



Tax Hints

Tax Cuts and Jobs Act Issue

February 2019

A Note from Abraham I. Horwitz, CPA: This newsletter is being distributed to current and past clients, friends and family. I have always loved sharing information and I hope you will find something useful in this newsletter. If you wish to be removed from the distribution list, please email me at ah@cpabe.com and ask to be removed.

2017 Tax Cuts and Jobs Act (TCJA)

The TCJA Represents the biggest change in taxes since the 1986 Tax Simplification Act. Covering every change is beyond the scope of what can be done in a brief newsletter, however we hope to provide some of the key basics and a few areas of potential tax reduction opportunities. We will be happy to provide more details related to your specific situation.

The Shrinking Tax Form

I have always found magicians who use slight of hand to be fascinating. Apparently, someone in the federal government does as well. If you have been following the news, you are probably aware that we now file our federal tax return on a postcard with schedules.

The government has reduced the two-sided Form 1040 to a postcard size, however it has added six new schedules. It has taken a two-sided form where you could leave out the lines that didn't apply and rearranged it into an eight-sided form including all the schedules.

They have also eliminated the form 1040-A and 1040-EZ which were designed to handle simpler returns. The people with simple returns now must deal with the postcard and potentially with schedules, and the people with more complicated returns now must schedule more things and consolidate them on the main postcard form.

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20% Qualified Business Income (QBI) Deduction

The TCJA includes a new deduction allowing a potential tax deduction of up to 20% of **Qualified Business Income** from your sole proprietorship and / or pass-through entity such as a partnership or subchapter S corporation.

The rules are somewhat complicated, and the deduction can be phased-out or eliminated under a complex set of rules. However, under the right circumstances, reducing your taxable income by 20% of your business earnings can result in a substantial reduction in taxes.

In order to qualify for the deduction, the business must rise to the level of being a “trade or business”. It must be operated on a regular basis, a continuous basis, with a profit motive, and in a business-like manner.

***Tax Trap:** If a business does not rise to the level of being a “trade of business”, it may be deemed to be a hobby. Gross income from a hobby is reported as other income. In prior years, expenses related to a hobby were allowable as an itemized deduction subject to the 2% limitation to the extent of the hobby income. Under TCJA, all itemized deductions that fell under the 2% limitation have been eliminated. That means that if your business does not rise to the level of a “trade or business”, the income is still reportable, however you get no deduction for the expenses of the “hobby”.*

Rental real estate may also qualify for the QBI deduction. It must rise to the level of being a “trade or business”, and the government has established a safe harbor test to show that rental real estate qualifies as a trade or business. It is difficult to qualify rental real estate as a business unless you own multiple properties. Additionally, please keep in mind that if rental real estate is treated as a business for purposes of the QBI deduction, it probably also qualifies as a trade or business for the requirements of issuing 1099s to individuals providing services to the property (plumbers, repair men, etc.)

The QBI deduction is complex and has a lot of rules, including income limits, phaseouts and rules related to specified service trades or businesses where the deduction is fully eliminated above an income cap.

“The TCJA includes a new deduction allowing a potential tax deduction of up to 20% of Qualified Business Income “

Changes at Home

Under TCJA the deduction for mortgage interest has been tightened so that it now only applies to qualified residence interest. For new mortgages the maximum amount of debt has been reduced to \$750,000. The \$1,000,000 cap for previously existing mortgages remains in effect. Keep in mind that if you refinance and take out additional funds or increase the term of the mortgage, it may affect deductibility of interest on a pre-existing mortgage.

Additionally, the ability to deduct interest on up to \$100,000 of home equity debt has been eliminated.

At this point in order to deduct mortgage interest, the funds must have been used to buy, build, or substantially improve *the home that secures the loan*. If a home equity loan was used for those purposes on the home that secures the loan, subject to the dollar limitations, interest on home equity debt may be deductible as mortgage interest.

If you have refinanced your original mortgage or are carrying home equity debt or a line of credit, we now must trace how the funds were used in order to establish how much of the interest is considered qualified residence interest.

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Changes at Home

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Because debt follows the tracing rules you may want to remember that interest for other allowable purposes may also be deductible. For example, if you use a portion of the home equity debt to fund your business, the interest on that portion maybe deductible as a business expense.

Meals and Entertainment

The TCJA effectively eliminated all deductions for entertainment expenses. The IRS has clarified that 50% of business meals may still be deductible if they are purchased separately from the entertainment (or are separately stated on the bill, invoice or receipt).

