November Monthly Newsletter 2014

*** IRS UPDATE: Tangible Property Regulations ***

In September of 2013, the IRS issued regulations, required to be employed on tax year 2014 returns, that created guidelines for treatment of tangible property expenditures, whether tangible personal or real property. These new tangible property regulations (TPRs) provide guidance on the capitalization and depreciation of capital expenditures, the treatment of materials and supplies, and the opportunity to write off all or a portion of an asset when disposed of. The regulations are over 200 pages with 170 examples of implementation. Final guidance on these regulations was just issued in September of 2014. *They present new risks and opportunities that affect taxpayers in every industry that owns depreciable capital assets, spends funds on repairs and maintenance, and/or material and supplies.* Below is a summary of the new regulations and how they will impact your business.

Required Tax Filings

The good news of the TPRs is that taxpayers who have significant fixed assets with remaining depreciation or real property will typically have large current and future tax deductions. In order to obtain these tax deductions, a significant amount of "one time" work and related IRS tax filings need to occur, and occur by tax year 2014. This work relates to accounting method change forms. On the other hand, taxpayers who have been able to write their asset acquisitions off under bonus or Section 179 deductions will see minimal tax deductions but are still subject to the "one time" new tax filing requirements for 2014.

It is unfortunate that the IRS has required the majority of the TPRs to be implemented: (a) retroactively, and (b) via the filings of numerous additional required special tax forms for tax year 2014. Retroactive application of the TPRs requires taxpayers to revisit every asset on its depreciation schedule to see if it should have been capitalized under the new capitalization rules or criteria (see below). If a prior asset/expenditure does not qualify as an asset under the new principals, it must be written off by 2014, or the opportunity to write off that item by tax year 2014 will be lost. The scary part of the TPRs is the threat of the IRS to disallow any future depreciation for prior items that do not pass the new capitalization criteria. Example, ABC, Inc. capitalized a $40,000 roof expenditure ten years ago. After applying the new criteria, it is determined that the remaining tax depreciation of $30,000 should be written off in 2014. If ABC does not properly complete the "one time" tax filings in their 2014 return, ABC will permanently lose $30,000 as a tax deduction. It is not allowed to continue to take annual depreciation for this item. Even if ABC did not have a tax deduction to take for tax 2014, ABC still has to file those numerous "one time" tax forms. Additionally, the IRS requires that the accounting method change forms not all be filed together. This will require several different sets of these forms to be filed.

The word "required" used above is very important to us as your tax return preparers. As CPAs and as your tax preparer, we are required to follow the rules and restrictions of our state and federal licensing parameters. Those parameters subject us to very large preparer's penalties and sanctions, should we not follow them. One of those rules and regulations prohibits us from preparing and/or signing your 2014 return unless that return includes the new TPR implementation and form submissions.

Capital expenditures

Taxpayers and their accountants have always faced the challenge of differentiating between what are capital improvements or repair and maintenance expenses as they sought the balance between accurately reflecting business profits verses maximizing tax deductions. The new TPRs dictate that expenditures must be written off as repairs if they are not required to be capitalized. That is, repairs and maintenance are the opposite of what is required to be capitalized. Consequently, an understanding of the capitalization rules is imperative. Rule: a taxpayer must capitalize any amounts that are paid to improve a unit of property or assets purchased. One makes an improvement to a unit of property if it is deemed to be betterment, a restoration, or adaption to a new or different use. The employment of this guidance is heavily fact specific. While there are no bright line tests, there are now known specific criteria that need to be applied to the expenditures. The new criteria also require a thorough review of the past and future expenditures on improvements. That review will determine if prior capitalized expenditures should now be written off and will determine whether future ones will be capitalized.

Unit of Property

The foundation of the capitalization rules is in the comparison of the expenditure to the unit of property. A unit of property consists of a group of functionally interdependent components. In other words, if placing one component in service is dependent on placing another component in service, then they are functionally interdependent and considered one unit of property. For example, a truck and its components (engine, tires, etc.) are one unit of property because each of those components needs to be placed in service at the same time in order for the truck to function. The regulations have special rules for buildings. In general, a building and its structural components are one unit of property. Examples of the structural components would be roofs, walls, floors, ceilings and other items that relate to the operation of a building. There are also certain "building systems" that the regulations have defined as separate units of property. These building systems include HVAC system, plumbing, electrical, escalators, elevators, fire protection, alarm/security and gas distribution. Even though a building is one unit of property, the capitalization criteria must be applied at the building structure or system level, and then even smaller comparisons for any item that performs a material and discrete function.

