SOLUTIONS

Summer ◆ 2015

Dear Clients and Friends

Professionally Speaking

Congratulations to Stephanie S. Sommers, CPA, 2015 PICPA Young Leader Award recipient! This award recognizes Stephanie's excellent leadership and ongoing efforts in promoting the well-being of our profession and our community.

Welcome!
Our staff is growing with these new employees joining the St. Clair CPA Solutions family this summer. Please join us in welcoming new Manager, **Maureen A. Cardamone, CPA**; Senior Accountant **Eduardo (Eddie) Hernandez**; Staff Accountants **Cecilia Buck**, **Travis Cohle** and **Gregory Hipps**; and Administrative Assistants **Gabriela Brito** and **Julie Grant**. Maureen, Eddie, Travis, Gabriela and Julie will work in our PA office; Cecilia and Gregory will be based in our NJ office.

Presented by

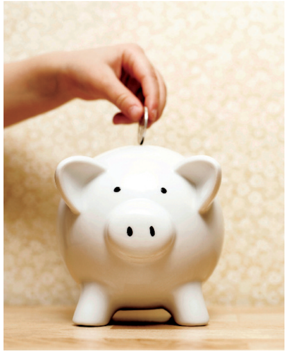
St. Clair CPA Solutions
and its subsidiaries
St. Clair CPAs, P.C.
CPA Financial Group, LLC

St. Clair CPA Solutions
Accounting for Life · Advising for Lifecycles™
Plan To Build Wealth™ PERSONAL • BUSINESS • ESTATE
www.cpasolutions.net

An independent member of BKR International

Raising Financially Aware Kids

Helping Your Kids and Grandkids Appreciate the Value of a Dollar



In a recent survey of high school students, 88% said that they learned about money from their parents. What lessons are your financial discussions — and more importantly, your behavior — teaching your children and grandchildren?

Retailers know that children have a powerful influence on the economy, making expenditure decisions that yield a direct economic influence of $188 billion, and influencing parental spending decisions up to $300 billion. By age five, children will have seen 30,000 advertisements that aim to turn your child or grandchild into an insatiable consumer. Collectively, children spend $25 billion of their own money.

To raise children who will grow into fiscally responsible adults and consumers, American Century Investments says that kids must have understanding, an allowance, and practice in money management. The best person to teach them is the CFP, or Chief Financial Parent, which might in fact be one or both parents, or even grandparents. Research shows that kids

Continued on page 4

Proposed DOL Rule May Make Millions More Eligible for Overtime Pay

In his 2015 State of the Union Address last January, President Obama said employees should get the overtime they've earned. He then directed the U.S. Department of Labor (DOL) to review and amend the overtime rules under the Fair Labor Standards Act (FLSA) to make more workers eligible.

On June 30, the DOL took steps in that direction, proposing to significantly change the federal overtime rules. However, the path from the proposed rule to a final rule could take several months — and it's possible it could be derailed.

Current Overtime Rules

Overtime pay is defined as one-and-one-half times an employee's usual pay rate for hours worked exceeding 40 per week. Today, for employees to be ineligible, they must meet a three-part "white collar exemption."

Continued on page 5

In This Issue

28 South Centre Street • Merchantville, NJ 08109 • (P) 856.482.5600 • (F) 856.665.3618 ◆ 101 West Elm Street, Suite 500 • Conshohocken, PA 19428 • (P) 610.862.1998 • (F) 610.862.3200

Do You Keep Adequate Records for Charitable Contributions?

The IRS rules for substantiating deductions for charitable contributions are strict. The taxpayers in a recent U.S. Tax Court case found this out the hard way when the court denied their deduction of more than $37,000 for numerous noncash items donated to various charities. To add insult to injury, the court assessed a 20% accuracy-related penalty on the taxpayers.

Overview of Recordkeeping Requirements

For federal income tax purposes, a taxpayer is generally entitled to deduct the fair market value (FMV) of donated property that's been held longer than a year, even if the property has appreciated in value. But strict substantiation requirements apply to all charitable contributions. If you fail to maintain timely, detailed records or overestimate an item's FMV, the IRS may challenge a deduction for donated personal property, claiming that the amount has been inflated.

