tax report

MAY 2016

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Bad Debt Deductions

Both nonbusiness and business bad debts may be tax deductible. However, you'll need to demonstrate that you have satisfied certain preconditions first.

Nonbusiness Bad Debts

Nonbusiness bad debts typically arise from unpaid cash advances. Generally, for an allowable bad debt deduction, the debt must be "bona fide," requiring that any loan or extension of credit was actually intended to be a loan rather than something else, such as a gift or capital contribution. For example, if you lend money to a relative or friend with the understanding that it may not be repaid, you must consider it a gift rather than a loan.

A similar issue will sometimes arise when an individual extends money to a closely held corporation. For example, a federal appellate court recently denied a taxpayer's claimed bad debt deduction because — despite the existence of loan paperwork documenting a $1 million "loan" from the taxpayer to her family-owned real estate company — the taxpayer had, at all times, treated the advance as a capital contribution rather than a loan.*

As with business bad debts, discussed next, nonbusiness bad debt deductions can only be taken in the year the debt becomes worthless. However, nonbusiness bad debts must be *completely* worthless to be deductible. You don't have to wait until a debt is due to determine that it is worthless. Nonbusiness bad debts are reported as short-term capital losses.

Business Bad Debts

Deductible business bad debts are typically limited to loans to clients and suppliers, business loan guarantees that the taxpayer had to satisfy, and credit sales to customers. Again, you must be prepared to demonstrate that the bad debt was bona fide. To claim uncollectible amounts due from customers as bad debts, you must have previously included the amounts in income.

A business bad debt must be either partially or completely "worthless" for the loss to be deductible. Whether it is worthless will again depend on all the facts and circumstances, but you may be able to meet this requirement if you have taken reasonable steps to collect a debt and there is no longer any possibility that you will receive payment.

Monitor Outstanding Debts

To ensure that you don't miss out on a bad debt deduction, review your records carefully before the end of the year to pinpoint any potentially worthless receivables you may still be carrying on the books. You also may be able to amend a prior year's business tax return to claim the loss. ■

* *Shaw v. Comm'r*, CA-9, 2015

2016 Mileage Rates

The good news is that gas prices are down. The bad news is that the IRS has announced reductions in the standard mileage rates for the use of an automobile for business, medical, and moving purposes.

The new rates — effective January 1, 2016 — are as follows:

- Business use of an owned or leased automobile — 54¢ per mile (down from 57.5¢ in 2015)
- Use of a vehicle for medical purposes or moving expenses — 19¢ per mile (down from 23¢ in 2015)

Taxpayers use the business mileage rate to calculate the deductible costs of operating an automobile for business purposes. The medical and moving expense rates are used to calculate deductions related to travel for necessary medical treatment and certain job-related moves.

Alternatively, taxpayers may generally choose to calculate the applicable deduction by using the *actual costs* associated with operating the vehicle.

short takes

Increase in Monthly Transportation Allowance

As a result of recent legislation, the fringe benefit allowance for monthly transit passes and van pool benefits has increased to $255 per month for 2016. The legislation permanently extended a rule requiring that such allowances maintain parity with the monthly allowance for qualified parking benefits. If all requirements are met, employer reimbursements for these expenses are excluded from the employee's wages for both income- and payroll-tax purposes.

Health Savings Accounts for Retirement

The unique tax advantages of health savings accounts (HSAs) can make them a useful tool for saving for retirement medical expenses. Contributions are deductible up to certain annual limits (for 2016, $3,350 with individual coverage under a high deductible health plan and $6,750 with family coverage). Upon reaching age 55, individuals may contribute an additional $1,000 annually. Employer contributions are generally not subject to income, Social Security, or Medicare taxes. No HSA contributions are allowed once a person is enrolled in Medicare. Investment earnings in an HSA are not taxed, and account distributions are tax free when used for qualified medical expenses.