New Capitalization Criteria

Once a unit of property is defined, a taxpayer then needs to determine if the amounts paid result in a betterment, restoration or adaption to new/different use, as follows:

Betterment: Funds spent to correct a material defect/condition that existed prior to the acquisition of a unit of property; result in a material addition to the unit of property (i.e. enlargement, expansion or extension); and/or result in a material increase in capacity, productivity, efficiency, strength, quality or output of the unit of property.
Restoration: Funds spent to return the unit of property to its ordinarily efficient operating condition if the property was in disrepair and no longer functional; replacement of a component of a unit of property where a gain/loss is recognized on the component; rebuilding the unit of property to a like-new condition after the end of its class life; or the replacement of part(s) that comprise a major component, large physical portion, or substantial structural part of the unit of property.

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New/Different Use: Funds spent to adapt a unit of property to a new or different use if the adaption is not consistent with the taxpayer's original intended use of the unit of property when acquired.

Example: Able Contractors LLC purchased a bulldozer tractor in 2008. In 2014, it paid $20,000 to have the engine and transmission rebuilt and everything repainted. Under the new regulations, this cost would fall under the restoration category discussed above and would be required to be capitalized. The applicable class life for a tractor is 6 years and in this example the item was rebuilt to a like-new condition after the end of its class life. Let's assume the same facts but the bulldozer was purchased in 2010. As the class life of the tractor (6 years) does not end until 2015, the expenditures could be deducted.

Routine Maintenance Safe Harbor (RMSH)
The IRS offered some opportunities in the regulations by acknowledging that taxpayers do incur expenditures that assist in keeping a unit of property in its efficient operating condition. As a result, the IRS created the RMSH rule that allows taxpayers to expense certain costs that are routine and reoccur at specific times during the use of unit of property. For personal property, an activity is reoccurring if you expect to do it more than once during the applicable class life of the unit of property. The RMSH has special rules for buildings and their structural components. In the case of a building and/or its components, an expenditure can be treated as a repair & maintenance if one reasonably expect to perform it more than once over a 10 year period of time.

De Minimis Safe Harbor (DMSH) to acquire property
When a taxpayer purchases a unit of property, generally capitalization is required; however, the IRS provided some relief under the TPRs by creating a DMSH exception. This exception allows taxpayers to immediately deduct amounts they pay to acquire or improve property, if the taxpayer complies with all of the DMSH rules. The DMSH rules can be applied by all taxpayers if the rules are met. First, one must have a capitalization policy in place before the tax year starts. This policy must specify that an expenditures under a certain dollar amount (i.e. like $1,000 and under). Additionally, the taxpayer must have an invoice, and deduct the expenditure on its books. Under the regulations, taxpayers who have an applicable financial statement (AFS) are granted safe harbor to be able deduct up to $5,000 of the cost of an item of property (per invoice) or expenditure. For those who do not have an AFS, the $5,000 safe harbor is reduced to $500 per item. Although the regulations state the $5,000/$500 as safe harbor limits, the capitalization policy should be set to an appropriate level for your business. During an IRS audit, the taxpayer has the burden of proving to the IRS that the amount paid in excess of the safe harbor was reasonable. The DMSH is a safe harbor and not a restricted ceiling limitation. Example: XYZ, Inc. does not have an AFS, has a written policy in place before tax year begins that states they will expense property that costs $500 or less. XYZ purchases 25 items that cost $400 each on a total invoice of $10,000. Since XYZ has a written policy in place and each item (unit of property) is $500 or less, XYZ must expense the full $10,000 paid if it writes these items off on its books.

Disposals
As another positive aspect of the TPRS, it also allows taxpayers the opportunity to partially dispose of duplicate portions of property, including buildings and their structural

components. Historically, for example, if one replaced a roof on a building and capitalized the replacement costs the taxpayer was not allowed to dispose of the prior roof. Under the TPRs, a taxpayer can elect to dispose of the prior roof. These partial asset dispositions provide an opportunity to write off duplicable assets for tax years prior to 2014 and are only available through the filing of the 2014 tax returns.

