

Tax Tips

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foxvalley
CPA's

Built-in Gains Tax

Tax relief extended for 2013

When a C corporation converts to an S corporation, it is subject to an extra set of tax rules. Although the conversion itself is not a taxable event, assets held at the time of conversion when sold during a certain time frame are subject to an extra tax. This time frame is called the recognition period, and income from the sale is subject to built-in gains tax.

A built-in gains tax is the highest corporate tax rate imposed on the business on the appreciation in asset value that existed on the date the business became an S corporation. Individual shareholders may have to pay an additional tax on distribution of the sales proceeds. However, the built-in gains tax can be avoided if the assets are sold after the recognition period.

The recognition period used to be ten years, but it was lowered to seven years when President Obama signed *The American Recovery and Reinvestment Act of 2009*, and then to five years when he signed the *Small Business Jobs Act of 2010*.

The shorter recognition period was scheduled to return to ten years after 2012; however, the *American Taxpayer Relief Act of 2012* extended the five-year recognition period to cover all sales that take place through the end of 2013.

A good year-end tax planning strategy would be to sell assets that you have held at least five years, thus avoiding the built-in gains tax. In 2014, you'll have to pay the extra tax on any assets that you have not held for at least ten years. But, who knows? Perhaps Congress will provide another extension with the passage of an eleventh-hour tax relief bill.



Does Your Business Have a Website?

If so, you may be entitled to certain tax deductions

Whether you are planning to start a new business or looking to advertise your existing business, having a website is a good marketing strategy. It's also a good tax planning strategy if you're looking to reduce taxable income. Developing a functional website may be difficult, but taking the tax deduction is easy. Just keep track of the following expenses:

- Computers and peripherals, including monitor, mouse, keyboard and printer. Note whether it is new or used, so bonus depreciation can be taken if eligible.
- Internet and phone charges.
- Consultant fees (an expert can be helpful for a quick set-up and thoughtful design).
- Domain registration fees.
- Web hosting fees (monthly or annual).
- Software used to develop and maintain the site.

New Reporting Requirement for Responsible Parties

Report change of officers or addresses to the IRS

Beginning January 1, 2014, any entity with an employer identification number (EIN) must file Form 8822-B, *Change of Address or Responsible Party — Business*. For entities that trade shares or interests on a public exchange, or that are registered with the Securities and Exchange Commission, the responsible party is: (a) the principal officer, if the business is a corporation; (b) a general partner, if a partnership; (c) the owner of an entity that is disregarded as separate from its owner; or

(d) a grantor, owner or trustor, if a trust. For all other entities, the responsible party is the person who has a control over funds or assets.

Use Form 8822-B to notify the IRS if you changed your business mailing address, your business location or the identity of your responsible party. Form 8822-B must be filed within 60 days of the change. If the change in the identity of your responsible party occurred before 2014, and you have not previously notified the IRS of the change, file Form 8822-B before March 1, 2014, reporting only the most recent change. Generally, it takes four to six weeks to process your address or responsible party change.

What is Constructive Receipt? The timing of income reporting can affect taxes

When a business files its first tax return, an accounting method is determined—cash basis or accrual. In most cases, large businesses use the accrual method of accounting, which recognizes income when the business sends out invoices, regardless of when the income is actually received. The cash basis method of accounting, on the other hand, recognizes income when payment is actually received. So what happens when a cash basis business receives a large check dated December 31, 2013, on January 2, 2014?

According to the IRS, income is constructively received when an amount is credited to your account or made available to you without restriction, even if you don't have possession of it. If a bank is holding the money for you, it may be considered to be received by you, even if the money is not in your bank account. Income is not constructively received if your

control of its receipt is subject to substantial restrictions or limitations.

Therefore, a check dated December 31, 2013, that you receive on January 2, 2014 is constructively received in tax year 2014 because the check was being handled by the United States Postal Service. However, if a customer hands you a check on December 31, you could inevitably cash it that same day. In that case, constructive receipt would be in 2013 and you would have to include it in your 2013 gross income.

Determining constructive receipt is important when large amounts are involved, as it could greatly affect the amount of taxes owed and income reported to the IRS. For instance, a customer sends a large check late in December and files a Form 1099-MISC, the form will report that amount paid to you in 2013. If you did not report that income until 2014, because of constructive receipt, you may be called upon by the IRS to prove when you received the check. Deliberate attempts to delay receipt will not work and the IRS will require the income to be reported in the proper year.



Quik Tips

1

Proper year-round record-keeping is the first step to ensure your taxes are filed accurately. Save essential paperwork that could be needed to substantiate deductions, should the IRS audit your return.

2

A federal excise tax is imposed on gasoline (\$.184 per gallon), clear diesel fuel (\$.244 per gallon) and clear kerosene (\$.244 per gallon). The amount of these taxes may be credited or refunded if these fuels are used in certain types of off-road uses.

