NEW IRS REGULATIONS ON CAPITALIZING REPAIRS, MAINTENANCE AND IMPROVEMENTS TO BUSINESS PROPERTY

By David Volkert, Senior Accountant

In December of 2011, the IRS issued temporary regulations to provide guidance on when repairs and maintenance can be deducted and when they must be capitalized as a fixed asset. These temporary regulations will significantly change how and when you're allowed to deduct your repair costs. Originally, these rules were set to be in effect for tax years starting in 2012; however, public outcry made the IRS declare these temporary regulations to be optional for tax years starting in 2012 and 2013. The IRS is expected to release final regulations in 2013 which will not be optional.

Background

Before going into the details, here's some general information on what's going on. An IRS temporary regulation is essentially what it sounds like: a rule put into effect which only applies for a short period of time (typically 2-3 years). The IRS frequently uses these to test the waters when putting out new rules as they can carry the full weight of the law but are much easier to change after a trial period. While final regulations usually change from their temporary forerunners, they can be useful in determining what the final regulations will look like.

The reason these temporary regulations have come up is that there's a fairly sizeable hole in the law - there is very little guidance on when items can be expensed vs. capitalized. Instead, we have a series of court decisions which create case law that leaves lots of room for interpretation on both the IRS and the taxpayer side. The regulations seek to codify some of the existing case law in some areas and to create new law where the IRS believed the case law guidance was lax.

An overview

The temporary regulations are long and complex - so complex that the IRS has said that the final regulations may include some simplifications for small businesses to improve compliance. This summary cannot cover all the ins and outs of the regulation but should give you a general idea of what to expect.

More defined units of property

These temporary regulations introduce a more defined "unit of property" (UOP) when determining whether a disbursement should be expensed or capitalized. The smaller the UOP, the more likely it is that a cost related to the UOP should be capitalized. For example, repairs to an engine in a truck are more likely to be an expense if the

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UOP is the vehicle; however, if the UOP is the engine, the opposite would be true.

To capitalize or deduct

When paying to improve a UOP, the amount must be capitalized. These new regulations create considerable guidelines in determining what constitutes an improvement. Repairs and maintenance are then defined as anything that isn't required to be capitalized.

Additionally, UOPs that cost less than $100 to purchase or produce can be expensed during the year it is acquired. There are further de minimis rules which may apply to you if you issue a financial statement, establish a written accounting policy and the total amount expensed is below certain revenue and depreciation based threshold. Obviously, this second de minimis rule gets complicated.

Buildings get their own rules

Generally, buildings and their structural components are treated as one UOP, however, the new regulations list nine building "systems" that are separated from the structure itself. These systems are considered UOPs by themselves so you must consider the effect on the system rather than the building as a whole. Therefore work performed on the HVAC system may be considered an improvement rather than a repair when only looking at the effect on the system itself.

Most everything else

A UOP is considered a component that can be placed into service without other components to function. So the engine in a truck is not a UOP as it cannot function without the rest of the truck. However, a conveyor belt which feeds items to a packaging machine is a separate UOP as it can still serve its function without the packaging machine in place.

Routine maintenance

There is a special safe harbor for routine maintenance performed on UOP that is not a building or structural component thereof. Under this safe harbor, routine maintenance is reoccurring activities that the business expects to perform to keep the UOP functioning properly. This would include activities like cleaning, testing, replacing worn out parts with new parts of the same type and inspections. The business must expect to perform these services more than once over the depreciation life of the property.

For example, a machine with a 7-year life property must have an annual maintenance which includes replacing various parts which wear out through ordinary use of the machine; additionally, there is an electric motor which is designed to last 10 years which has failed. The ordinary annual maintenance would fall under the routine maintenance safe harbor, however, the electric motor would need to be considered a capital expense as it is not expected to need to be replaced more than once over the life of the property.

