July 2017

Volume 7, Issue 1

Leslie A. Cesario, Ltd. Monthly Newsletter

Thinking of Tossing Old Tax Records? Read This First.

Article Highlights:

- Reasons to Keep Records
- Statute of Limitations
- Maintaining Records of Asset Basis
- Keeping Records for Carryforward Losses

Now that your taxes have been completed for 2016, you are probably wondering which old records can be discarded. If you are like most taxpayers, you have records from years ago that you are afraid to throw away. It would be helpful to understand why the records must be kept in the first place.

Generally, we keep tax records for two basic reasons: (1) in case the IRS or a state agency decides to question the information reported on our tax returns, and (2) to keep track of the tax basis of our capital assets so that the tax liability can be minimized when we dispose of them.

With certain exceptions, the statute for assessing additional taxes is **three years** from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states is one year longer than the federal law. In addition to lengthened state statutes that cloud the recordkeeping issue, the federal three-year assessment period is extended to six years if a taxpayer omits from gross income an amount that is more than 25 percent of the income reported on a tax return. And, of course, the statutes don't begin running until a return has been filed. There is no limit where a taxpayer files a false or fraudulent return to evade taxes.

If an exception does not apply to you, for federal purposes, most of your tax records that are more than three years old can probably be discarded; add a year or so to that if you live in a state with a longer statute.

> ***Examples -*** *Sue filed her 2013 tax return before the due date of April 15, 2014. She will be able to dispose of most of the 2013 records safely after April 15, 2017. On the other hand, Don files his 2013 return on June 2, 2014. He needs to keep his records at least until June 2, 2017. In both cases, the taxpayers may opt to keep their records a year or two longer if their states have a statute of limitations longer than three years. Note: If a due date falls on a Saturday, Sunday or holiday, the due date becomes the next business day.*

The big problem! The problem with the carte blanche discarding of records for a particular year because the statute of limitations has expired is that many taxpayers combine their normal tax records and the records needed to substantiate the basis of capital assets. These need to be separated, and the basis records should not be discarded before the statute expires for the year in which the asset is disposed. Thus, it makes more sense to keep those records separated by asset. The following are examples of records that fall into that category:

• Stock acquisition data - If you own stock in a corporation, keep the purchase records for at least four years after the year the stock is sold. This data will be needed to prove the amount of profit (or loss) you had on the sale.

• Stock and mutual fund statements (If you reinvest dividends) - Many taxpayers use the dividends they receive from stocks or mutual funds to buy more shares of the same stock or fund. The reinvested amounts add to the basis in the property and reduce gain when it is finally sold. Keep statements at least four years after the final sale.

• Tangible property purchase and improvement records - Keep records of home, investment, rental property, or business property acquisitions AND related capital improvements for at least four years after the underlying property is sold.

For example, because of the generous $250,000 ($500,000 for joint filers) home gain exclusion available to most homeowners, some taxpayers have become lax in maintaining home improvement records, thinking the large exclusions will cover any potential appreciation in the home's value. But that exclusion may not always be enough to cover sale gains, particularly in markets where property values have steadily risen, so records of home improvements are vital. Records can be important, so please use caution when discarding them.

If you sell securities (stocks, bonds or mutual funds) that result in a loss, after you've offset any capital gains from other sales, you may end up with a larger loss than can be deducted in one year (maximum $3,000 or $1,500 if married filing separate). In that case, you are allowed to carry over the excess loss to use in future years. When this happens, you will need to keep the purchase and sale records of the securities for four years after filing the return when the last of the carryover loss is used.

Similarly, if you have a net operating loss from a business that is being carried forward to future years, you'll need to keep the business records from the loss year until four years after the return on which all of the loss was used up.

What about the tax returns themselves? While disposing of the backup documents used to prepare the returns can usually be done after the statutory period has expired, you may want to consider keeping a copy of your tax returns (the 1040 and attached schedules/statements plus your state return) indefinitely. If you don't have room to keep a copy of the paper returns, digitizing them is an option.

