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## Inside this issue



Tax & Business letter

SPRING 2014

# IRS issues "repair regulations" for 2014

To expense or to capitalize? If you buy, build, or repair business assets, you might ask that question when deciding whether your costs are currently deductible on your federal income tax return or whether they're considered capital improvements. Since deductions for capital improvements are typically spread over the life of an asset, the answer can be important even when accelerated depreciation methods are available.

New tax rules can make the expense-or-capitalize decision easier. These "repair regulations" provide guidelines and safe harbors to help you determine when certain purchases and expenditures are considered repairs, maintenance, improvements, materials, or supplies that can be deducted in the year of purchase. Here's an overview of safe harbor rules that may affect the way you classify expenses.

► *De minimis purchases.* In general, you can deduct the cost of tangible property purchased during a taxable year if the amount you pay for the property is less than $500 per invoice, or per item. This is an all-or-nothing rule, meaning if an asset costs more than $500, you cannot take a partial deduction.

To take the deduction, you'll need a written accounting policy in place by the beginning of your tax year, and you're required to file an annual statement with your federal tax return.


► *Repairs and maintenance.* You can expense costs for routine maintenance of buildings and other property. For buildings, "routine" means maintenance you expect to perform more than once in a ten-year period. The costs for material additions or defects or for adapting your property to a new or different use are not considered routine maintenance, and they should be capitalized.

For other assets, "routine" is defined as maintenance you expect to undertake more than once during the asset's depreciable class life.

► *Improvements.* Generally, improvements you make to your business building are capitalized and depreciated over the life of the building. Under the new rules, if your business's gross receipts are $10 million or less and the unadjusted basis of your building is $1 million or less, you may choose to write off the cost of improvements.

You can make the election annually on a building-by-building basis for property you own or lease by filing a statement with your tax return. To qualify, the total amount you pay during the year for repairs, maintenance, and improvements cannot be greater than $10,000 or 2% of the unadjusted basis of the building, whichever is less.

*Note:* The total includes amounts you deduct under the "repairs and maintenance" and "de minimis" safe harbors.

► *Materials and supplies.* Incidental materials and supplies costing less than $200 can be expensed in the year of purchase.

*Note:* This safe harbor does not affect prior rules for deducting materials and supplies, such as restaurant smallwares.

The repair regulations will affect your 2014 federal income tax return. In some cases, you can apply the new rules to prior years. Please call us for additional information. ◆

# If you make gifts, you may be required to file a gift tax return

Are you planning to give sizeable gifts to family members this year? Due to generous provisions in the tax code, you may not owe any federal gift tax, but you still might be required to a file a gift tax return.

Here's a quick review of the basic rules. Despite a common misconception, gift tax is paid by the gift giver, or "donor," not the recipient, or "donee." This applies to gifts of cash, property, and other interests. For 2013 and thereafter, the top gift tax rate is permanently set at 40%, a slight increase from 35% in 2012. However, you may be able to avoid gift tax liability due to two key tax breaks.

### Annual gift tax exclusion

Under the exclusion, annual gifts to a donee valued up to $14,000 in 2014 (the same as in 2013) are completely exempt from gift tax. Note that the exclusion is available for gifts to as many recipients as you choose.

### Lifetime gift tax exclusion

In addition to any amount covered by the annual gift tax exclusion, you can benefit from a lifetime gift tax exemption of $5 million, inflation-indexed to $5.34 million in 2014. However, this exemption is unified with the federal estate tax exemption, so amounts used for gifts will erode the tax shelter available for bequests from your estate.

Generally, you don't have to file a gift tax return, Form 709, for gifts covered by the annual exclusion, but you must file this form if you tap into the lifetime exemption amount. Also, when you make a "split gift" with your spouse, the annual exclusion amount is doubled to $28,000 per donee, but a gift tax return is required even if you don't owe any tax. Furthermore, if you give a gift of a "future interest," such as a transfer of assets to a trust, a gift tax return must be filed in any event.

In some cases, you might file a gift tax return when you're not legally required to. This starts the statute of limitations running on the time the IRS will have to challenge the valuation of the gift. It also discloses the gift for other purposes.