Changes to 529 Plan Distribution Rules

A Section 529 college savings plan allows you to make contributions to an investment account set up to pay qualified higher education expenses. Though contributions are not deductible on your federal income-tax return, account distributions (including earnings) are exempt from federal — and sometimes state — income taxes when used for the account beneficiary's qualified higher education expenses.

The Protecting Americans from Tax Hikes (PATH) Act of 2015 has loosened some restrictions governing these accounts.

Expansion of qualified higher education expenses. The definition of qualified higher education expenses has been expanded to include expenses for the purchase of computer equipment, computer software, and Internet access and related services, *provided* these items are to be used primarily by the account beneficiary during any of the years he or she is enrolled. (Purchases of computer software designed for sports, games, or hobbies generally cannot qualify.)

Elimination of aggregation rule. For purposes of determining the taxable portion of any distribution exceeding qualified higher education expenses, there is no longer any requirement that all accounts for the beneficiary be aggregated. This means that the best strategy may be to take the distributions from the 529 account with the least amount of earnings.

60-day rule for returning distributions. Refunds of qualified higher education expenses made by an eligible educational institution will not be subject to federal income tax if redeposited in the beneficiary's 529 account within 60 days. ■

Charities and Politics Don't Mix

With the 2016 election season well underway, nonprofit organizations claiming tax exemption under Section 501(c)(3) of the federal tax code — religious groups, hospitals, social service providers, and other public charities — should be careful not to violate the law's prohibition on political campaign activities.

Prohibited Activities

Participation or intervention in a political campaign on behalf of, or in opposition to, a candidate for public office is absolutely prohibited, whether it's done directly or indirectly. This restriction applies to campaigns of candidates running for national, state, or local public office.

Examples of prohibited political campaign activities include:

- Endorsing a candidate
- Donating to a candidate's campaign
- Allowing a candidate to make a campaign speech at an organization-sponsored event
- Distributing materials that favor or oppose a candidate
- Posting comments about a candidate on the organization's website or maintaining a link to only one candidate's profile on the site

Permissible Activities

Education of voters must be conducted in a nonpartisan manner. For example, organizations may prepare and distribute voter education guides, but they must maintain neutrality in all aspects of the publication. Likewise, if the nonprofit chooses to hold a public forum, all candidates seeking the same office should have an equal opportunity to be represented or to participate.

Failure To Comply

Violating the prohibition on political campaign activities can result in revocation of an organization's tax-exempt status and the imposition of certain excise taxes.

The rules governing the permissible political activities of nonprofits are detailed and extensive. Contact us if we can help. ■

Operating a SEP or SIMPLE IRA Plan — Watch for Common Pitfalls

Two retirement plans available to small businesses are the Simplified Employee Pension (SEP) plan and the "SIMPLE" Individual Retirement Account (IRA) plan. Following are brief overviews of these plans and the types of errors frequently seen by the IRS.

SEPs — General Rules

With SEPs, IRAs are set up for each eligible employee and contributions are made *only* by the employer.* The employer has complete discretion in determining whether or not to make annual contributions. Qualifying contributions are tax deductible by the employer and not taxed to the employee until withdrawn from the plan.

Contribution limits are subject to annual inflation adjustment. For 2016, the maximum contribution for each employee is the lesser of 25% of annual compensation (up to $265,000) or $53,000.** There is a special computation for figuring the maximum contribution to a self-employed individual's own SEP account.

Common SEP Pitfalls

According to the IRS, common errors in SEP plans include:

Discrimination in employer contributions. Contributions may not discriminate in favor of "highly compensated employees" (generally, a 5% owner or a person with compensation exceeding $120,000**). Contributions must also bear a uniform relationship to the first $265,000 in compensation.**

Improper exclusion of employees. Eligible employees include all those who have (1) reached age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $600 in compensation.**

Permitting elective salary deferrals by employees. No salary deferrals are allowed under a SEP plan.*

Delays in taking required minimum distributions (RMDs). Employees must begin taking their RMDs at age 70½, whether or not they are still working.