If you have questions about whether or not to retain certain records, give this office a call first; it is better to check before discarding something that might be needed down the road.

Borrowing Money to Finance an Education?

Article Highlights:

- *Home Equity Loan*
- *Home Equity Interest Deduction*
- *Alternative Minimum Tax*
- *Above-the-line Interest Deduction*
- *Qualified Expenses*

If you are considering borrowing funds to finance your education or the education of your spouse or children, you may wish to take advantage of the available tax benefits.

If you itemize your deductions and have sufficient equity in your home, you might consider borrowing the needed cash from your home. Generally, homeowners can take $100,000 of equity debt on their home and still deduct interest against the regular tax. Unfortunately, *the interest on equity debt is not deductible against the alternative minimum tax (AMT), so consider other alternatives first if you are subject to the AMT. However, even if you are subject to the AMT, your best option may still be taking equity from your home. You may lose the benefit of the interest deduction, but the low interest rate on home loans is still in your favor.*

If you don't itemize your deductions or are subject to the AMT, you may still be able to utilize the above-the-line education interest deduction. This deduction has several restrictive qualifications and is limited to a maximum annual deduction of $2,500. It is phased-out ratably for taxpayers with an AGI (income) of $65,000 to $80,000 ($135,000 to $165,000 for joint returns). These amounts are for 2017; contact this office for the amounts for other years.

The above-the-line interest deduction may only be claimed by a person who is legally obligated to make the payments on the qualified educational loan. However, tax regulations allow payments on above-the–line education interest made by someone other than the taxpayer/borrower to be treated as a gift, allowing the interest to be deductible by the taxpayer.

The above-the-line deduction is not limited to interest on government student loans. The interest paid on other types of loans qualifies, including a home equity loan and even credit card interest, if only qualified education expenses are charged on the account. The borrowed funds must be used solely for qualified educational purposes, and the lender cannot be a relative. Generally, the funds must be used for qualified expenses within a reasonable period of time, usually 90 days before or after borrowing the funds. A home equity line of credit can be used to meet these requirements by paying education expenses as they become due, provided that the loan is not used for another purpose.

If you are considering borrowing money to pay for education, it may be appropriate to consult with this office, since there are other limitations. Please call for assistance.

Does Your Employer Misclassify You as an Independent Contractor Instead of as an Employee?

Article Highlights

- Employee
- Independent Contractor
- Behavioral Control
- Financial Control
- Relationship
- Request For IRS Determination
- Self-Employment Tax

It is not uncommon for employers to misclassify employees as independent contractors, either to intentionally avoid their withholding and tax responsibilities or because they are not aware of the laws regarding the issue. If your employer reports your income on a Form 1099 (as opposed to a W-2), you are being treated as an independent contractor, not as an employee. This can have significant ramifications in terms of how much you have to pay in income, Social Security, and Medicare taxes.

The general distinction, of course, is that an employee is an individual who works under the direction and control of an employer, and an independent contractor is a business owner or contractor who provides services to other businesses.

To determine whether a worker is an independent contractor or an employee, the IRS examines the relationship between the worker and the business and considers all evidence regarding control and independence. This evidence falls into the following three categories:

(1) Behavioral control covers whether the business has the right to direct or control how the work is done through instructions, training, or other means. Employees are generally given instructions on when and where to work, what tools to use, where to purchase supplies, what order to follow, and so on.

(2) Financial control covers whether the business has the right to control the financial and business aspects of the worker's job. This includes the extent to which the worker has unreimbursed business expenses; the extent of his or her investment in the facilities being used; the extent to which his or her services are made available to the relevant market; how he or she is paid; and the extent to which he or she can realize a profit or incur a loss.

(3) Type of relationship includes any written contracts that describe the relationship the parties intended to create; the extent to which the worker is available to perform services for other, similar businesses; whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay; the permanency of the relationship; and the extent to which the worker's services are a key aspect of the company's regular business.