The IRS suggests using guidelines from charities, such as the Salvation Army or Goodwill, to establish the FMV of household items that have declined in value over the years. To qualify for any deduction, the items must still be in good condition. The specific recordkeeping requirements for non-cash contributions depend on the value of the gifts.

- **Gifts under $250.** Obtain a receipt from the charity showing the name of the organization, the date and location of the contribution, and a detailed description of the property. However, you're not required to get a receipt when it's impractical. For example, no receipt is required if you leave property at a charity's unattended drop box after hours. You must also keep other reliable written records, including the FMV of the donated items and how you arrived at that amount.
- **Gifts of $250 to $499.** Obtain a written contemporaneous acknowledgment from the charity, describing the property and specifying whether you received any benefits in return for your gift. If you received benefits, provide a good-faith estimate of the value of such benefits.

Note: An acknowledgment is required for each contribution of $250 or more, even if several donations are made to the same charity during the tax year. Multiple contributions are not aggregated for purposes of the $250 limit as long as they are made on separate occasions.

- **Gifts of $500 to $4,999.** In addition to other substantiation requirements, maintain records of the approximate date the property was acquired, the manner of its acquisition, a detailed description of the property, the cost or other basis of the property, the FMV of the property when it was donated, and the method you used in determining the value. For this category, contributions of "similar items" must be aggregated.
- **Gifts of $5,000 or more.** In addition to the previously mentioned requirements, provide an independent appraisal of the donated property. Attach a copy of the appraisal to your federal income tax return. When determining whether your deduction is over $5,000, combine deductions for all similar items donated to any charitable organization during the year.

When should you obtain a "contemporaneous" written acknowledgment from a charity?

The IRS requires this documentation to be obtained by the earlier of:

1. The date you file your tax return, or
2. The due date for the return (including any extensions).

Case in Point

A recent Tax Court case demonstrates how these recordkeeping rules often trip up taxpayers who make charitable donations. On their 2011 tax return, a married couple claimed a total charitable deduction of $37,315, comprised of gifts of property to four organizations. The IRS denied these deductions due to lack of substantiation.

Continued on page 8

Health Coverage: IRS Guidance on Forms 1094 and 1095

If your company has 50 to 99 full-time equivalent employees, you may want to start gearing up to meet some new IRS filing requirements next year. These requirements relate to the "shared responsibility" rules of the *Affordable Care Act*. In particular, it's time to become familiar with two new IRS forms that report enrollment and eligibility for health care coverage. Larger employers should already have done this.

The IRS has provided both new and updated question-and-answer guidance on the reporting requirements for applicable large employers under the federal tax code. As background, beginning in 2016, applicable large employers must file Forms 1094 and 1095 to provide 2015 health coverage information to the IRS and plan participants.

The forms are used by the IRS to enforce employer penalties under the federal tax code, as well as individual mandate and tax credit eligibility rules. The latest guidance consists of updated Q&As covering basic reporting requirements and new Q&As addressing more specific issues that may arise while completing Forms 1094 and 1095.

Note that even if you have fewer than the minimum number of full-time employees (at least 50 next year), the inclusion of part-timers in the full-time equivalent calculation may require you to file Forms 1094 and 1095.

Highlights of the recent IRS guidance include:

- **Clarification on who must report.** The guidance clarifies that an applicable large employer with no full-time employees for any month of the year isn't obligated to report unless the employer sponsors a self-insured health plan in which any employee, spouse, or dependent is actually enrolled. In that case, it must still file Forms 1094-C and 1095-C even if it has no full-time employees. The guidance also confirms that an applicable large employer must file, and provide Form 1095-C to all full-time employees, regardless of whether they were offered coverage during the year.
- **Controlled groups.** Examples show how reporting differs where an applicable large employer reports for separate divisions and where applicable large employers are part of a controlled group. In the former situation, employees working for multiple divisions must receive aggregated information on a single Form 1095-C. In the latter situation, employees will receive a separate Form 1095-C for full-time employment with each applicable large employer in the controlled group.
- **Qualifying offer method of reporting.** The updated Q&As address reporting under the qualifying offer method, which allows applicable large employers to furnish a simplified employee statement to employees receiving qualifying offers for all 12 months of the year. The IRS emphasizes that use of simplified statements is not available for employees who actually enroll in an applicable large employer's self-insured health plan.
- **Delivery to employees.** The guidance confirms that a Form 1095-C may be delivered to employees in any manner permitted for delivery of Form W-2, including hand-delivery. However, unlike Form W-2, employers need not furnish a midyear Form 1095-C upon an employee's request following termination of employment.
- **New hires and terminating employees.** When reporting offers of coverage on Part II of Form 1095-C, applicable large employers may indicate that a coverage offer was made for a month only if the offer would have provided coverage for every day of the month. Therefore, applicable large employers should report on Form 1095-C that no coverage was offered in the month an employee was hired (unless an offer of coverage extended to every day of that month).

  Similarly, if a terminating employee's coverage ends before the end of the month of termination, the applicable large employer must report that no coverage was offered for the month. (The applicable large employer may be able to avoid liability for employer penalties under the federal code, even though coverage was not offered for the full month.) In contrast, when reporting coverage information under Part III of Form 1095-C, an employee should be reported as having coverage if the employee is enrolled on any day of the month.
- **Third-party reporting.** The guidance verifies that applicable large employers may designate third parties to perform reporting on their behalf. This confirms that a governmental applicable large employer may designate another governmental entity to accept reporting responsibility on its behalf. The Q&As also explain the allocation of responsibilities under various combinations of self-insured and fully insured coverage options.

Continued on page 7

Raising Financially Aware Kids, Helping Your Kids and Grandkids Appreciate the Value of a Dollar, cont.

whose parents or grandparents talk to them about money are more likely to be "savers" than spenders, and that talking about money and financial behavior is critical to a child's successful financial education.

Experts say that the earlier you start talking to kids about money, the better, but it's important to make it a dialogue and not a lecture. Even children as young as age three can understand basic concepts such as bartering, earning, saving, investing and currency. Older children can manage more complex concepts such as an allowance and money management.

Start by explaining that money is a medium of exchange or measure of value, and that good "money" behavior is another way of living your values. While you're getting kids to understand principles of good financial behavior, be careful not to judge their priorities in terms of needs and wants: for example, a stuffed animal that may seem like just a toy to you might be a source of comfort to child; or a teen's desire for designer clothing may really signal a need for peer acceptance.

Before you initiate an allowance, determine your child's readiness and decide whether it will be unconditional or tied to a measure such as grades, chores or good behavior. Another alternative is to let children earn their money and "pay as they go" to learn how to control spending and saving. Readiness might be signaled by the child expressing interest in wanting an allowance, demonstrating an understanding of the value of money and the difference between needs and wants, the ability to count and having a safe place for saving money at home, before it is deposited in a bank account.

Recognizing that younger children have less need for their own funds, once you have decided to grant an allowance, a good rule of thumb is $1 for each year of age per week, so that a 12-year old would receive a weekly allowance of $12 (unless the child is expected to pay for expenses such as school lunches, clothes, gas and more, in which case a higher allowance might be necessary and appropriate).

To teach money management, help children understand concepts such as budgeting, income, savings, investing, expenses, spending plans and financial goal setting by involving them in *your* finances. Discuss how you earn money and how you allocate it between your family's needs and wants. Stress the importance of "paying yourself first" through retirement plans, investments and 529 College Savings Plans. When children express a financial goal, talk about how they will achieve that goal through savings and/or earning more money.

Accumulating wealth is accentuated when the practice starts as early as possible, with regular savings. James E. Stowers, founder of American Century Investments, encourages parents to remind children often that "You can always spend what you save, but you can never save what you spend."

Children who have the ability to understand the power of compounding can experiment with examples that illustrate the impact of various starting sums and rates of return over different periods of time. Ask children which they would rather have: a check for $1 million or a penny that doubles in value every day for 30 days?