Materials and Supplies

Materials and supplies (M & S) are defined as tangible property, excluding inventory, which is used or consumed in operations and is: either (a) A component acquired to maintain, repair or improve a unit of tangible property, (b) bulk, such as fuel, water, lubricants and similar items that are reasonable expected to be used in 12 months or less, (c) temporary or emergency spare parts, (d) units of property whose useful life is 12 months or less, or (e) a unit of property with a cost less than $200. Once an item is determined to be M & S, the regulations require a taxpayer to classify these M & S as either incidental or nonincidental. Incidental materials and supplies can be deducted when they are purchased. On the other hand, nonincidental materials and supplies are required to be deferred and deducted in the year they are used or consumed. No later than tax year 2014, taxpayers are required to defer and keep a physical inventory or a record of consumption for its nonincidental M & S. This rule is trumped, up to the taxpayer's DMSH. Taxpayers must review and adapt its accounting by tax year 2014 to conform its treatment of M & S to the TPRs. Example, Bob's Wood Shop has temporary machine parts and bulk wood treatment on hand at tax year end 2014, that are above its DMSH. Bob's has to defer, and not take as tax deduction in 2014, these items.

While the new regulations are complex, understanding how they impact your business is critical to maximizing tax deductions while maintaining tax compliance. Past decisions regarding the materials and supplies (M & S) expenditures, as well as the capitalization or write off of repairs and maintenance (R & M) must be reviewed to determine what changes are necessary under the new regulations. These changes will require the filing of certain IRS tax forms no later than the filing of your 2014 tax return while other changes are either new annual elections or choices.

Now that we finally have guidance, we need to begin working on these changes immediately since filing them timely with the 2014 tax return will provide audit protection for changed accounting methods for the years that are still open. Please note this is strictly compliance work that we do not actively seek out (we have enough of this type of work), but necessary nonetheless. We anticipate 2 – 6+ hours of preparation time to complete the regulations implementation forms. We will begin work on your form in the fall of 2014. Due to the limited amount of time we have to accomplish this, it may be necessary to obtain an extension of time to file your 2014 tax return. We must review all items on your depreciation schedule and repairs/maintenance for the last three years for compliance with these new regulations. **Please contact us immediately with questions and to authorize initiation of this work. The sooner we hear from you, the less likely your tax return will be put on extension. Please note that we will not be able to sign your tax return without necessary accounting method change forms attached. If you have no questions and wish for us to proceed immediately, please sign the attached engagement letter and send back to us so we can start on this task.**

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IRS Repeats Warnings About Identity Theft

The IRS is again warning taxpayers to be on the alert for tax scams. According to IRS Commissioner John Kaskinen, millions of taxpayers have already been taken in by scammers impersonating IRS agents.

Whether initiated by sophisticated overseas operators or homegrown con artists, all bogus IRS schemes have a similar objective in mind: to steal your identity and gain access to your accounts. Phony IRS agents often use common American names and fake badge numbers. To enhance legitimacy, they may provide limited personal information about you, such as the last four digits of your social security number or birth date. Others may manipulate caller ID to show that the call originated from Washington, DC. If you reply to a call-back number, an answering machine may announce that you've reached the criminal investigation division of the IRS. A fraudster may even become aggressive and threaten jail time if you don't comply with his demands, then hang up and direct a co-conspirator to call back in the guise of a local policeman.

Some employ a different tactic, offering a carrot instead of a stick. You may be told that the IRS owes you some money. But to get your proffered refund you'll need to disclose bank account numbers and other personal information.

Crooks have used e-mail and other forms of electronic communication as well to perpetrate the scam. The text may include links to sham websites designed to mimic official sites, encouraging you to fill in forms with confidential data such as bank account numbers and passwords. E-mail attachments may contain malicious code designed to infect your computer or allow unauthorized access to your financial information.

