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Did Tax Reform Goof When Disallowing Deductions for Client Meals?
Tax professionals want tax deductions for business meals with clients and prospects. Business owners want those meals deductible, too. Add us to this list. We want that deduction for our clients (and, of course, for ourselves).

In recent days, we learned that lawmakers did not intend to eliminate business meals with clients and prospects. We're not exactly sure how lawmakers can undo what they've done to the tax code in this area, but experience says that if there's a will, there's a way. We think it may take a technical correction to the tax code, but some speculate that you could get this done with a Joint Committee on Taxation Bluebook explanation.

Regardless, at the moment this appears to be really good news. Obviously, we would like to see some already-in-place technical action on which we could hang our hat, but that's not going to happen for some time, perhaps many months. Meanwhile, here's what you need to do:

1. Track and document your client and prospect business meals as you have done (or should have done) in the past.
2. Keep the pressure on your lawmakers, asking them to codify or otherwise clarify that client and prospect business meals are indeed deductible.
3. Hope that client and prospect meals are indeed deductible for all of 2018.

Chart of Meals and Entertainment after Tax Reform
Tax reform has had a significant impact on the tax deductions you can now claim for business entertainment and meals. The chart below shows you how the Tax Cuts and Jobs Act treats 12 meal and/or entertainment events.

	Amount Deductible for Tax Year 2018		
Description	**100%**	**50%**	**Zero**
Meals with clients and prospects		X*	
Entertainment with clients and prospects			X
Employee meals for convenience of employer		X	
Employee meals for required business meeting		X	
Meal served at chamber of commerce meeting		X	
Meals while traveling away from home overnight		X	
Year-end party for employees and spouses	X		
Golf outing for all employees and spouses	X		

Year-end party for customers			X
Meals for general public at marketing presentation	X		
Team-building recreational event for all employees	X		
Golf, theater, or football game with your best customer			X

* Technically, the TCJA made meals with clients and prospects not deductible. We understand that the tax writers will modify the law to make "so-called non-entertainment meals" with clients and prospects deductible. We don't know when we will see this change; therefore, track your meals with clients and prospects as if the tax writers will truly make them deductible.

I think you will find this chart helpful. If you have questions, please don't hesitate to contact me.

Tax Reform Puts Screws to Hobbies

The tax law has mistreated hobbies for a long time. But the most recent tax reform brings the grim reaper to the party, and it's not pleasant. This means you need to focus on making your activity a business and not a hobby.

Under both prior law and the new law after the recent tax reform, your activity is either a business (for profit) or a hobby (not for profit). With the hobby classification, tax law makes you suffer. Your taxable gross income includes income from any source unless there's a specific exclusion, and there's none for hobby income. Thus, tax law taxes your hobby income.

Don't think that you need a hobby to have what is called hobby income. In an article in Tax Notes titled "Potential Pitfalls for Direct Sellers," author Monika Turek states that there are 15.2 million direct sellers who fall into the tax law–defined hobby category. Direct sellers include distributors for companies such as Amway, Herbalife, and Mary Kay. For sure, many of the 15.2 million are going to feel cheated by the recent tax reform. At the other end of the spectrum, you find many hobby-loss tax cases that involve doctors or lawyers who like racehorses or ranching. They too will feel cheated.

Under the recent tax reform, the law taxes your hobby income and gives you a zero deduction for any business expenses to produce that income. That's about as draconian as the law can get. The only out is to establish your activity as a business. This may or may not be possible, but it is certainly something I might be able to help you with and that we should discuss.

Tax Reform Attacks Home Mortgage Interest Deductions

The recent tax reform contains two big changes to how much you can deduct in mortgage interest for tax years 2018 through 2025:

1. During this seven-year period, you may not deduct any interest on prior or current home equity debt, with certain exceptions.
2. Also during this seven-year period, the maximum amount you may treat as acquisition debt for homes purchased after December 15, 2017, is $750,000.

Exception alert. Your home equity loan may include acquisition or home-improvement debt, and that debt continues as deductible under the recent tax reform rules.

