SBG Consulting, Inc.

Tax-Saving Tips

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Tax Reform: Planning for Your New 20 Percent Deduction

As you likely know by now, the Tax Cuts and Jobs Act created a 20 percent tax deduction under new tax code Section 199A.

The question for you: Will you reap any benefits from this new deduction? And the second question: If your chance of qualifying for the 20 percent tax deduction looks bleak, what can you do now to create some hope that you'll get the deduction?

If your defined taxable income is $315,000 or less (joint return) or $157,500 or less (single), you can relax. You don't need any strategies to realize your Section 199A deduction. It is simply the lesser of 20 percent of your taxable income (less net capital gains) or 20 percent of your qualified business income.

Example. John is single, a lawyer, with $125,000 in qualified business income and $150,000 in taxable income (excluding net capital gains). John's Section 199A tax deduction is $25,000 (20 percent x $125,000).

Once you exceed $315,000 (married) or $157,500 (single), we should spend at least a few minutes reviewing your deduction.

Here's an example of why this is important. We just reviewed a return that would have had $315,001 in taxable income and $350,000 in qualified business income. With that income, the 199A deduction was zero for this individual, but with $1 less in taxable income, this individual's deduction is $63,000. We are helping this individual avoid that highly troubling $1 so he can realize his $63,000 deduction.

If you expect to exceed the thresholds, we should talk, because some planning ideas require that you have time on your side. Also, once the year is over, you have very few, if any, Section 199A planning opportunities.

Divorce? Alimony? Tax Reform Says Get Divorced Now—Don't Wait

Tax reform changes the alimony game. This may or may not have any relevance to you, but if it does, you will want to move quickly.

The Tax Cuts and Jobs Act (TCJA) eliminates tax deductions for alimony payments that are required under post-2018 divorce agreements. More specifically, the TCJA's new denial of alimony tax deductions applies to payments required by divorce or separation instruments

- executed after December 31, 2018, or
- modified after that date, if the modification specifically states that the new TCJA treatment of alimony payments now applies.

Example. Betsy is divorcing Tim, and Betsy will pay $120,000 a year in alimony. If Betsy can deduct the $120,000 in her 50 percent combined federal and state

income tax bracket, her net cost is $60,000 ($120,000 x 50 percent).

To look at the alimony in another light, with no tax deduction, Betsy has to earn $240,000, then pay taxes of $120,000 in her 50 percent bracket, before she can give Tim the $120,000. Regardless of how you look at the cost of alimony, the loss of the alimony tax deduction is huge.

Note: You deal with a judge (court) to finalize the divorce. This could take some time, so don't procrastinate, or you'll surely miss the deadline.

Avoid Being an IRS Target When Your Business Loses Money

If you operate what you think is a business, but that business loses money, it may not be a business at all under the tax code. Such a money-losing activity can look like a tax shelter to the IRS, and that substantially increases your chances of an IRS audit.

The tax code contains a business loss safe harbor that's known as a presumption of profit. You meet this safe harbor when your activity produces a profit in three of five years (two of seven for breeding, training, showing, or racing horses). When you meet the safe harbor, you are presumed a business unless the IRS establishes to the contrary.

We know this for-profit tax code section as the hobby loss section. But you can see that this tax code section creates trouble for much more than what you would consider a simple hobby. Here's an example of how badly the recent tax reform under the Tax Cuts and Jobs Act can treat a business that loses money.

Example. Henry has an activity that fails the business test and loses money. Last year, he had $70,000 of income and $100,000 of expenses. Under pre-tax-reform law, Henry could claim the hobby-related business deductions up to the amount of his income. So Henry deducted $70,000 (subject to some minor adjustments) and reported close to zero taxable income.

Not this year. Tax reform is going to make Henry suffer. With the same facts, Henry's business deductions are zero. His taxable income is $70,000. Think about that. Henry lost $30,000 ($70,000 - $100,000) in real money. He now pays taxes on $70,000 of phantom income.

What can Henry do to make this problem go away? He has two choices.

- First, he could create a "for profit" business defense in the hope that he would defeat the IRS in an audit.
- Alternatively, he could stop the taxation on his phantom income by operating his activity as a C corporation.

Tax Reform Update on Business Meals with Clients and Prospects

Here's the updated strategy: deduct your client and business meals as if tax reform never took place.

Wow. Is this aggressive? Not if

- the IRS comes out with regulations that follow a model set by the American Institute of CPAs, or
- the Joint Committee on Taxation in its explanation of the Tax Cuts and Jobs Act states that client and business meals continue as deductions, or
- lawmakers enact a new tax code section that authorizes client and business meal deductions.

How big is the "if" in the if? We have some insights that say business meals will be deductible for all of 2018. Of course, nothing is certain except the current uncertainty.