Getting kids interested, educated and excited about good financial management at an early age is one of the best gifts you can give a child. To learn more and access additional resources, visit www.YesYouCanOnline.info or join us for an upcoming educational event on this topic:

OUR NEW JERSEY OFFICE

28 South Centre Street, Merchantville, NJ, 08109 ◆ 856.665.3618		
Lunch 'n Learn	Tuesday, September 22	12:00-1:30 pm
Evening Event	Thursday, October 15	6:30-8:00 pm

OUR PENNSYLVANIA OFFICE

101 West Elm Street, Suite 500, Conshohocken, PA 19428 ◆ 610.862.1998		
Lunch 'n Learn	Wednesday, September 30	12:00-1:30 pm
Evening Event	Tuesday, November 20	6:30-8:00 pm

Please register for these events on the Community page of our website, or contact Marsha Brown at mbrown@cpasolutionsllc.net or 610-862-1998 for personal assistance.

Deducting Business Start-Up Expenses: Tax Court Case Explains the Rules

A recent U.S. Tax Court decision drives home the important point that current deductions aren't allowed for most expenses incurred while a new business is still in the start-up phase. Other decisions have dealt with the same issue in recent years. As a result, the proper federal income tax treatment of start-up expenses remains an ongoing source of confusion for taxpayers.

Continued on page 6

Proposed DOL Rule May Make Millions More Eligible for Overtime Pay, cont.

To be exempt from overtime pay, an employee must generally meet the following requirements:

1. Be paid a predetermined and fixed salary.
2. Be paid above a specific salary threshold, currently $455 a week ($23,660 for a full-year worker). The threshold was last increased in 2004.
3. Primarily perform executive, administrative, or professional duties, as defined in DOL regulations.

What is Being Proposed?

Under the DOL proposal, the salary threshold for the white collar exemption would increase to approximately $970 a week ($50,440 for a full-year worker) and would be adjusted annually. The exact amount is estimated in the proposed rule because it relies on Bureau of Labor Statistics compensation data that may need to be updated by the time the rule change would take effect in 2016 or later.

If the increased exemption in the proposed rule is finalized, the DOL estimates that nearly 5 million workers will become newly eligible for overtime pay.

The DOL is also proposing to set the "highly compensated employee annual compensation level" at $122,148 (from $100,000) for retirement plan discrimination testing purposes. This amount would also be adjusted annually.

Designed to "Restore Effectiveness"

The purpose of raising the salary threshold and making it annually adjustable, stated the DOL, is to "restore the effectiveness of the salary test" and to "ensure that the Fair Labor Standards Act's intended overtime protections are fully implemented."

The DOL explained that the changes seek "to update the salary level test to ensure that the FLSA's intended overtime protections are fully implemented, and to simplify the identification of overtime-eligible employees, thus making the white collar exemptions easier for employers and workers to understand."

The reason the FLSA didn't provide overtime for some individuals, according to the DOL, "was premised on the belief that the exempted workers earned salaries well above the minimum wage and enjoyed other privileges, including above-average fringe benefits, greater job security, and better opportunities for advancement, setting them apart from workers entitled to overtime pay."

Job Duties Test

These basic principles, taken from a DOL Wage and Hour Division fact sheet, guide job status determination for three categories of white collar jobs:

Executive Exemption:

- The employee's primary duty must be managing the enterprise or managing a customarily recognized department or subdivision of the enterprise.
- The employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent.
- The employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion, or any other change of status of other employees must be given particular weight.

Administrative Exemption:

- The employee's primary duty must be the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers.
- The employee's primary duty must include the exercise of discretion and independent judgment with respect to matters of significance.

"Learned Professional" Exemption:

- The employee's primary duty must be the performance of work requiring advanced knowledge, defined as work that is predominantly intellectual in character and work requiring the consistent exercise of discretion and judgment.
- The advanced knowledge must be in a field of science or learning.
- The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.

Continued on page 7

Deducting Business Start-Up Expenses: Tax Court Case Explains the Rules, cont.

Here's what you need to know about deducting start-up costs, along with an example of how the Tax Court applied the rules.