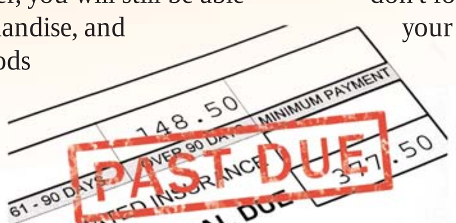
The deadline for filing federal gift tax returns is the same as the one for income tax returns. Thus, if you gave more than $14,000 to a donee in 2013, you have until April 15, 2014, to file the return, but you can apply for an automatic six-month filing extension. Caution: This extension is for filing only and not payment of any gift tax that is owed. ◆

# What can you deduct when customers don't pay?

If you're in business long enough, you'll run into a customer who doesn't pay his bill. And despite your best efforts, you come to the conclusion that it will never be paid. You then wonder if you can deduct this "bad debt" on your tax return. As with many tax issues, the answer is complicated.

Most individuals and their associated business and rental properties are "cash basis" taxpayers. That means that you report taxable income when you receive it and report deductible expenses when they are actually paid. That makes things quite simple from an accounting/tax standpoint. So is there a bad debt deduction? Essentially, there is no direct deduction for a cash basis taxpayer. Since the income was never received, it was never reported or taxed. However, you will still be able to indirectly deduct the labor, merchandise, and overhead used to provide for the goods or services that were delivered but went unpaid.

On the other hand, some businesses use the "accrual method" of accounting and reporting taxes. That means that you report income when it is billed out (when the invoice is sent to the customer), and expenses are deducted when they are due, regardless of when they are paid. This method is much more complicated from an accounting/tax standpoint, since the business must deal with issues such as accounts receivable and accounts payable. However, in this case, you reported taxable income when you sent the customer the invoice. If it goes unpaid, you do have a bad debt deduction that you can claim as an operating expense on your books. And if you're required to pay sales tax on the invoice, don't forget to adjust your subsequent sales tax report to reduce your total sales taxes by the amount of the unpaid sales tax. Bad debt deductions can get tricky. Make sure to contact us if you need help with this issue. ◆




# IRS Audits: What you need to know to reduce your risk

There's nothing good about being selected for an IRS audit. At best it's a time consuming nuisance, and at worst you'll be poorer in the end. But you can reduce your likelihood of being audited, or if you are selected, of being billed.

There are three types of IRS audits. The simplest and most common is a correspondence audit, where the IRS mails you a request for further information about one or more items on your return. In most cases the issues can be resolved by responding with the appropriate documentation.

If you're selected for an office audit, the IRS will schedule an appointment for you to meet with an auditor at their local facility. They'll tell you in advance which specific areas of your return(s) will be addressed and what types of documentation you should bring in.

A field audit is more comprehensive. An IRS agent will travel to your home, business, or representative's office, review the returns at issue, request documentation for questioned items, and ultimately issue a report either recommending a tax change or accepting the returns as filed.

*The selection process.* Correspondence audits are often triggered by information matching. The IRS receives W-2s, 1099s, and similar reports from businesses and financial institutions and matches the numbers to the tax returns filed by the individuals involved. If the returns don't agree with reported figures, the individual will be asked for an explanation and/or simply mailed a bill.

The IRS also uses a computer scoring system to select audits. Based on past experience, the system assigns a score to each tax return indicating the likelihood that the tax was understated or certain income was not reported. Common red flags include the following:

- Disproportionately high charitable deductions in relation to income.
- Large deductions for travel, entertainment, and business meals.
- Unusually high ratios of business use claimed for automobiles.
- Unusually high home office deductions.
- Excessive and/or repeated business losses.
- Unreported foreign bank accounts.

It's advisable to be conservative on your tax returns with respect to these "red flag" areas, although you needn't forgo claiming legitimate deductions. Be prepared to support your position by keeping meticulous records and retaining every relevant document.

*2014 audit activity.* In 2014, above-average audit activity may be expected for upper income individuals, sole business proprietors, partnerships, and S corporations. Cash-intensive enterprises (bars, restaurants, taxis, hair salons, etc.) are particularly apt to receive a higher rate of scrutiny.

If you do happen to be selected for an audit, call us. We're prepared to assist you with whatever is needed. ◆

## IRS TAX NOTES

### New rule on tips for 2014

When is a tip not a tip but a service charge instead? Sound like hair splitting? Well, not according to a new IRS rule that went into effect in January 2014.