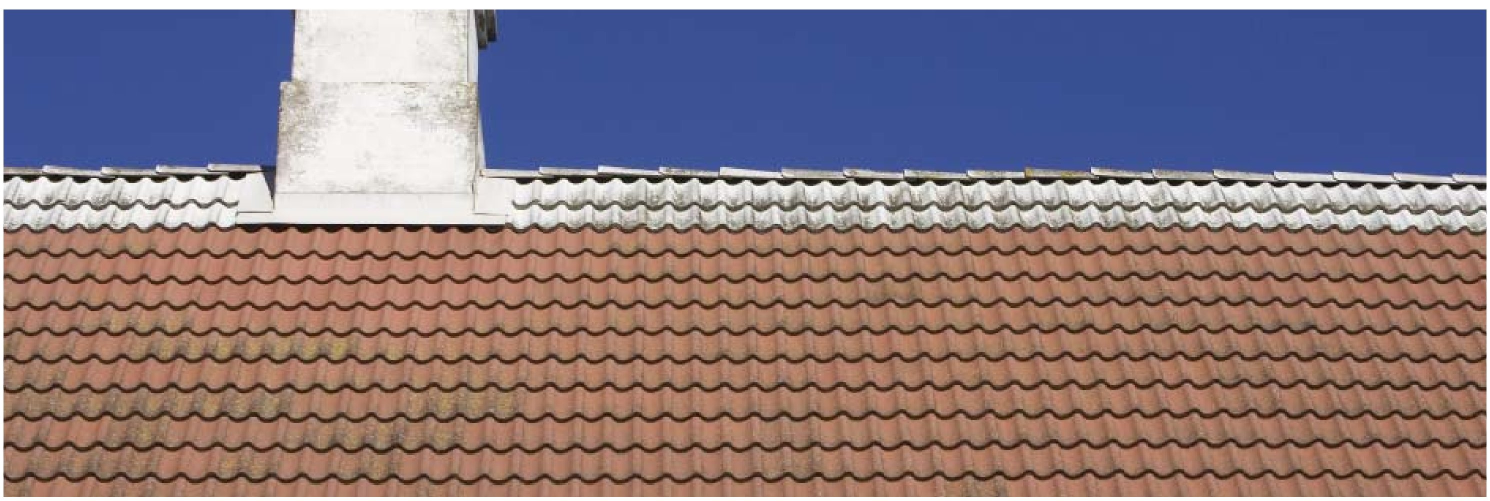
Bottom line

At first glance, it may seem that there's not much for businesses to celebrate in these new regulations but there are significant tax savings through cost segregation**.** As an example, both prior to and after these new regulations, a new roof on a building would need to be capitalized and depreciated as real property. However, under the old regulations, there was no provision to allow the business to "dispose" of the original roof. The cost of the original roof is wrapped up in the cost of the building and will continue to be depreciated even though it no longer exists. With the new regulations, the roof is identified as a separate UOP from the building; therefore, the cost of the old roof can be written off when the new roof is placed into service.

To do this, you would need to have the roof separately identified and valued through a cost segregation study which we can help you with. A cost segregation study will break out the building UOP from the nine building systems UOP which will save you tax when you need to replace one of these systems.

The second de minimis exception may apply

As mentioned, there is a second de minimis exception for purchasing lower cost items that last longer than 12 months which some business may be able to implement. This would allow the business to establish an internal expensing policy to follow effectively decreasing the volume of items required to be capitalized, tracked and depreciated as fixed assets. However, the temporary regulations provide very specific rules in this area which some businesses may struggle to calculate on an annual basis. Please contact us and we can help you decide if this planning opportunity works for your business.



SAVING YOUR TAX RECORDS: WHAT YOU NEED TO KNOW

April 15th is seen as the end of the traditional tax-filing season. And, while it may be tempting to purge certain tax documents from your files for the current and past tax years, you want to be careful. It is important to retain relevant tax records in the event that the IRS — or another taxing authority — requires that those records be produced as part of an audit.

Keep at least three years

The following records are commonly used to substantiate a taxpayer's income and deductible expense items:

- Form(s) W-2
- Form(s) 1099
- Form(s) K-1
- Bank and brokerage statements
- Canceled checks or other proof of payment of deductible expenses

At a minimum, the above tax records should be kept for a three-year period following the date that you file your return (or its due date, if later).

However, the IRS's time limit for initiating an audit on a return where income was grossly understated, but no fraud is discovered, is six years. Therefore, it is ideal to retain the above documents for six years to better protect yourself in the event of an audit.

