EES Newsletter 0719

Three Safe Harbors for Business Repairs
Tax differences from improvements

Do you need to make repairs to your business premises or equipment? It can make a big tax difference if the work is characterized as a “repair” or an “improvement.” In brief, a repair is **currently deductible** by your business, while the cost of an improvement must be written off over time.

The IRS and taxpayers often disagree over the exact tax treatment. At least recently-issued final regulations provide a measure of clarity.

As a rule of thumb, the IRS has traditionally said that a repair merely keeps property in efficient operating condition, while an improvement prolongs the useful life of the property, enhances its value or adapts it for a different use. For example, fixing a leaky faucet is likely to be a currently deductible repair. But the addition of a new wing to a business building is considered to be an improvement.

The final regulations sought to provide more definitive guidelines for distinguishing repairs from improvements. The main takeaway from the regs for many small business owners is that they can rely on these **three safe-harbor rules**.

1. Small-cost items: A business can currently deduct repair and maintenance costs that don’t exceed $2,500 per item. What’s more, this threshold is increased to $5,000 for a business with an “applicable financial statement” (AFS) approved by a CPA.

2. Small projects: A small businesses with $10 million or less in average gross receipts can currently deduct improvements to a building with an unadjusted basis of $1 million or less. However, the total amount paid for repairs, maintenance and improvement to the building can’t exceed the lesser of (a) $10,000 or (b) 2% of the unadjusted basis of the property.

3. Routine repairs and maintenance: If amounts are paid only for routine repairs and maintenance, those expenses are currently deductible. But the IRS imposes the following requirements:

- The repairs must be regularly recurring activities that are expected to be performed.
- The repairs must result from the wear and tear of being used in a trade or business.
- The repairs are required to keep the property operating efficiently in its normal condition.
- The repairs are expected to be necessary more than once during the first ten-year period for buildings, and structures related to buildings, or more than once during

the property's class life for other property. The “class life” is the number of years over which the IRS expects property to be depreciated.

The IRS requires business owners to make a tax return election to take advantage of any one of these three safe harbors. Note that other special rules—for example, when there is a partial disposition—may come into play. Consult with your professional tax advisor concerning partial dispositions or any borderline calls.

Finally, be aware of a **potential tax trap**. If you make repairs and improvements at the same time, the entire cost may be lumped together as a “general betterment plan” that must be depreciated over time. Depending on your situation, it may be preferable to arrange to have repairs performed separately. Take all of the tax factors into account.

When Good Employees Quit Bad Jobs
Avoid common mistakes of supervisors

Is employee turnover a continuing problem at your company? Frequently, high turnover can be traced to mistakes being made at the supervisory level. Worst of all, the problems may be fixed easily, either through greater effort or a slight change in perspective. With that in mind, here are ten common reasons why employees leave their jobs.

Reason #1: They are overworked.

It may time to lower expectations if good employees keep leaving because of the workload. That is not to say you must adhere to a rigid 40-hour workweek, but requiring substantially more time, especially 60 hours per week and up, is ultimately counter-productive.

Reason #2: Supervisors do not recognize contributions.

It may be trite, but everyone enjoys getting a pat on the back every now and then. Recognize the needs of valuable employees and respond in kind.

Reason #3: They are not properly rewarded.

For many workers, it is a case of “show me the money.” Employees should be compensated in line with their performance. If they are not, they will likely walk away at some point.

Reason #4: The boss does not care about workers.

Supervisors do not have to be best friends with employees—in fact, it is usually better if they are not—but professionalism should be balanced with sensitivities. Show employees that you really care during both good times and bad.

Reason #5: Promises are not lived up to.

If you make a commitment to an employee and follow through, it breeds loyalty. However, reneging on a promise, be it a salary increase or some other accommodation, can lead to distrust and resentment.

Reason #6: New-hires and promotions reflect poor judgment.

Good people want to work alongside other good people. It is discouraging when new-hires do not measure up. Even worse, if poor performers are promoted, it sends a negative message, especially to someone who believes he or she was wrongly passed over.

Reason #7: There is no chance of advancement.

Managers cannot expect employees to stay on the job long-term if there is no possibility of growth, either financially or intellectually, or both. Establish a logical career path that can be followed.

Reason #8: They are not inspired.

Smart supervisors know how to tap into enthusiasm of workers to being out the most of their talents. Giving employees the chance to explore their passions is a strong motivator, while failing to do so may actually decrease productivity.

Reason #9: They are not properly trained.

How can you expect employees to do a good job without adequate training? When you simply throw new-hires into the deep end of the pool, some may swim but others will sink. Similarly, additional education can lead the way to advancement.

Reason #10: Their jobs are mundane.

Doing the same thing day-in- and day-out gets old very quickly. Even for jobs requiring a routine approach, try to unlock the creativity of workers and challenge them to do better.

There are no absolute guarantees, but addressing these issues may reduce a higher turnover rate. At the very least, it may ensure that new-hires stay longer.

IRA Rollovers: Make Your Move
How to complete timely maneuver

If you receive a distribution from an employer's retirement plan, like a 401(k), you generally are required to pay ordinary income tax on the payout. However, with a timely maneuver, you can continue to postpone tax until you are ready to make withdrawals.

Basic rules: There is no current income tax liability on a distribution from a qualified retirement plan if you "roll over" the funds within **60 days**. For example, if you have a 401(k) account at your job and you are retiring, you may transfer all of the funds to an IRA without paying any tax.