Here are the details. Many restaurants charge automatic gratuities of 15% to 20% for large parties. Treated as tips, these amounts have been paid to restaurant workers along with their other tips, and the workers have been responsible for reporting them as income to the IRS.

According to the IRS, a payment from a customer can only be considered a tip if the customer determines the amount. If the payment is a specified amount added to the bill for large parties, it's a service charge, not a tip. Service charges are treated as regular wages subject to withholding by the employer.

This ruling complicates income reporting for both restaurant employees and employers. For assistance with the bookkeeping to deal with this new rule, give our office a call.

### FSA rules modified

Flexible spending accounts (FSAs) allow taxpayers to set aside pre-tax dollars to pay for out-of-pocket medical expenses. The drawback has been the fact that unused amounts each year are forfeited. Plans could provide a 2½ month grace period to use up unspent set-asides. Now a change announced by the IRS adds more flexibility to these accounts. Plans can be modified by employers to allow up to $500 of unused amounts to be carried over into the following year. Health FSAs cannot have both the old 2½ month grace period and the $500 carryover; they can have one or the other (or neither). ◆

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With over 125 years combined experience as certified public accountants, we have the credentials and expertise to assist individuals and growing businesses in complex accounting and tax matters. We serve a variety of clients, with specializations in aviation, oil and gas, architecture, engineering, construction, and technology. Among our services are the following:

- Tax planning, projection, and preparation
- Business valuations
- Litigation consulting
- Compiled and reviewed financial statements.
- Outsource Accounting
- Family Office Services
- Accounting Software Consulting and custom QuickBooks add-ons.

# Should you lease or buy equipment?

It's not easy to decide whether it's wiser to buy or lease a piece of business equipment. For most business owners, the first impulse is to buy. But there may be times when leasing is preferable.

- *Capital conservation.* Purchases normally require a 10% to 20% down payment, whereas equipment leases often require a smaller down payment. Additionally, "soft costs" such as shipping, installation, and warranties can be built into the lease.
- *Obsolescence.* If the equipment becomes obsolete before the end of its useful life, leasing the equipment may allow for a "turn back" or upgrade at the end of the lease, thereby keeping the technology current and minimizing repair and replacement costs.
- *Urgency.* For expensive equipment that is required immediately, leasing might be the best way to obtain it quickly. If you purchase, you might be tied up with your lender for some time, providing financial statements necessary for loan approval.
- *Deductions.* If you find that you're unable to expense the equipment, a lease might allow for a shorter deduction period compared to depreciation.

Sold on leasing? Don't be. Buying has its advantages also.

- *Immediate deduction.* You may be able to immediately deduct up to $25,000 of the cost of qualified equipment in the year of purchase, using the first-year expensing rules.
- *Appreciation.* Some equipment actually increases in value over time.
- *Useful life.* The equipment may be productive long after the lease has expired. Purchasing will allow you to continue to use that equipment and avoid the need to return or upgrade it at the end of the lease term. ◆

***NOTE:*** *This newsletter is issued quarterly to provide you with an informative summary of current business, financial, and tax planning news and opportunities. Do not apply this general information to your specific situation without additional details. Be aware that the tax laws contain varying effective dates and numerous limitations and exceptions that cannot be summarized easily. For details and guidance in applying the tax rules to your individual circumstances, please contact us.* *©MC*

**We appreciate your business.** Please call any time we can be of assistance to you in your tax, financial, or business affairs.

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## Tax CALENDAR SPRING 2014

**March 17** – Deadline for calendar-year corporations to elect S corporation status for 2014.

**March 17** – Deadline for filing 2013 tax returns for calendar-year corporations.

**March 31** – Deadline for payers who file electronically to file 2013 information returns (such as 1099s) with the IRS.

**March 31** – Deadline for employers who file electronically to send copies of 2013 W-2s to the Social Security Administration.

**April 15** – Deadline for filing 2013 individual tax returns.

**April 15** – Deadline for filing 2013 partnership returns.

**April 15** – Deadline for filing 2013 gift tax returns.

**April 15** – Deadline for making 2013 IRA contributions.

**April 15** – First installment of 2014 individual estimated tax is due.

**May 15** – Deadline for nonprofit organizations on a calendar-year to file information returns. ◆