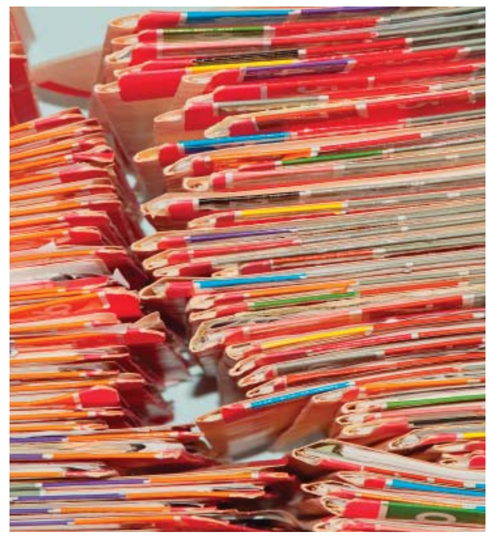
Similarly, you should keep investment records (brokerage statements, etc.) after you liquidate any given investment. Documentation that substantiates the gain or loss on an investment should be kept for the length of time that corresponds with the time frame that you retain other tax documents related to the return on which you report the sale.

Prior years' tax returns

It is also a good idea to maintain one or more permanent files with important legal and personal documents, including those relating to taxes. Specifically, as a general rule, you should retain copies of your federal and any state income-tax returns (and any tax payments) indefinitely. For instance, the IRS or another taxing authority could claim that you never filed a particular year's return. If that occurs, the IRS (or other authority) could assess tax and penalties relating to the return in question. You will need a copy of your return to bolster your position that you actually filed the return.

Need more information?

Filing your returns on a timely basis is just one aspect of properly handling your taxes. Be prepared to defend yourself in the event of an audit by retaining your records for the appropriate time period. Contact us if you have any further questions.



HEALTH CARE LAW'S EMPLOYER MANDATE DELAYED

One of the more highly publicized provisions of the Patient Protection and Affordable Care Act of 2010 ("PPACA" or "health care reform law") is the requirement that so-called "large" employers provide adequate health care coverage for workers and, if they fail to do so, pay a penalty. This "employer mandate" was to go into effect on January 1, 2014. Recently, however, the Obama Administration announced that it would delay enforcement of the employer mandate provision for one year.

Under PPACA, "applicable large employers" must comply with the principal requirement that they offer employees health care coverage that meets specified standards or be subject to penalties. An "applicable large employer" is an employer that employed an average of at least 50 full-time (or full-time equivalent) workers on business days during the preceding calendar year. The penalty for not providing coverage is at least $2,000 for each worker who should have been covered. The law is complex — several special requirements and exceptions apply.

Enforcement of this employer mandate (including the penalty provisions) is now delayed until 2015.

Note that the so-called "individual mandate," which under the health care reform law requires most Americans to carry health insurance or pay a fine, continues to be effective starting in 2014. The newly announced enforcement delay applies only to business penalties (though some lawmakers are urging the Administration to delay the individual mandate as well). Employees who aren't provided appropriate coverage through an employer or otherwise will remain eligible for tax credits to help pay for the cost of purchasing their own coverage.

ESTATE AND GIFT TAXES HAVE BEEN CLARIFIED

A single, unified exemption is available to taxpayers for the estate and gift taxes. A taxpayer can use the exemption to offset otherwise taxable lifetime gifts, and the taxpayer's estate can use the amount remaining at his or her death to offset otherwise taxable bequests.

The amount of the exemption was a major issue throughout 2012. That exemption was set at $5 million, adjusted for inflation. The inflation adjusted amount for 2012 was $5.12 million. At that level, relatively few estates owed federal estate tax. However, the law in effect during 2012 called for the exemption to return to its 2003 level of $1 million in 2013. That would have exposed many estates to federal estate tax, with rates as high as 55%.

Instead, Congress largely left the 2012 estate and gift tax rules in place. The unified federal estate and gift tax exemption for 2013 and future years has been permanently set at $5 million adjusted for inflation, with the inflation-adjusted amount for 2013 being $5.25 million. Therefore, estates of people who die with a net worth under $5.25 million and did not make significant gifts during their lifetime generally will not have to pay estate tax.

The only major estate tax change in the new law regards the maximum federal estate tax rate, which has been increased from 35% in 2012 to 40% in 2013 and subsequent years.