Deduct Section 162 Expenses Now

Internal Revenue Code Section 162 allows current deductions for "ordinary and necessary" business expenses. Section 162 expenses are basically routine expenses incurred in operating an up-and-running business. Examples include employee wages, rent, utilities, and advertising. Section 162 expenses can generally be deducted in the year when they're paid or incurred.

Many taxpayers are unaware that Section 162-type expenses incurred by a start-up can't necessarily be deducted right away. The reason is that these expenses are classified as Section 195 start-up expenses until the "active conduct" of business begins.

Once a taxpayer meets the active-conduct standard, Section 162-type expenses become Section 162 expenses, and the taxpayer can deduct them currently. (This assumes that other provisions — such as the passive activity loss or at-risk basis rules — don't come into play and prevent current deductibility.)

Deduct or Amortize Section 195 Expenses When Business Commences

ection 195 start-up expenses are Section 162-type expenses that are incurred before the business actively commences operations. Start-up expenses can include costs incurred:

- To investigate the creation or acquisition of a business;
- To create a new business; or
- To engage in any for-profit activity before the active conduct of business begins, in anticipation of such an activity becoming an active business.

Common examples of Section 195 start-up expenses include employee training, rent, utilities, and marketing expenses incurred prior to opening a business.

In the tax year when active conduct of business commences, the Section 195 rules allow taxpayers to elect to amortize start-up expenses. The election potentially allows an immediate deduction for up to $5,000 of start-up expenses. However, the $5,000 deduction allowance is reduced dollar-for-dollar by the amount of cumulative start-up expenses in excess of $50,000. Any start-up expenses that can't be deducted in the tax year the election is made are amortized over 180 months on a straight-line basis. Amortization starts in the month in which the active conduct of business begins.

A taxpayer is deemed to have made this election in the tax year when active conduct of business commences unless, on a timely filed tax return for the year, the taxpayer elects instead to capitalize start-up expenses.

Important Note: Section 195 start-up expenses don't include interest expense, taxes, or research and development costs. Those expenses are subject to specific rules that determine the timing of the deductions. Section 195 start-up expenses also don't include corporate organizational costs or partnership or LLC organizational costs, although the tax treatment of those expenses is similar to the treatment of start-up expenses.

How the Tax Court Ruled Recently

A recent Tax Court case demonstrates potential pitfalls that taxpayers should avoid when claiming deductions for start-up expenses. In this case, the taxpayer was a civil engineer with 25 years of experience as a highway designer and construction engineer.

Continued on page 9

Proposed DOL Rule May Make Millions More Eligible for Overtime Pay, cont.

What Other Changes Might be Ahead?

The proposed modifications to the overtime pay rule are significant, but many related questions remain that may soon be addressed, such as:

- **The Job Duties Test.** The proposed rule didn't tamper with the job duties test. However, the DOL states that it is "seeking comment on whether the standard duties tests are working as intended to screen out employees who are not bona fide white collar exempt employees."
- **Inclusion of Bonuses.** The DOL will consider whether "nondiscretionary bonuses, such as certain production or performance bonuses," should be added to an employee's salary to determine eligibility or exemption from overtime pay requirements.
- **Working on Electronic Devices after Hours.** When it first announced that it was examining overtime rules, the DOL was asked to determine whether employees should be compensated for time spent on devices, such as smart phones and laptops, doing work after hours. The DOL didn't tackle that question in the proposed rule but stated it would ask for input on the topic in coming weeks.

What Happens Now?

There is a 60-day comment period for businesses and other interested parties to provide feedback to the DOL. The proposal immediately triggered criticism from some employer and industry groups. For example, the National Retail Federation, the National Restaurant Association, and the U.S. Chamber of Commerce issued statements that they oppose the changes. These and other groups argued that increased overtime costs may force employers to cut back on workers' hours, limit opportunities for employees, and negatively affect businesses.

For its part, the DOL said it would finalize the proposed rule "only after reviewing and considering all the comments" it receives. Given the stakes, opponents are likely to not only comment but to urge Congress — and perhaps take legal action — to modify, delay, or drop the proposal.

Health Coverage: IRS Guidance on Forms 1094 and 1095, cont.