Years ago, the rollover rules were much more restrictive than they are now. For example, you were required to roll over the entire amount of in your account balance with a lump-sum distribution. Now you might decide to take advantage of a partial rollover. Any portion of a distribution that is not rolled over is taxed as ordinary income.

In addition, rollovers could be used only upon separation from service or upon reaching age 59½. Depending on your employer's plan in-service distributions are permitted.

Nevertheless, certain qualified plan distributions are **not eligible** for tax-free rollover treatment. The list includes these items:

- Required minimum distributions (RMDs)
- Loans treated as distributions
- Hardship distributions
- Distributions of excess contributions and related earnings,
- A distribution that is one of a series of substantially equal payments
- Withdrawals electing out of automatic contribution arrangements
- Distributions to pay for accident, health or life insurance
- Dividends on employer securities
- S corporation allocations treated as deemed distributions

Furthermore, if you receive a qualified retirement plan payout, income tax is automatically withheld at a 20% rate, even if you intend to roll over the funds to an IRA within 60 days.

You cannot recoup this amount until you file your income tax return for the year of the distribution. To make matters worse, you may also be assessed a **10% penalty tax** for plan withdrawals made prior to age 59½. The penalty is equal to 10% of the taxable portion of the withdrawal.

Key exception: There is no withholding requirement or penalty for a trustee-to-trustee transfer. Say that you're age 55 and you are receiving a $100,000 distribution from your retirement plan. For instance, if you have your plan administrator directly transfer the $100,000 to the trustee of the IRA, you avoid both the 20% withholding requirement and the 10% penalty tax.

Of course, there are other factors to consider when you receive retirement plan distributions. For example, you may want to time receipt of a distribution in a year when you expect to be in a low tax bracket. Note that different tax rules apply to transfers to a Roth IRA.

Ultimate question: Should you roll over to an IRA or not? It all depends on your personal situation. Discuss the options with your professional advisors.

Do You Need a Spendthrift Trust?
Technique for protecting assets

Estate taxes are generally less of a concern than they used to be, but estate planning is not just about taxes. For instance, if you have accumulated significant wealth, you may be concerned that beneficiaries of your estate might squander the funds when you are gone. Or one or more of your heirs may not have the financial acumen to manage the assets. In that case, you might take steps to protect the wealth, such as using a "spendthrift trust."

How it works: With assistance from an attorney, you can set up a trust according to state law and transfer assets to the trust. Usually, the assets will include securities like stocks and bonds and possibly other property like real estate and some cash. Then you designate someone—frequently, a professional—to manage the assets as the **trustee**.

Significantly, the terms of the trust restrict the ability of beneficiaries to spend the money or sell off assets in the trust account. So, your 18-year-old child can't go out and buy a Lamborghini or take a yearlong cruise around the world. In addition, the assets transferred to the trust are protected from the reach of the beneficiary's creditors.

In lieu of direct access, beneficiaries may receive regular payments from the trust or payments based on the discretion of the trustee. For example, if a beneficiary is in college, the trustee may provide payments to the school. However, once an amount is in the hands of a beneficiary, he or she has control over it.

Naming the trustee is critical to the process. Depending on the trust terms, the trustee may have **wide discretion** over use of funds. For instance, the trust may empower the trustee to make payments to a beneficiary on an "as needed" basis. Alternatively, the trustee may be held responsible for making scheduled payments or be authorized to act upon the happening of a specific occurrence (e.g., a child reaching a certain age).

Whom should you name as the trustee? Technically, it is not illegal to act as the trustee yourself, although this may lead to complications and is generally not recommended. More often than not, the trustee will be a professional like the attorney who helps to create the trust. Or you might choose another family member or close friend. Either way, it should be someone with the requisite financial knowledge.

Furthermore it is important to name a **successor** trustee in the event the designated trustee dies before the end of the term or otherwise cannot handle the duties. At the very least, you may name a professional as the successor trustee.

There are several other important aspects to consider, including provisions for terminating the trust and addressing contingencies such as a beneficiary predeceasing the grantor. Along the same lines, the trust may have to be revised to accommodate changes in the tax law or other new developments.

Do not try to go it alone. Consult with your **estate planning team** to determine if this approach makes sense for your family.

New Law Aims to Put Taxpayers First

Congress passed the "Taxpayer First Act" in late June. This new groundbreaking legislation creates an independent office of appeals within the IRS, **modernizes IRS operations** and improves cyber security measures. The new law also expands safeguards addressing ID theft of taxpayers.

But this is likely not the end of the story. Most experts believe more improvements are needed. Expect to hear about modernization of the IRS again in the near future.

Facts and Figures

Timely points of particular interest

Audit Rates—According to the new IRS "Data Book," the audit rate for individual taxpayer continues to decline. The new Data Book, reflecting figures from Fiscal Year 2018 (FY 2018), show the IRS audited nearly 1 million individual tax returns in FY 2018, or 0.5% of all individual returns. In comparison, the IRS audited 0.6% of the individual returns filed in FY 2017. The rate was as high as 1.11% as recently as FY 2011.

Instant Action—Is your business thriving? One of the keys to being successful is the ability to get things done. Thus, many business experts have endorsed the need for speed. By showing a **sense of urgency**, you can cut through the red tape, deliver goods or services on time and realize goals. Conversely, if you are waiting around for things to happen, you will likely achieve less and not be as successful.