When a worker's status is in doubt, Form SS-8 (Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding) can be used. This form may be completed by an employer or a worker; it asks the IRS to determine whether the worker is an employee or an independent contractor for federal tax purposes. Form SS-8 is filed separately from the requestor's tax return. The IRS does not issue determinations for proposed employment arrangements or hypothetical situations, and it will only issue a determination if the statute of limitations for the year at issue hasn't expired.

If an employee wants to avoid paying self-employed tax on 1099-MISC income after he or she has already been determined to be an employee – or when he or she has filed an SS-8 but has not received a response – that individual can file Form 8919, which only requires payment of what would have been withheld if the worker had been treated as an employee. Form 8919 requires the employee to choose one of these codes:

Code A. I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.

Code C. I received other correspondence from the IRS that states I am an employee.

Code G. I filed Form SS-8 with the IRS but have not received a reply.

Code H. I received a Form W-2 and a Form 1099-MISC from this firm for the same tax year. The amount on Form 1099-MISC should have been included as wages on the Form W-2.

If using Code H, do not file an SS-8. Here are some examples of amounts that are sometimes erroneously included (but not necessarily deliberately misclassified) on Form 1099-MISC and that should be reported as wages on Form W-2: employee bonuses, awards, travel expense reimbursements not paid under an accountable plan, scholarships, and signing bonuses.

If Code G is used, both the employee and the firm that paid the employee may be contacted for additional information. Use of this code is not a guarantee that the IRS will agree with the worker's opinion as to his or her status. If the IRS does not agree that the worker is an employee, the worker may be billed an additional amount for the employment tax, as well as penalties and interest resulting from the change in the worker's status.

If the IRS determination is for multiple open years, the employee can amend returns for open years to recover a portion of the self-employed tax paid.

If you have questions about being misclassified as an independent contractor, please give this office a call.

Can You Deduct a Home Office, and Is It Worth It?

Article Highlights:

- Qualifications
- Employee Issues
- Method Options
- Income Limitations
- Relocation

"Home office" is a term used to describe the tax deduction for the business use of your home, which may or may not be an office. It is often misunderstood and claimed by those who don't qualify for it or not claimed to the taxpayer's best advantage. Understanding the requirements, options, limitations, advantages and disadvantages will help you determine if you qualify for the deduction and whether it is right for you.

Qualifications – In general, for you to deduct home office expenses, the office area must be used exclusively (no personal use) in your trade or business on a regular, continuing basis, and one of the following must apply—it is:

1. Used for storing inventory for a wholesale or retail business for which your home is the only fixed location. Use of the area need not be exclusive under this test, but it must be regularly used;
2. Used as a licensed day care center (exclusive use not required);
3. A separate structure not attached to your home but used for business;
4. A place where you meet with customers, patients or clients (just telephone contact with clients isn't enough to meet this test); or
5. The principal place of business for any of your trades or businesses.

Employee Issues – If you are an employee, in addition to the general qualifications for a home office discussed above, the home office use must also be for the convenience of your employer. Convenience of the employer means a business necessity—the use of the home must be a condition of employment. The employee needs a place to work, but the employer doesn't provide one (or the office provided by the employer is inadequate or unsafe). Usage by the employee for personal convenience is not enough.

Method Options – Two methods are available for determining the amount of the home office deduction: the actual expense method and the simplified method (sometimes termed the safe-harbor method).

- **Actual Expense Method** – The actual expense method uses home expenses that are prorated based upon the portion of the home that qualifies as a home office, generally based upon square footage. The prorated expenses include mortgage interest, real property taxes, insurance, heating, electricity, maintenance and depreciation. In the case of a rented home, the interest, tax and depreciation expenses are replaced by rent. Besides the prorated expenses, 100% of the costs directly related to the office, such as painting the office or repairs specific to the office, are allowed.