Please keep in mind that in order to be deductible as a business expense, meals still must (1) be ordinary and necessary, (2) not be lavish or extravagant, (3) have the taxpayer or employee of the taxpayer present, (4) be with a current or potential client or consultant, and (5) be purchased separately from any entertainment.



Automobiles

While it doesn't specifically apply to automobiles used for business, the change in Internal Revenue Code (IRC) Section 1031 rules are very likely to crop up there. §1031 is commonly referred to as "like-kind exchange". Prior to TCJA an asset could be exchanged for a "like-kind" asset and the gain on the asset exchanged would be deferred into the new asset. One of the most common uses for this has been the trade-in of a business automobile when purchasing a new one. In the past, no gain was recognized on the trade-in of the old automobile as the cost basis was passed from the old one to the new one. TCJA eliminated the use for §1031 for anything other than real estate. Under TCJA if an automobile is traded-in, it is treated as a sale of the automobile for the trade-in allowance. It must then be reported and normally there will be a taxable gain. Although the automobile originally cost more than the trade-in value, the cost basis of the automobile is reduced by the amount of depreciation on the automobile. The new automobile will have a cost basis equal to the purchase price rather than the carried-over basis from the old automobile as under the old rules. Expect to pay more taxes if your business automobile is traded-in.

State Tax Returns



Several states have decided not to incorporate the federal tax law changes into their state tax law, effectively decoupling from the federal tax code. This means that your federal and state income tax forms are filed under two different sets of rules. Some of the states have made some additional adjustments to their tax rules in order to facilitate maintaining the old tax rules. For example, New York State now allows you to itemize on the state return even if you do not itemize on the federal return. This will allow you to itemize on the state return if you would have itemized under the old rules, even if under the new rules you can no longer itemize on the federal return.



Potential Loophole for Cooperative Shareholders

Let me preface by reminding that this is not intended to be tax advice, and that taking advantage of this loophole (1) most likely should be disclosed on your tax return, and (2) most likely will get challenged by the Internal Revenue Service.

I am sharing this for purposes of discussion.

The TCJA created a \$10,000 state and local taxes (SALT) cap. I have seen respected tax attorneys take the position that the deduction for the proportionate share of real estate taxes paid to a cooperative housing corporation is not limited under the SALT cap.

“...the deduction for the proportionate share of real estate taxes paid to a cooperative housing corporation is not limited under the SALT cap.”

The deduction for mortgage interest and real estate taxes paid to a cooperative housing corporation are not governed by the tax code sections that allow real estate taxes and mortgage interest.

Under Internal Revenue Code §216 a tenant-stockholder can deduct

amounts (not otherwise deductible) paid to a cooperative housing corporation to the extent that the amounts represent the proportionate share of real estate taxes allowable to the corporation under §164 and interest allowable to the corporation under §163.

The deduction for state and local taxes, including real property taxes, is governed by §164. The TCJA placed a limitation stating that the deductible taxes under §164 shall not exceed \$10,000.

Because the payments to a cooperative housing corporation are paid as maintenance and not for each individual expense, they are effectively rent, not real estate taxes. Because of this they don't fall under §164 and are “not otherwise deductible” and therefore they are allowed under §216.

Effectively, because §216 is really a deduction for the proportionate share of rent or maintenance, rather than for taxes, it should not fall under §164, which is the section that contains the SALT cap.

Additionally, according to a Tax Court decision, affirmed in the Second Circuit, “a tax deductible under §216 is not deductible under §164”. Again, this indicates that the SALT cap does not apply to the proportional payment to a cooperative housing corporation.

The Staff of the Joint Committee on Taxation concerned that the courts would be literal and only apply the cap to real estate taxes under §164, indicated (without citing any authority) that it was the intent of Congress to apply the cap to §216, however, they did acknowledge that it may require a technical correction to end up with that result.

The technical correction act drafted on the last day of the prior Congress did in fact contain such a correction.

At this point, there has been no correction leaving open the legitimacy of deducting the entire proportional share of real estate taxes paid to a cooperative housing corporation. Unfortunately, this is not the only issue that requires a technical correction.



Tax Strategies with Renewed Importance due to TCJA

Qualified Charitable Distribution (QCD) from an IRA

Upon reaching the age of 70 ½ an individual must begin to take the Required Minimum Distributions (RMD) from their IRAs. This distribution can increase an individual's income on their tax return. There are certain items affected by the amount of income on the tax return. Social security taxability is based on the income. If income can be reduced, it may not only have the effect of eliminating that taxable income, but it could also reduce the amount of taxable income from social security.