How can you tell whether the IRS is really contacting you? The agency's official website (*www.irs.gov*) makes it quite clear: The IRS "does not initiate contact with taxpayers by e-mail to request personal or financial information. This includes any type of electronic communication, such as text messages and social media channels." The IRS website further states that the agency "will always send taxpayers a written notification of any tax due via the U.S. mail." IRS agents will never ask for credit card, debit card, or prepaid card information over the telephone. Nor will they ask for PINs, passwords, or other confidential access information.

If you think you might actually owe taxes, call the IRS directly. If you receive a call that appears bogus, ask for a call back number and employee badge number. Then report the details to the Treasury Inspector General for Tax Administration and the Federal Trade Commission (FTC) using their "FTC Complaint Assistant" at *FTC.gov*.

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Self-employment Gives You Some Tax Breaks

When it comes to taxes, being self-employed has some advantages. Whether you work for yourself on a full-time basis or just do a little moonlighting on the side, the government has provided you with a variety of attractive tax breaks.

- **Save for retirement.** When you're self-employed, you're allowed to set up a retirement plan for your business. Remember, contributing to a retirement plan is one of the best tax shelters available to you during your working years. Take a look at the SIMPLE IRA, SEP IRA, or Solo 401(k), and determine which plan works best for you.
- **Hire your kids.** If your business is unincorporated, employing your child under the age of 18 might make sense. That's because your child's earnings are exempt from social security, Medicare, and federal unemployment taxes. This year, your son or daughter can earn as much as $6,200 and owe no income taxes. You get to deduct the wages paid as a business expense.
- **Deduct health insurance.** Are you paying your own medical or dental insurance? How about long-term care insurance? As a self-employed individual, you may be able to deduct 100% of the cost of these premiums as an "above the line" deduction, subject to certain restrictions.
- **Take business-use deductions.** Self-employed individuals can also deduct "mixed-use" items directly against their business income. Use your car for business and you can deduct 56¢ per business mile driven. The business-use portion of your computer purchases, Internet access, and wireless phone bills is also allowable. And if you meet the strict requirements, claiming the home office deduction makes a portion of your home expenses tax-deductible.

Please give us a call to find out more about the tax breaks available to self-employed individuals.

More Businesses Are Using Part-Time Workers

Recent job statistics indicate that more employers are using part-timers to deal with variations in workload and for short-term projects. Here are a few tips your business will find useful if you hire part-time workers.

- **Communicate clearly with the part-timer.** Explain the person's duties, the hours and benefits, and the individual to whom the part-timer will report.
- **Tell your full-time staff why you're hiring the part-timer.** Make it clear what that person will and won't be expected to do.
- **Provide introductory training for the part-time worker.** Assign someone the new person can turn to with everyday questions.
- **Monitor the part-timer's progress.** Provide feedback on performance and recognition for doing a good job.

Pay attention to these points if you want hiring part-time workers to be a good choice for your company.

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Contact Us Soon For A Year-End Tax Review

An important part of our service to you is to help identify actions you can take before year-end to minimize your 2014 income tax bill. Accelerating or delaying income and deductions, contributing to retirement plans, and taking investment losses are just a few of the strategies you might want to consider. There are also tax credits that require careful planning or they may be lost. If you'd like to discuss tax-cutting options that fit your particular situation, please contact us soon for a year-end planning review.

Portal News & Tips

Edition 1.9

Here at Stephenson and Warner we take great care with your sensitive information. We have been using "The Portal", our secure file sharing system, to share documents with you for years. We remain committed to keeping your personal and company information private and safe and choose not to email a copy of your tax return to you or a third party. Now that tax season has passed the portal remains up and ready to receive your information or gain access to electronic copies of your returns.

Common Questions:

- ✓ **Why is the password I created not being accepted by the system?**
  - Sharefile (portal) has added protection measures to better safeguard your secure documents. Passwords must now be 8 characters long + contain one capital letter + contain one lowercase letter + one number.
- ✓ **I still can't get on the system with my password. What do I need to do now?**
  - Please give me us a call. We can reset your password from the office. You can then change your password at a later time when it is more convenient to you and still access the documents you need today.

We use real problems and questions that come to us each month.
Do you have additional questions?
Email me at: thughett@stephensonwarnercpas.com.
We might even use them in our "Portal News & Tips" edition next month!

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