- **Simplified Method** – In lieu of the actual expense method, the simplified method can be elected annually. The deduction is $5 per square foot, with a maximum square footage of 300. Thus, the maximum deduction is $1,500 per year. If the space was not used the entire year as a qualified home office, then this simple method becomes a little more complex, as the deduction must be limited to $5 times the average monthly square footage. Under the actual expense method, since part of the home mortgage interest and taxes are deducted as home office expenses, only the difference between 100% of the mortgage interest and taxes and the amount claimed for the office expense is allowed as a Schedule A itemized deduction. With the simplified method, all of the qualified home mortgage interest and taxes can be deducted on Schedule A.

When using the actual method, the unused deduction as a result of the income limitations (discussed below) carries over to future years, but none of the unused deduction figured by the simplified method will carry over.

<u>Income Limitations</u> – Even if you qualify for a home office deduction, the home office deduction is limited to the business activity's gross income or, in the case of an employee, wages from the employer. Many people mistakenly believe that the limitation is the activity's net income. The gross income limitation is actually the gross sales less the cost of goods sold, the business portion of the home's mortgage interest and taxes and the otherwise deductible business expenses that are not related to the home's business use. If the simplified home office deduction is used, there is no adjustment for home mortgage interest and taxes.

<u>Relocation</u> – There are additional things to consider when you deduct a home office and subsequently leave the rental or sell the home.

- **Renter** – When you rent your home, move and use space at the new location as a home office, for the year of the move, you'll need to figure the deduction separately for each home office based on the specific expenses and business use area of each home. If you don't use space at your new living quarters for business purposes, then your home office deduction for the year of the move will only need to factor in the expenses for the time you lived in the first home.

- **Homeowner** – If you own the home, sell it and had lived in it for 2 of the 5 years prior to the sale date, you can exclude up to $250,000 of gain ($500,000 for a married couple). However, you cannot exclude the part of any gain to the extent of depreciation you claimed for the home office after May 6, 1997.

  In addition, if the home office was within the same structure as the home, the exclusion will apply to the entire gain from the home except for the deprecation claimed. On the other hand, if the office was within a separate structure, then the sale must be treated as two sales – one for the home and one for the office – and the gain from the home office portion cannot be excluded, which can be a huge negative to claiming the home office deduction in the first place.

As you can see, there is more to the home office deduction than meets the eye. If you have questions about how a home office might fit into your tax situation, please give this office a call.

Are You Ignoring the Household Employee Payroll Rules?

Article Highlights:

- Household Employees
- Tax Avoidance
- Filing 1099s
- Correct Procedures
- W-2s, Payroll Taxes and Reporting
- Overtime
- Hourly Pay Or Salary
- Separate Payrolls

If you hire a domestic worker to provide services in or around your home, you probably have a tax liability that you don't know about – or one that you do know about but are ignoring. Either situation can come back to bite you. When the worker is your employee, your liability includes both withholding and paying payroll taxes as well as issuing a W-2 after the close of the year.

Sure, it is a lot easier simply to pay your worker in cash so as to avoid federal and state payroll taxes – and all the paperwork that goes with them. Your domestic worker will likely be fully cooperative with a cash deal because he or she can also avoid paying taxes. However, if the IRS or your state employment department finds out about these payments, the result could be very unpleasant for you.

Not everyone who performs services in or around your home is classified as an employee. For instance, a plumber or electrician who makes repairs in your home will generally be a licensed contractor; the government does not classify contractors as employees.

On the other hand, the IRS has conclusively ruled that nannies, housekeepers, senior caregivers, some gardeners and various other domestic workers are employees of the people for whom they work. It makes no difference if you have a written contract with the employee; similarly, the number of hours worked and the amount paid do not matter.

You are probably thinking, "Wait a minute" – perhaps everyone you know pays in cash, and none of them has paid payroll taxes or issued a W-2 for a household employee. However, if a worker gets injured on your property or if you dismiss the worker under less-than-amicable circumstances, it's a pretty sure bet that your household employee will be the first one to throw you under the bus by reporting you to the state labor board or by filing for unemployment compensation.