Let's put it this way: If you do what you need to do to deduct the meals, then you are in a position to claim the business meals deduction when one of the above happens. So, make sure you have your 2018 business meals documented as follows:

- The name of the person you had the meal with.

- The name of the restaurant where you had the meal.
- A short description of the business discussed.
- If the meal costs $75 or more, keep the receipt that shows the name of the restaurant, number of people at the table, and itemized list of food and drink consumed.

How to Deduct Your Legal Fees after Tax Reform

The Tax Cuts and Jobs Act (TCJA), known as tax reform, made it more difficult for you to deduct your legal fees. The new tax reform law suspended (killed is a better word) your legal fees as 2 percent miscellaneous itemized deductions for tax years 2018 through 2025.

This means you need to look for other possible ways to deduct legal fees, such as claiming them as business or rental property expenses. Here are some examples:

- You incur legal fees to sue a client for nonpayment of your invoices. You deduct those legal fees as a business expense.
- You incur legal fees to sue a vendor that did not perform the services you paid them to perform. You deduct those legal fees as a business expense.
- You incur legal fees to sue a vendor that damaged your rental property. You deduct those legal fees as a rental expense.
- You incur legal fees to evict a tenant who stopped paying rent. You deduct those legal fees as a rental expense.

New tax reform exception. The TCJA disallowed all business deductions for settlements or payments and the related legal fees for sexual harassment or abuse claims if the settlement or payment is subject to a nondisclosure agreement.

If you incur legal fees related to the ownership or protection of your property, then you generally capitalize the legal fees and add them to the tax basis of your property.

Reduce Self-Employment Taxes by Renting from Your Spouse

As a sole proprietor, you know that the 15.3 percent self-employment tax can eat up your profits in a hurry. You may be able to use a simple strategy to ease this tax burden.

If you own an office building or other assets, you can set up a rental arrangement with your spouse that could significantly cut your self-employment taxes. Here’s an example of how this strategy works:

Example. Wendy operates a sole proprietorship and earns $100,000 of net income. This income creates a self-employment tax liability of $14,129.55.

Wendy gives the office building to Jim, her spouse, who then rents the office space back to Wendy. Wendy pays Jim $2,000 rent each month (the fair rental value of the building), which moves $24,000 off Schedule C and onto Schedule E. Schedule E, unlike Schedule C, does not give rise to self-employment taxes.

The rent-from-my-spouse strategy cuts Wendy’s self-employment income by $24,000, which puts an extra $3,391.09 of cash in her pocket at the end of the year. And she plans on doing this for at least 10 years, which means she’ll pocket $33,910.90 before considering her investment earnings on this money.

Your Personal Home Is Not Your Tax Home

The fact that your personal home is not your tax home is one income tax issue. Here's another: Business travel is different from business transportation. Your tax deductions, tax strategies, and tax records hinge on the following federal income tax–defined terms:

1. Personal home
2. Tax home
3. Business travel
4. Business transportation

We know you don't have an issue with your work deductions at the moment, but we want to make sure you are aware of what could happen if you moved your business location or personal home.

Meanings

Personal home	This is where you live.
Tax home	This is where you maintain your principal place of work.
Business travel	You are in tax-deductible travel status when you travel away from your tax home overnight or long enough to require sleep.
Business transportation	You deduct business transportation as a cost of going to and from tax-deductible business destinations, whether in town or out of town.

Five Good Things to Know

1. Have your personal home within 50 miles of your tax home.
2. When you have your personal home within 50 miles of your tax home, claim the home-office deduction under the administrative office rules so you can eliminate commuting to your outside-the-home office.
3. Deduct overnight business travel when you travel on business outside the area of your tax home.
4. If you have more than one business, the business on which you spend the most time and make the most money is the principal business. It's the location of your tax home. Overnight travel outside the tax-home area of the principal business to a secondary business is deductible. For example, if you have your principal office in Worcester, Massachusetts, you can deduct your overnight travel to your second business in New York City.
5. If you have one business with multiple offices in different cities, the office where you spend the most time, do the most important things, and make the most money is your tax home. When you travel away from this office overnight to a secondary office, you are in business travel status.

Hiring Your Children to Work on Your Rental Properties

Have you considered hiring your children to work on your rental properties? If so, were you concerned when you did not see a line item for wages on Schedule E of your Form 1040?

Don't let that bother you. The IRS in its instructions explains that wages and other ordinary and necessary business expenses of the rental that are not named on Schedule E go on line 19.

Because you own more than one rental property, your children may work on more than one. No problem. You need to allocate the wages and associated expenses to the properties on a reasonable basis. The most apparent allocation basis for the money you are paying the children being time spent by the children at each property.