- **Reporting offers of COBRA coverage.** The IRS illustrates reporting under various COBRA scenarios. The guidance explains how sponsors of self-insured plans should report enrollment information for non-employee COBRA beneficiaries, such as former spouses. Qualified beneficiaries electing COBRA independently from the employee must receive separate forms, while those who have COBRA due to an employee's election should be included on the same form that is provided to the employee. (As previously noted in the instructions to the final forms, reporting may be made on either Form 1095-B or 1095-C for individuals who were not employees at any time during the year.)

  Should an applicable large employer complete Form 1095-C for full time employees who receive COBRA offers due to termination or a reduction in hours? In general, a COBRA offer made due to termination of employment is reported as an offer of coverage only if the former employee enrolls in COBRA coverage and the employee's cost of coverage reflects the COBRA premium for the lowest-cost, self-only coverage providing minimum value. In contrast, a COBRA offer made to an active employee due to a reduction of hours would be reported as an offer of coverage on Form 1095-C even if the employee declines COBRA coverage.

Note: Unfortunately, the example used to illustrate this final point does not extend more than 60 days after the loss of eligibility, so it is unclear whether the applicable large employer would still report that coverage is offered after the employee's COBRA election period has ended.

With mandatory reporting starting in early 2016 (for 2015 coverage), understanding the complexities of the reporting requirements is critical. While some of the Q&As in the IRS guidance were previously addressed in the instructions to Forms 1094 and 1095, others provided helpful clarification and new information. Employers subject to the reporting requirements should contact their tax advisors with questions and for assistance filing the forms.

28 South Centre Street • Merchantville, NJ 08109 • (P) 856.482.5600 • (F) 856.665.3618 ◆ 101 West Elm Street, Suite 500 • Conshohocken, PA 19428 • (P) 610.862.1998 • (F) 610.862.3200

Do You Keep Adequate Records for Charitable Contributions?, cont.

The taxpayers deducted $13,115 of non-cash charitable contributions to a church during its annual flea market, including:

- $8,000 of books;
- $1,303 of household items;
- $1,000 of clothing;
- $822 of toys;
- $800 of telescopes;
- $780 of jewelry; and
- $410 of furniture.

They also reported combined donations of $24,200 to Goodwill Industries, the Military Order of the Purple Heart Service Foundation, and the Vietnam Veterans of America. The second group of donations included:

- $20,920 of clothing;
- $2,680 of furniture;
- $350 of household items; and
- $250 of toys.

The taxpayers testified that they contributed batches of items to Goodwill at various times, generally leaving goods in large bins after hours. They left large items, such as furniture, outside the warehouse door. For the donations to the Purple Heart and Vietnam Veterans, the taxpayers scheduled pick-ups by charity personnel and left the items outside their home. The charity usually left a doorknob hanger saying only, "Thank you for your contribution." The taxpayers claimed they were careful to ensure that the items in each batch were worth less than $250, because they believed that this eliminated the need to obtain receipts.

Substantiation Blunder

The court didn't find the taxpayers' testimony to be credible. The contributions to the church's flea market occurred as a single event worth more than $13,000. With respect to the other contributions, the court noted that for the taxpayers to have intentionally made contributions worth less than $250 each, it would have required 97 separate donations, which is "implausible and has no support in the record." What's more, the taxpayers didn't assign values to the donated items until they prepared their 2012 tax return.

As part of its analysis, the court grouped their 2011 charitable deductions — totaling $37,315 — into the following categories:

- Clothing valued at $21,920;
- Books valued at $8,000;
- Household furniture valued at $3,090;
- Household items valued at $1,653;
- Toys valued at $1,072;
- Telescopes valued at $800; and
- Jewelry valued at $780.

Based on this analysis, the court reasoned that the taxpayers failed to satisfy the extra substantiation rules for all seven categories. In addition, they also didn't provide "reliable written records" to support the claims for drop-offs at unattended sites. Furthermore, two categories — clothing and books — had alleged values exceeding $5,000. For these categories, the couple should have also obtained independent appraisals and attached them to their federal tax return.