Even some big-name people have been caught up in this issue. Just recently (as seems to happen every four years), a presidential nominee, Rep. Mick Mulvaney (R-SC), was revealed to have failed to pay more than $15,000 in taxes on behalf of the nanny for his newborn triplets. He subsequently paid the back taxes and was confirmed as Director of the Office of Management and Budget.

Some individuals try to circumvent the payroll issue by treating a household employee as an independent contractor, incorrectly issuing the household employee a Form 1099-MISC.

Here are the correct actions you should take for domestic employees:

- Obtain a Federal Employer Identification Number (FEIN), which you will use in lieu of your Social Security Number when filing the required reporting forms. *Note:* If, as the owner of a sole proprietorship business, you already have a FEIN, you should use that number instead of requesting a separate one as a household employer.
- Obtain a state ID number for unemployment insurance and state tax withholdings.
- Withhold Social Security and Medicare taxes from the employee's pay if it exceeds

the annual threshold ($2,000 for 2017).

- Withhold income tax from the employee if the worker requests and if you agree to do so.
- File state employment tax returns as required – generally quarterly (although beware that some states require monthly returns) – and make the required deposits for state employment taxes.
- Prepare a W-2 for the employee and a W-3 transmittal; file them by the end of January.
- File Schedule H with your federal individual income tax return, and pay all the federal payroll and withholding taxes (i.e., the federal taxes that you withheld from the employee's pay, plus your matching share of Social Security, Medicare and federal unemployment taxes). *Limited exception:* If you operate a sole proprietorship with employees, you may include the payroll taxes of your household workers with those of the business's employees, but you cannot take a business deduction for those taxes. Generally, it is better to keep the personal and business reporting separate.

Some additional issues to consider are as follows:

Overtime – Under the Fair Labor Standards Act, domestic employees are nonexempt workers and are entitled to overtime pay after working 40 hours in a week. Live-in employees are an exception to this rule in most states.

Hourly Pay or Salary – It is illegal to treat nonexempt employees as if they are salaried.

Separate Payrolls – If you own a business with a payroll, you may be tempted to include your household employees on the company's payroll. The payments to the household employees are personal expenses, however, and are not allowable deductions for a business. Thus, you must maintain a separate payroll for household employees; in other words, you must use personal funds to pay household workers and instead of paying them from a business account.

Eligibility to Work in the U.S. – It is illegal to knowingly hire or continue to employ an alien who is not legally eligible to work in the U.S. When hiring a household employee who works on a regular basis, you and the employee each must complete Form I-9 (Employment Eligibility Verification). You will need to examine the documents that the employee presents to establish the employee's identity and employment eligibility.

Other Issues – Special situations not covered in this overview include how to handle workers hired through an agency, how to gross up wages if you choose to pay an employee's share of Social Security and Medicare taxes, and how to treat noncash wages.

Please call this office if you would like assistance with your household employee tax and reporting requirements or with any special issues that apply to your state.

The IRS Has Become More Liberal With College Expenses

Article Highlights:

- Computers
- Internet Access
- Qualified State Tuition (Sec. 529) Plans
- American Opportunity Tax Credit
- Required for Enrollment or Attendance

Computers and the Internet have become integral parts of education by providing access to online courses, learning and research. It is virtually impossible to be enrolled in postsecondary education without a computer, which is needed to complete written assignments, type reports, prepare theses and access the Internet.

Recent tax regulations have acknowledged the fact that computers, peripheral equipment, certain types of nonentertainment software, Internet access and related services are essential for postsecondary education. Thus, when those items are used primarily by a beneficiary of a qualified state tuition (Sec 529) plan, the cost of the items can be reimbursed from the plan's funds, tax-free.

In addition, the regulations for the American Opportunity Tax Credit (AOTC) have been modified (effective in 2016) to clarify that the AOTC's definition of qualified tuition and related expenses includes books, supplies and any other equipment that is required for enrollment or attendance at an eligible institution. For this purpose, the materials must be needed for "meaningful attendance or enrollment" in a course of study; they can be purchased from the institution or an outside vendor.