One strategy for reducing income for charitable minded individuals is to take advantage of the QCD rules.

Because of the larger standard deduction, it is less likely that you will itemize deductions on your tax return. Without itemizing you get no benefit for your charitable contributions. Using the QCD rules allows you to make a charitable contribution directly from your IRA account. The amount contributed counts against your RMD, however it does not get included in income. The downside is that it also doesn't qualify as a deductible charitable contribution. However, if you are not able to itemize you would get no benefit for the contribution anyway.

In the past, there was benefit to a QCD in that it reduced income which could effectively reduce other income or increase other deductions. The downside was giving up the charitable contribution. However, it often made sense to reduce the income by using the QCD rules rather than making a direct charitable contribution. Now that it is less likely to get any benefit from charitable contributions, it is even more important to take advantage of the QCD rules.

There are some additional factors that you should be aware of when doing this, including being sure that you receive acknowledgement of the contribution from the charitable organization, but QCD should be considered if you are required to take IRA distributions and you are charitable minded.

Bunching of Deductions

With the increase in the standard deduction, the elimination of certain itemized deductions and the cap on SALT, it has become less likely that there will be enough deductions to itemize each year. However, if the deductions are significant, one strategy that could work is a strategy called "bunching".

The goal with bunching is to move items that would be deductible as itemized deductions to alternate years, thereby doubling up on the

amounts and benefiting by taking advantage of itemizing deductions every other year. While this can't be done for every deduction, it can be done for several of them.

If your state and local taxes are below \$10,000, carefully consider when to make any estimated payments. If they can be pushed from being paid in a year when you will take the standard deduction to a year when you will itemize, you can increase your deduction.

With medical expenses, if you are expecting major expenses, such as dental work or braces, consider when to pay for the bill. You may be able to arrange to make most of the payment in a year when you will be itemizing, and you may have enough medical expenses to increase your itemized deductions.

Another area you can consider bunching is charitable contributions. If you are going to itemize every other year, try to stagger your charitable contributions so that the combined amount for the two years is given in the year you are planning to itemize. While some people don't want to give a charitable organization double the amount in one year and none in the next, you may want to consider a donor advised fund.

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Tax Strategies with Renewed Importance due to TCJA

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While donor advised funds are the subject of a future newsletter, they allow you to make the contribution to the fund and get the charitable deduction, while allowing you to advise the fund to distribute the contributions over more than one year.

The Expected Surprise

On top of all the other issues, many people will be in for a surprise this year when they file their tax returns. The calculation for withholding of taxes to be withheld was adjusted in the IRS tables to reflect the lowering of tax rates in order to provide more dollars out of each paycheck. Unfortunately, new w4s weren't required and the tables were not adjusted for the change in things such as the disallowance of dependents, disallowance of certain deductions, etc.

Many people who are expecting refunds will either see smaller refunds or owe additional taxes and many people who in the past have had small refunds or paid a small amount will be facing much bigger tax bills in April than expected.

The IRS has reported statistics for the first week of tax season and they point to the "surprise" that many of us have been expecting.

- ◆ The number of returns filed during the first week is down 12.4%. It seems to me that the people who are in a hurry to file early are the people who expect refunds. So, the lower number, among other things seems to point to the fact that not as many people are expecting a refund compared to prior years and the logical leap is that they are holding their returns rather than filing early because they have a balance due with the return rather than a refund.
- ◆ The number of returns showing refunds is down 24.3%, and the average refund dropped 8.4%.
- ◆ The biggest drop reported was in the total dollar amount of refunds which dropped 30.6%. This seems to confirm what the prior information seems to show. The drop in the dollar amount is greater than the other drops because it is affected both by the lower number of people who are getting refunds and by the lower dollar amount of those refunds.

A Final Note from the 2018 Tax Information Cover Memo

Over the past year I have taken approximately 4 times the required continuing education hours. I have also been reading a great deal about the new tax law from many different sources. I have seen endless discussion about tax return fees indicating plans to raise them anywhere between 10% and 50% this year. While there are some challenges, apart from the qualified business income (QBI) deduction, tax return preparation should not significantly change if it was done properly in prior years. Apart from adding a fee for the QBI deduction, and a minor increase in one of the handling charges, my fee schedule for 2018 tax returns will remain the same as it was for 2017 returns.

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