Example. Billy took out a $90,000 home equity loan in 2015. He used $50,000 to remodel portions of his home and used the remaining $40,000 for his daughter's college tuition. Billy's total home mortgages never exceeded $1.1 million. Under the new law, Billy may deduct five-ninths of his home equity loan interest in 2018.

Acquisition debt. When you buy your main home or a second home and take out mortgages secured by those homes, your mortgages are called acquisition debt. You can add acquisition debt when you improve your main or second home, and that new debt is secured by the home you improved.

Refinancing alert. Your acquisition debt does not increase when you refinance unless you use the new monies to improve the home.

Example. Tom bought a home in 2010 and took out a $500,000 mortgage that he secured with the home. In 2018, Tom has paid down his mortgage to $430,000, and his home has increased in value to $800,000. Tom refinances the home and takes out a new mortgage in the amount of $600,000, secured by the home.

If Tom uses none of the new money to improve his home, his mortgage interest deduction in 2018 is based on the $430,000 of mortgage principal that remained as of the date of his refinancing. To put this in perspective, your original acquisition debt never increases on that original home. To increase your debt eligible for the home mortgage interest deduction, you need to use the new debt to improve the home.

Ceilings. Because of tax reform, you now have two possible 2018 ceilings on your home mortgages that are eligible for the mortgage interest deductions.

$1.1 million. For indebtedness incurred before December 15, 2017, you may not deduct interest on more than $1.1 million in mortgages ($1 million in acquisition debt and $100,000 in home equity debt used for acquisition or improvements). The original $1.1 million ceiling is grandfathered for acquisition and improvement loans in existence before December 15, 2017.

Example. Sam took out his mortgages during 2013. Sam faces the $1.1 million ceiling in 2018.

$750,000. For home mortgage indebtedness incurred on or after December 15, 2017, you may deduct interest on no more than $750,000 of home mortgages.

Example. Jim took out his mortgage in 2018. He faces the $750,000 ceiling.

Exception. If you entered into a written, binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and you complete the purchase before April 1, 2018, you fall into the $1.1 million ceiling category.

<u>Tax Reform Imposes a Penalty Tax on Transportation Fringe Benefits</u>

The recent tax reform destroyed what was a win-win tax benefit for the employer and the employee. Transportation fringe benefits came into being in 1992 under the Energy Policy of 1992 (Pub. Law. 102-486).

One difficulty was that the benefits expired often and worked their way into the group of tax provisions called extenders. No problem—lawmakers extended the transportation benefits provisions continuously from 1992 until they made the benefits permanent with the Protecting Americans from Tax Hikes Act of 2015 (Pub. Law. 114-113).

The now-permanent tax-free fringe benefit still exists. But because of the recent tax reform, employers get stuck with a penalty tax when they grant employees any of the following qualified tax-free transportation fringes:

- Qualified parking
- Transit passes
- Certain commuter transportation costs

The penalty tax on the qualified tax-free transportation fringes applies to the business owner. It works like this: the business gets no tax deduction for the qualified tax-free transportation fringe benefits.

Example. Henry is in the 35 percent tax bracket, operates his business as an S corporation, and has 14 employees. His penalty tax rate on the loss of his S corporation’s transportation fringe benefits deduction is 35 percent.

Employees continue to receive the benefits tax-free as before.

Example. You reimburse your employee Fred for mass transit commuting fees. It costs you $3,160 for tax year 2018. Fred gets the mass transit benefit free of tax, but you don’t get a tax deduction for the $3,160.

If you want the tax deduction, you simply put the mass transit benefit on Fred's W-2 as additional taxable compensation to Fred.

But in some locations, including Washington, D.C., New York City, San Francisco, and Los Angeles, you may be required to pay for Fred's mass transit, depending on the number of employees that you have. In such cases, you can't stick it to Fred. You simply get the short end of the stick.

New Court-Approved Way to Defeat IRS Penalties

You hate IRS penalties, right? Everyone does! There are a lot of strategies we can use on your behalf to potentially defeat an IRS penalty. Thanks to the courts, though, we now have a brand-new way to beat an IRS penalty. It's Section 6751(b) of the Internal Revenue Code.

