Teleconference: Minimizing Property And Income Taxes By Tightening Fixed-Asset and Real Property Controls And Processes

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Miscapitalization Of Costs

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I. Problems Related To Cost Capitalization errors:

A. Majority of firms maintain a single fixed-asset accounting record

B. Record used to report fixed assets for:

1) Financial accounting

2) Income tax reporting

3) Personal property tax

C. Typically, the financial accounting function maintains the record

D. Primary drivers for record maintenance are:

1) Financial depreciation

2) Inclusions based on capital vs. expenses decisions for financial reporting

3) Capital/expense policy is usually:

a) Based on a dollar cut-off

b) Modified for major construction projects

c) Modified by financial results, "good years vs. bad"

E. Records are coded based on financial accounting criteria for:

1) General ledger account classification

2) Location controls

3) Record breakdown and descriptions

G. Result

1) Property not recorded consistent with tax rules

2) Personal property cost reported to assessor often overstates taxable base (and thus tax)

3) If it is a very aggressive "expense" practice, reported cost could under-report cost to assessor

H. Examples of ineffective records

1) ***Ink System Run-In - $750,000:*** (labor cost for running the new ink system in its first year of operation). The company was a start up and not profitable. The labor cost was an operating expense and should not have been capitalized. Cost should be excluded for personal property tax. Without proper coding, will be on the tax role for years

2) ***Relocate Packaging Line - $128,000:*** (packaging equipment relocated within the plant.) Cost is excluded for property tax but would show on the tax roles for years if not coded as an exclusion

3) In an off year for sales, the firm shows a line item: ***Office Furnishing - $12,000*** (actual contents of line item are toner, paper, postage). Record should be flagged as non-taxable for property tax purposes since the contents are expense items

4) ***Clean-up after flood - $25,000:*** Another non-taxable capitalization that should be coded exempt for property tax

5) ***Upgrade Phone System for New Software - $18,000:*** Capitalized for financial reporting, but should be exempt for property tax. Does not add value nor extend the life

6) ***Calibrate lab equipment - $2,500:*** Part of an annual maintenance of lab equipment. Not a taxable item if it can be excluded from the cost base when reporting personal property

7) ***Acquisition of Reagents - $8,500:*** The reagent is a consumable in the production process. It is not a capital expenditure. Without proper coding, would be subject to personal property tax for many years. The cost should be excluded for personal property tax reporting

8) ***No Entry:*** The firm changed its capitalization policy to $10,000. Bought five personal computers at $1,800 each (total $9,000). These may be taxable property to the assessor

9) ***Coating Line Equipment -$2,500,000:*** The entry is too broad and general to facilitate tracking and control of the physical assets or removal from the book when components of the line are retired or transferred

I. Correction is a two-part process

1) Address recordkeeping practices

a) Identify sources for coding new records

b) Develop specific property tax references

c) Follow up to see that they are properly applied

d) Over time, the record will self-correct

e) Part of cost classification is having adequate descriptions to link asset records to physical property. Descriptive data should include, in sortable fields:

i. Noun (what the asset is), followed by adjectives

ii. Tag number (if attached to the unit)

iii. Manufacturer's name

iv. Model number

v. Serial number

vi. Size, horsepower, capacity, etc.

vii. Additions to prime assets should be linked by their control number as illustrated in the examples

f) The above data is needed to facilitate having the records removed from the book upon retirement or transfer of the physical asset

2) Clean-up of existing record

a) Reality: Financial accounting (usually) will dictate that the overall cost base NOT be changed (unless the firm has a separate property tax "book")

b) Property tax resolutions thus have to work within the existing record structure

c) Clean-up activities may include:

i. Asset inventory or cost, verification, but with the added attention to the removal of incorrectly capitalized costs for property tax reporting
ii. Record review for incorrectly capitalized cost that can be identified and corrected or removed as appropriate.
iii. An allowance for expenditures capital in nature that are taxable for property tax purposes, but were never capitalized on the book.
iv. "Dis-aggregate" group records. Example: Record is "***Coating Line Equipment -$2,500,000***"

v. Investigate project files and work orders to break out the physical property and respective costs of each component

vi. Replace the group entry by the detail

J. Documentation for the assessor

1) Issue is, in the year of clean-up: A beginning cost for reporting will be inconsistent to a previous ending period cost

2) Difference will be the items subject to removal from the tax base that were in last year and would be off the record in the reporting year

3) Documentation of the changes is critical to show the assessor the audit trail for the clean-up. That is:

a) Cost by acquisition year at the beginning of the clean-up

b) Cost by acquisition year at the end of the clean-up

c) Cost difference by year

d) Cost removals related to non-taxable items included in the starting base

e) Supporting detail of the removals, with justification/explanation of each type of adjustment