Example 1: Anna Carter dies in 2013, when the exemption is $5.25 million. Anna did not use any of her exemption amount on gifts during her lifetime and leaves an estate valued at $6 million. The $750,000 over the exemption amount will be taxed at the maximum rate of 40%, so Anna's estate will owe $300,000 (40% of $750,000) in federal estate tax.

Preserving portability

With a $5.25 million federal estate and gift tax exemption amount, a married couple that does not use the exemption to offset any lifetime gifts can potentially leave up to $10.5 million in assets free of estate tax. In fact, the new tax law makes that simpler to do than has been the case in the past because Congress made permanent what had been a temporary "portability" provision. In prior years, lack of portability created problems for many married couples.

Example 2: Barry and Carla Duncan, a married couple, had total assets of $8 million. Barry died in 2009 and left all of his assets to Carla. Because one spouse's bequest to the other spouse typically avoids estate tax, regardless of the amount, no estate tax was due. Assume Carla dies in 2013 with an $8 million estate, and she did not use any of her exemption amount on lifetime gifts. She'll be $2.75 million over the $5.25 million exemption amount, and her estate will owe $1.1 million in federal tax, at a 40% rate.

To remedy such outcomes, Congress created a temporary portability provision for 2011, a provision that's now a permanent part of the tax code. With portability, any unused portion of a deceased spouse's exemption amount can be used by the surviving spouse's estate. Originally, Congress created this portability opportunity only for deaths in 2011 and 2012. The new law makes portability permanent.

Example 3: If Barry Duncan had died in January 2013, leaving all of his assets to Carla, he would have left $5.25 million of his exemption unused. That amount can be transferred to Carla if Barry's executor makes a timely election to do so on a properly filed estate tax return, IRS Form 706. If Carla then dies in December 2013 without using any of her exemption for gifts, her estate would have a total exemption of $10.5 million (her own $5.25 million exemption and a similar one from Barry). Carla's $8 million estate wouldn't be taxed by the federal government, for a $1.1 million tax saving.

The new tax law also preserves the federal tax deduction for state estate taxes. This provision should remind you that estates may owe state estate tax even if they are exempt from federal estate tax.

Example 4: Edward Franklin dies in 2013 with a $3 million estate, so he owes no federal estate tax. However, Edward's home state exempts only $1 million of assets from state estate tax. His estate is $2 million over the threshold; depending on the state's tax rates, Edward's estate may owe many thousands of dollars in state estate tax.

The bottom line is that you should not ignore estate tax planning, even if you have little concern about federal estate tax. Our office can work with you on strategies to reduce exposure to estate tax, state or federal.

Generous gifts

As noted above, you can use your unified federal estate and gift tax exemption amount to offset otherwise taxable lifetime gifts, thus reducing the amount of gift tax you have to pay. However, using the exemption for lifetime gifts reduces the amount of the exemption available to your estate to offset otherwise taxable bequests and reduce the amount of the estate tax.

Example 5: Nancy Harris has never made any taxable gifts. In 2013, she gives $1 million to her daughter Lisa. The first $14,000 of that gift is tax free, covered by the annual gift tax exclusion for 2013. The other $986,000 is considered a taxable gift but Nancy owes no gift tax because of the lifetime gift tax exemption. After making the gift, Nancy's lifetime gift-tax exemption is $4,264,000: her original $5,250,000 exemption minus the taxable gift of $986,000. That $4,264,000 exemption, indexed for future inflation, can shelter future gifts or bequests from tax.

What's more, the concept of portability, explained earlier In this article, also applies to gift tax, so once a surviving spouse has increased his or her exemption by the deceased spouse's unused exemption amount, that increased amount can be used to offset either gift or estate tax.

Example 6: Assume that the transfer tax exemption, which is $5.25 million in 2013, rises to $6 million in a future year, and the annual gift tax exclusion remains $14,000. Nancy Harris dies that same year, having made no additional taxable gifts. Nancy leaves all of her assets to her husband, Pete, thus incurring no estate tax. In this scenario, Nancy's unused exemption is $5,014,000: her $6 million exemption minus $986,000 In taxable gifts.

Assume that Pete has not made any taxable gifts. Pete could have a total exemption of $11,014,000 in this example, including Nancy's unused amount. Pete could make up to $11,014,000 in tax-free gifts, and when he died, any unused gift tax exemption would be available to provide estate tax shelter.