This provision can get you out of a penalty—even if you are truly liable for it under the law—if the IRS didn't follow proper legal procedures before assessing it. Code Section 6751(b) says that the IRS cannot assess a penalty unless an IRS supervisor or higher-level official designated by the Treasury secretary personally approved the determination in writing.

If the IRS does not follow this administrative requirement, then the IRS erroneously assessed the penalty, and we can have it abated for you.

This provision does not apply to individual and C corporation late-filing and late-payment penalties, individual and C corporation estimated tax payment penalties, or any other penalty automatically calculated through electronic means.

This abatement also does not apply to FBAR penalties. Title 31 of the United States Code authorizes FBAR penalties, and the penalty abatement provision we're talking about covers only Title 26 penalties (i.e., penalties under the Internal Revenue Code).

Some of the penalties that Section 6751(b) applies to include:

- Accuracy-related penalties
- Civil fraud penalties
- Daily delinquency penalties (e.g., Form 990)
- Information return penalties (e.g., Form 1099, Form W-2)
- International information return penalties (e.g., Form 8938, Form 5471)
- Partnership and S corporation late-filing penalties
- Tax return preparer penalties
- Trust fund recovery penalties
- Valuation penalties

Tax Reform Punishes W-2 Employees—Get Even!

The recent tax reform added new tax code Section 67(g), which states, "No miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026."

Let's say you are a W-2 mortgage banker paid on a commission basis, and during 2018, you will incur $27,000 of employee business expenses. Your 2018 tax deduction for employee business expenses will be zero. How do you think you will feel?

Before the recent tax reform, employees were already getting the short end of the stick when it came to business expenses. Why? The alternative minimum tax (AMT) did not allow tax deductions for employee business expenses, so those employees who had to pay the AMT were granted no business deduction tax benefits.

Of course, not all employees suffered the AMT. Those who did not simply suffered a 2 percent of adjusted gross income floor on deductions that fell into the miscellaneous itemized deduction category. All of this was bad, but it was NOTHING compared with ZERO business deductions—period. Getting a zero deduction for your legitimate business expenses is absolutely unfair. Is it possible that you can get even?

Maybe. Let me tell you the story of Dan Butts.

Dan Butts, an Allstate insurance agent, paid almost $10,000 more in federal income taxes than his State Farm counterparts did, because Allstate treated him as an employee. State Farm treated its agents as independent contractors.

In other words, with exactly the same income and the same tax deductions as a State Farm agent, Butts, the employee, paid $10,000 more in federal income taxes than a State Farm independent contractor agent did, for only ONE reason—the AMT does not allow a penny in deductions for business expenses.

Butts decided that he was not going to take this AMT unfairness lying down. He took on the system. He amended his tax return and put his W-2 employee commission income on Schedule C. He then subtracted his business expenses from this Schedule C income just as the State Farm agents did, and presto, he saved almost $10,000 in taxes.

The IRS immediately noticed that Butts had put his income and expenses on the wrong tax form. After discussions, the IRS sent Butts a notice of deficiency stating that it wanted the almost $10,000 in taxes. Butts said, “Forget it!” He took the IRS to court and won.

This was no ordinary case. Allstate had treated Butts as a W-2 employee from the time he started to work for them almost 20 years before. He was happy with this employee arrangement—happy, that is, until lawmakers enacted the Tax Reform Act of 1986 and applied the AMT to his employee business expenses, which hammered his business deductions right out of his tax return.

In this case, the court granted Butts independent contractor status even though Allstate Insurance

- paid him on a W-2,
- compensated him for vacation days,
- covered him with pension benefits,
- matched his 401(k) contributions,
- paid 75 percent of his health insurance,
- paid his insurance licensing fees,
- paid part of his group life insurance costs, and
- provided him with errors and omissions malpractice insurance coverage.

The court ruled for Butts because he had a “risk of loss” in his sales activities, and that made him just like other independent contractor agents.

It’s possible you could have facts that line up with those of Butts or another taxpayer who won status as an independent contractor despite being paid on a W-2.

Sincerely,

Robyn Urig EA

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