SIMPLE IRAs — General Rules

While SEPs are available to employers of any size, SIMPLE IRAs are available only to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding year. As with a SEP, a SIMPLE IRA plan requires the employer to establish IRAs for each eligible employee. Unlike a SEP, SIMPLE IRAs may allow eligible employees to defer compensation into the plan. For 2016, deferrals may not exceed $12,500, or $15,500 for those 50 or older.

Additionally, employers *must* make an annual contribution by electing to either (1) *match* employee salary contributions up to 3% of pay*** or (2) *contribute* 2% of pay for each employee who's eligible to contribute, even if the employee chooses not to do so.

Common SIMPLE IRA Pitfalls

According to the IRS, frequently seen errors in SIMPLE IRA plans include:

Matching errors. Though the employer match may be reduced to as low as 1%, the match may fall below 3% in no more than two out of the previous five years.

Late deposits of employee contributions. The U.S. Department of Labor requires that deposits be made at the earliest date they can reasonably be segregated. Alternatively, a seven-day safe harbor rule may be available.

Required 60-day notices. Generally, eligible employees must receive notice during the 60-day period prior to the beginning of the plan year of the employer's decision to make a fixed or matching contribution and of the employees' right to make or modify a salary deferral election.

Pitfalls Common to Both Plans

According to the IRS, frequently seen errors in both plans include improper application of the plan's definition of "compensation" and failure to timely amend the plans. The IRS recommends that employers check their plans yearly. ■

* A limited exception applies to a salary reduction simplified employee pension (SARSEP) in effect on December 31, 1996.

** Subject to future inflation adjustment.

*** The employer may elect a lower matching percentage in certain years.

Calendar of Filing Dates

MAY

10 Employers: Deferred due date for Form 941, if timely deposits were made.

16 Exempt Organizations: File 2015 Form 990, 990-EZ, or 990-N, if the organization reports on a calendar-year basis.

16 Partnerships and S Corporations: If an election to use a tax year other than a required tax year was made, file Form 8752 to report the required payment.

JUNE

15 Individuals: Second installment of 2016 estimated tax due.

15 Corporations: Deposit second installment of estimated income tax for 2016, if the organization reports on a calendar-year basis.

AUGUST

1 Employee Benefit Plan Sponsors: File 2015 Form 5500 Annual Return/ Report of Employee Benefit Plan. If your plan is not a calendar-year plan, file the form by the end of the seventh month after the plan year ends.

1 Employers: File Form 941, Employer's Quarterly Federal Tax Return; quarterly deposit due.

Solar Energy Property Credit Extended

Taxpayers who install solar electric or solar water heating systems in their homes may qualify for a generous income-tax credit. And thanks to recent legislation, the credit for solar energy property will be available through 2021.

REEP Credit Refresher

The credit is a component of the residential energy efficiency property (REEP) credit, a credit available for up to 30% of the expenses paid for qualifying solar energy, fuel cell, small wind energy, and geothermal heat pump property. For fuel cell property, there is an additional credit cap of $500 for each half kilowatt of capacity. Otherwise, there is no dollar limit on the amount of the credit, and no phaseout applies for taxpayers at higher income levels.

Each type of equipment must meet specific energy-efficiency requirements and be installed in the taxpayer's new or existing U.S. residence. Fuel cell property must be installed in the taxpayer's *principal* residence.

New Timelines

Under the original REEP credit rules, qualifying property must be placed in service before January 1, 2017. This "sunset" date still applies to all but qualifying solar energy property. The new legislation extends the credit for solar energy property, gradually reducing the credit percentage as follows:

- Placed in service prior to January 1, 2020 — 30%
- Placed in service during 2020 — 26%
- Placed in service during 2021 — 22%
- Placed in service after December 31, 2021 — 0%

If you have any questions about the credit, please don't hesitate to contact us. ■