Computers are not specifically listed in the new AOTC regulations, but the wording certainly implies that a computer qualifies as long as it is required for meaningful attendance. This change is so new that there is no precedent for how the IRS will apply the regulations to computers, as the regulations do not specifically include them. To be on the safe side, each student seeking the credit should get an instructor to write a letter (on school letterhead) stating, "A computer is required for meaningful attendance."

For more information regarding which education expenses qualify for Sec 529 plan reimbursements or for the AOTC, please give this office a call.

How An Accounting Pro Can Help Your Small Business Boom

One of the most positive qualities that many small business owners share is a burning desire – an insatiable willingness – to "do it all." It's what separates entrepreneurs from employees in the first place. An employee is more than willing to set out on the path that someone else has carved for them. An entrepreneur has a need to carve a path for themselves.

Unfortunately, this mentality can also get even the most passionate small business owners into a bit of trouble – particularly when it comes to their finances. Being able to balance your own checkbook and running the finances of a small business are NOT the same thing, nor should they ever be treated as such. To that end, the importance of finding the right accounting professional to help support your small business as it continues to grow and evolve cannot be overstated enough.

There are a number of essential ways, in particular, that an accounting expert can help your small business.

When You're Just Starting Out

Perhaps the most important role that an accounting professional will play in terms of your small business takes place when you're just starting out. One of the most common mistakes that many business owners make involves selecting the wrong business entity a small problem that can have major ramifications when tax season rolls around. A accounting pro who is intimately involved with the makeup of your business from a basic level can help make sure this doesn't happen to you.

Along the same lines, an accounting professional can also help make sure that your accounting system is properly set up in the first place. They can make sure that you're picking the right accounting system that actually supports your long-term goals for your business and can create a chart of accounts to offer superior visibility into money coming into and out of your organization.

The Day-to-Day Grind

Another one of the hugely invaluable ways that an accounting expert can help your small business comes by the small, yet critical, decisions they make on a daily basis. A financial expert can help give you greater visibility into cash flow (including accounts payable and accounts receivable), for example. Cash flow and other instability issues are one of the major reasons why most small businesses fail in the first place, and having the right person at your side can help you avoid them altogether.

An accounting professional can also help make sure your security controls are properly set up and executed, particularly in terms of factors like compliance. Remember that we're living in an era where the average cost of a data breach has ballooned to almost $4 million. If the security aspect of your finances is not properly accounted for, it could be putting your entire business at risk. Even one small data breach could expose the personal records of multiple clients, something that opens the door to things like lawsuits, and that could eventually close the door on everything you've worked so hard to build.

Other Benefits

A financial professional will also play an important role when it comes to growing your small business. Remember that both an inability to scale up as fast as you need AND growing your business faster than you can sustain are additional reasons why many small businesses fail. Because such a large part of your growth and expansion pace has to do with personal finances, it stands to reason that bringing someone into the fold who can leverage their years of experience to your advantage is a very good idea.

A financial expert can help you raise money – particularly helpful if you're getting ready to bring a new product or service to market. If you ever decide that this chapter of your life is closed and that it's time to look for new opportunities, these professionals can also help sell your small business as well. Selling a business is a process filled with potential mistakes just waiting to happen, and the expert hand of someone who has been in this position before is something that you literally cannot put a price on. It isn't just an investment in your organizational ability – it's an investment in the future of your business as a whole.

In the End

The fact of the matter is that there really is no "one size fits all" approach to small business accounting. Every business is a little bit different, which will require a certain level of care and finesse when it comes to finances in particular. Only by consulting the help of a professional as early on in the process as possible will you be able to avoid the normal pitfalls of running a small business and create a financially stable foundation from which to work.

If you are considering starting a new business, it may be appropriate to consult with this office before you get too far through the process.