In addition, the generation skipping transfer (GST) tax exemption also is $5.25 million in 2013, indexed to inflation. However, portability does not apply to the GST tax.

US SUPREME COURT STRIKES DOWN DOMA

On June 26, 2013, the U.S. Supreme Court, in United States v. Windsor, struck down Section 3 of the Defense of Marriage Act (DOMA), which had deemed all same-sex marriages invalid for purposes of federal law. The Windsor decision effectively changes the definition of "spouse" in over 1,000 federal statutes and at least as many regulations. Any individual in a same-sex marriage should carefully review his or her tax situation in light of the decision. In addition, employers should review the decision's potential impact on their benefit plans.

The ruling

The Windsor case involved a same-sex couple whose marriage had been legally recognized in their state of domicile. One of them died, leaving her entire estate to the other. On its federal estate-tax return, the estate claimed the unlimited marital deduction for property passing to a surviving spouse, but the IRS denied the deduction pursuant to Sec. 3 of DOMA and assessed over $350,000 in estate taxes. Windsor, the estate's executor, paid the taxes but filed suit, challenging Sec. 3 of DOMA as unconstitutional. The federal district court ruled in Windsor's favor, and both the federal appeals court and the U.S. Supreme Court affirmed.

Limited reach of the decision

Significantly, the Windsor decision did not address Sec. 2 of DOMA, which permits states to refuse to recognize same-sex marriages recognized in other states. As a result, at this time, any individual in a same-sex marriage who moves from a state where that marriage is legally recognized to one where it is not runs the risk of losing any rights newly acquired under Windsor.

Another outstanding issue concerns the federal legal status of arrangements such as "domestic partnerships" or "civil unions" — as opposed to state-sanctioned "marriages." What status these designations will have after Windsor remains to be resolved on a state-by-state basis.

Income-tax issues

As a general rule, an individual's filing status is determined as of December 31 of the tax year. Same-sex couples whose marriages are sanctioned after the Windsor decision are presumably required to now file either as married filing jointly or married filing separately, and they will no longer be allowed to file as "single."

Couples affected by the Windsor decision will want to consider carefully whether they may obtain refunds by amending any prior federal returns to show that they were legally married. Amended return(s) must be filed within the applicable statute of limitations.

Couples should be aware that the tax effects of the two filing statuses available to married persons — married filing jointly and married filing separately — can vary widely. Additionally, it's important to know that where two individuals file as married filing jointly, each is jointly and severally liable for any taxes, interest, and penalties ultimately deemed owing.

Those whose marital status for federal tax purposes has recently changed (or is about to) should consider the potential effect on several areas of their tax returns, including:

- Various deductions and credits (including deductions for individual retirement account (IRA) contributions and credits for higher education expenses
- Capital gains and income-tax rates
- Medicare surtax on net investment income
- Itemized deduction and personal exemption limitations

Estate Planning

With the increase in the federal estate and gift-tax exemption to $5.25 million in 2013, relatively few couples' estates will be affected by the Windsor decision. However, those whose estates are sufficiently large will want to reconsider their estate plans in light of (1) the availability of the unlimited marital deduction for both gift and estate-tax purposes and (2) the portability of the estate-tax exemption.

Also of interest to many married taxpayers are the favorable rules for the spousal beneficiaries of IRAs to delay and "stretch out" required minimum distributions (RMDs). Specifically, surviving spouses who are named as beneficiaries of their spouse's IRAs may choose to either directly roll over those IRAs or else treat them as their own — thereby potentially enabling them to avoid taxable lump-sum payouts, to take advantage of a more friendly schedule for RMDs, and to choose their own beneficiaries in order to maximize their tax deferral.

Benefit plans

The DOMA ruling will affect employee benefit plans in several areas. For example, any health care coverage provided by employers to their employees' same-sex spouses should no longer be treated as taxable income. In addition, such spouses should be treated as qualified beneficiaries for purposes of the COBRA continuation rules.

Sponsors of qualified retirement plans should assess the impact on their plans, including the application of the tax law's spousal consent, qualified joint and survivor annuity, and RMD rules to employees in same-sex marriages. The IRS and U.S. Department of Labor are expected to provide additional guidance to plan sponsors regarding plan amendments and other issues.

The DOMA decision presents a wide range of issues to consider. Contact us if we can be of assistance.

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