3

The rate for the new simplified method for the home office deduction is \$5 per square foot for the part of your home used for business. The maximum footage allowed is 300 square feet. This means the most you can deduct using the new method is \$1,500 per year.

4

If you are a sole proprietor or partner in a partnership, the money or other forms of payment you take from your business should be accounted for in a draw account.



IRS Letters to Small Businesses

Credit card payment reporting affecting some

Beginning in 2012, companies that process credit card payments were required to report the gross amount of previous year payments on Form 1099-K, *Payment Card and Third Party Network Transactions*. Form 1099-K reporting was initiated by Congress in an attempt to close the tax gap. Some businesses that use eBay, Amazon or other online providers don't report all of their income, thus contributing to the tax gap.

Small businesses are not required to separately state the amount reported on the Form 1099-K on their tax returns. Instead, these amounts should already be reflected on the gross income line. However, the IRS will compare the amounts reported on 1099-K forms to the business's tax return and in some cases, will send a letter to small businesses and question the possible underreporting of income.

The letter contains the header "Notification of Possible Income Underreporting." It begins with, "Your gross receipts may be underreported." The IRS cannot specifically suggest an amount underreported because of the possibility that credit card refunds, charge-backs or fees may be involved.

Based on the IRS's analysis of what was reported on the tax return and what the IRS expected to see reported, you may receive one of the following four variations of the letter:

- Letter 5035 is a soft notice, which requests that the business review the information reported and file an amended return, if necessary. However, no response to the IRS is required.
- Letter 5036 contains the gross receipts reported on the tax return filed and a list of 1099-K forms filed and asks the small business to provide a written explanation of why the portion of gross receipts from credit card payments and other 1099-K reportable transactions may be higher than expected. The response is due to the IRS within 30 days from the date of the letter.

- Letter 5039 requires Form 14420, *Verification of Reported Income*, to be completed and returned within 30 days. Form 14420 contains:
 - Verification of the accuracy of Forms 1099-K filed.
 - Estimated gross sales from types of orders (online, phone, catalog), sales from gift cards and sales from lottery tickets.
 - Whether or not you shared your credit card terminals and if so, with whom.
- Letter 5043 has the same basic request as Letter 5036.

If you receive one of these letters, contact me as soon as possible. In most cases, the IRS expects a response within 30 days. A failure to respond, when required, might result in a proposed assessment of additional tax or further compliance action.

Garnished Wages

What you need to know for payroll purposes

As you expand your business and take on new employees, you may come across a situation where you are required to garnish wages. Wage garnishment occurs when an employer is required to withhold the earnings of an individual for the payment of a debt in accordance with a court order or other legal procedure.

Title III of the *Consumer Credit Protection Act (CCPA)* permits a greater amount of an employee's wages to be garnished for child support, bankruptcy or federal or state tax payments. Title III allows up to 50 percent of an employee's disposable

earnings to be garnished for child support if the employee is supporting a current spouse or a child who is not the subject of the support order, and up to 60 percent if the employee is not doing so. An additional five percent may be garnished for support payments over 12 weeks in arrears.

An employee's disposable earnings is defined as the amount of earnings left after legally required deductions and expenses—federal, state and local taxes, social security, unemployment insurance and state employee retirement systems contributions—have been made. Deductions and expenses not required by law, such as union dues, health and life insurance and charitable contributions, are not subtracted from gross earnings when the amount of disposable earnings for garnishment purposes is calculated.

The IRS offers special payroll tax tables to help determine how much tax should be withheld.

Tangible Property Regulations Issued

Guidance affects all taxpayers who acquire, produce or improve tangible property

The IRS issued Treasury Decision 9636, which included 222 pages of guidance regarding the deduction and capitalization of expenditures related to tangible property. Tangible property in a business is anything that can be touched. Three major changes that go into effect January 1, 2014, include the following:

1. **Materials and Supplies**
The definition of materials and supplies has been expanded to include property (not including inventory) that has

a cost of \$200 or less. For example, if a business purchases a printer for \$175, the business can generally deduct the cost instead of capitalizing and depreciating over five years.

2. **Repair or Improvement**
To determine whether an expense may be deducted as a repair or must be capitalized as an improvement the business may use their financial accounting policies as a guideline, up to \$5,000. Small businesses without audited financial statements may adopt an internal policy for non-tax reasons to expense property less than \$500.
3. **Improvements to Buildings**
Qualifying small businesses have the option of applying the improvement rules to an eligible building property if the total amount paid during the taxable year for repairs, maintenance, improvement and similar activities performed on the eligible building does not exceed the lesser of \$10,000 or two percent of the unadjusted basis of the building.

