improve certain skills. For example, some educational software companies have developed courses so employees can progress at their own pace. A course may even have a built-in examination that is graded by the computer on the spot.

4. One of the latest technological advances in training is the interactive video disk. Computers with CD drives and video cards, as well as home interactive video systems, can be used as powerful training tools. They are designed to combine some of the best aspects of classroom instruction, video courses and computer-based educational software.

In effect, employees go one-on-one with the interactive course. The courses can truly be multimedia lessons, with text, graphics, voice, music, motion pictures, charts, graphs and animation aids added

to the mix. Training progresses at the learning pace of each individual employee instead of a teacher's pace or the pace of the slowest learner.

Which type of training is best for your company? There are many factors to consider, such as the skill level of your

employees, their current duties and your expectations.

In any event, those companies that focus on teaching their employees new skills can maintain an edge in this competitive environment.

Set Your Clocks by "Internet Time"

Time is usually a critical factor in the business world. But time commitments that were acceptable years ago may no longer be adequate. Not in this age of instant communication.

Instead of using regular time as a measuring stick, you might operate on "Internet time." Business managers have begun to realize that they must schedule projects under this new timeframe.

Case in point: New product development may have to speed up from years to months. Other projects should be reduced from months to weeks or even days. Decisions that previously took days to make must be researched, analyzed and delivered in hours.

How important is this? If you are not measuring work in Internet time, you are probably falling behind the competition. And that is not something that many companies can afford to do.

How to Spread Out Estate-tax Payments

Special election for estates of business owners

Although you may have spent years building up a business, your family may be forced to sell it soon after your death to pay the federal estate-tax bill. The full amount of the estate tax is generally due nine months after an individual's death. Although the federal estate tax is scheduled to be repealed in 2010, it will be revived in 2011 unless subsequent legislation is enacted. However, there is some possible estate-tax relief if a family inherits a small business.

Key point: Assuming the estate qualifies, an election can be made to pay no tax on the business interest for five years. What's more, subsequent payments can be stretched out over ten years. **Result:** The family can take up to 15 years to pay the tax. (Actually, it is a 14-year period, since the due date for the last installment of interest coincides with the first installment of tax.)

There is one catch. Interest must be paid each year on the unpaid portion of the tax. But the estate pays only 2% interest on the amount attributable to the first \$1 million (adjusted for inflation) of the taxable value of the business interest.

For 2007, the adjusted figure is \$1.25 million. The interest rate for tax underpayments applies to amounts in excess of the \$1.25 million threshold.

When does an estate qualify for the estate-tax deferral? Generally speaking, the business must comprise at least 35% of the adjusted gross estate. Your adjusted gross estate is the gross estate less any expenses, debts and losses.

In addition, you must have operated the business as one of the following: (1) a sole proprietor; (2) a partner with an interest of 20% or more in the partnership, or with an interest in a partnership that has no more than 45 partners; or (3) a corporate stockholder owning 20% or more of the voting stock, or owning stock in a corporation with no more than 45 shareholders.

Finally, a proper notice of election must be attached to a timely estate-tax return.

Caution: *The benefit of this special provision may be lost if all the technical rules are not observed. Consult with a professional estate-planning expert.*

Facts and Figures

Timely points of particular interest

- **Improved Tax Mileage** -- The IRS has announced the annual increase in the standard mileage rate for business drivers. For the 2007 tax year, you can deduct a flat rate of 48.5 cents for every business mile traveled (up from 44.5 cents per mile in 2006) plus business-related tolls and parking fees. This deduction may be claimed in lieu of deducting your actual expenses for business use of a vehicle such as depreciation, oil and gas, insurance, repairs, etc.
- **Pass-through Entities** -- According to a recent report by the U.S. Treasury Inspector General for Tax Administration (TIGTA), we are experiencing substantial growth in the number of S corporations and partnerships. For the period between 2000 and 2004, S corporation and partnership returns increased from 4.96 million to 6 million (up 21%). The annual returns for these pass-through entities are projected to reach 8.49 million by 2012 (up 42% from 2004).