Finally, most of the property the taxpayers claimed to have donated consisted of used clothing and household items. Because they failed to present credible evidence that these items were in good condition, the entire deduction was disallowed.

But that's not the end of the story. The court also imposed a 20 percent accuracy-related penalty on the taxpayers for intentionally disregarding the rules. The court wasn't persuaded by their contention that the underpayment met the "reasonable cause" exception because they allegedly believed that they weren't required to obtain receipts or acknowledgments from the charities for drop-offs at charity locations after hours or pick-ups by charity personnel from their home. (*Kunkel v. Commissioner,* T.C. Memo 2015-71)

Bottom Line

When making charitable donations, there's no substitute for accurate recordkeeping. Make sure you comply with the strict letter of the law so you can withstand any potential IRS challenge to your deductions. Contact your professional tax advisor if you're unsure about the substantiation requirements or need to be referred to a qualified appraisal professional. ■

Deducting Business Start-Up Expenses: Tax Court Case Explains the Rules, cont.

In 2008, while still employed in a full-time job, he decided to start his own business. He selected the name Civil Engineering Services (CES), printed business cards, designed stationery, and set up a website. He also purchased a computer, a desk and other office supplies, and set up an office in the basement of his home.

By mid-2008, the taxpayer's employer dramatically reduced his salary, and he decided to devote more time to developing CES. From his years of work experience, the taxpayer knew many contractors and project engineers who worked in the state. He regularly visited construction sites after his regular work to distribute business cards and speak with managers and others performing construction on local highways.

In addition to promoting his business, the taxpayer used these visits to stay abreast of developments in the highway construction engineering industry. He continued these trips throughout 2009, 2010, and 2011. In late 2010, he became unemployed and began focusing all of his attention on CES.

On his 2009 and 2010 federal income tax returns, the taxpayer claimed Schedule C business deductions totaling $46,629 and $45,618, respectively, for expenses purportedly incurred in the new business. After an audit, the IRS disallowed the deductions on the grounds that:

- They weren't properly substantiated, and
- CES hadn't yet commenced business because it didn't have any clients, wasn't hired to perform any services, didn't bid on any highway engineering jobs, and earned no income.

The IRS also disallowed some itemized deductions claimed on the taxpayer's 2009 and 2010 returns. The disallowed deductions resulted in a delinquent tax bill of about $30,000. The IRS also imposed a 20% substantial understatement penalty on the additional tax due. The Tax Court upheld both the IRS deficiency and the understatement penalty (*Tarighi v. Commissioner,* T.C. Summary Opinion 2015-28).

Factors to Consider

The Tax Court has historically focused on these three factors to determine if a taxpayer has commenced the active conduct of a business:

1. Did the taxpayer undertake the activity intending to earn a profit?
2. Was the taxpayer regularly and actively involved in the activity?
3. Has the activity actually commenced?

In the case described above, the Tax Court concluded the taxpayer wasn't engaged in a business during 2009 and 2010, because his business didn't have income or clients and didn't bid on any jobs during those years. Although the taxpayer did engage in promotional activities, he didn't intend to earn a profit in those years, because he didn't pursue contracts or bid on jobs.

Therefore, the court ruled that the IRS correctly denied the deductions reported on the taxpayer's 2009 and 2010 returns, because they were amortizable Section 195 start-up expenses rather than currently deductible Section 162 expenses. However, if the taxpayer could properly substantiate the expenses, the opinion noted that the taxpayer could begin amortizing them in the year when his business activity started.

Finally, the court ruled that the IRS was correct in imposing the 20% substantial understatement penalty, because the taxpayer failed to establish that there was any reasonable cause for the tax underpayment or that he had acted in good faith.

Important Reminders about Start-Up Costs

When you incur business start-up expenses, it's important to remember two key points. First, start-up expenses can't always be deducted in the year when they're paid or incurred. Second, no deductions or amortization write-offs are allowed until the year when active conduct of your new business commences. That usually means the year when the business has all the pieces in place to begin earning revenue. Time may be of the essence if you have start-up expenses that could be deducted this year. Contacting your tax adviser to explain your plans can result in more favorable tax consequences.