# TAX NEWS

WINTER 2017

## *Dear Client:*

Tax preparation time is almost here and there are some year-end reminders that need to be brought to your attention in order that you take advantage of all the benefits that you are allowed to have. In addition, there are items of information that you will need to provide so that the preparation of your return is complete and as accurate as possible. The preparation of your return is based on the information that you provide in written and oral format.

In addition to the preparation of the actual tax return, advice is provided to you which helps you plan better for the balance of the current year and also future tax periods. Here are some helpful items of information for you to use in order to minimize your tax liability and plan for the future:

**Reporting Gross Income**: The law requires that all of your income is required to be reported on your **Form 1040** no matter the source. All the earned income that a taxpayer receives from compensation as a **W-2** employee and/or the compensation as an "independent contractor" when services are provided to another party who is making the payments for the work offered to be performed. The inclusion of the compensation as an "independent contractor" is required to be included in the taxpayers gross income whether an IRS **Form 1099-MISC** is received or not received. Only income which is specifically exempted or excluded from gross income will be permitted an exception from being included on the **Form 1040**.

Payers of compensation must report the compensation paid to the recipient on IRS Form **W-2** if the worker is an employee no matter how much the wages paid. Payers who compensate "independent contractors" must report those amounts if the cumulative amount for the calendar year is **$600** or more. Those issuing IRS Form **W-2** and **Form 1099 MISC** as Non-employee Compensation in Box 7 must report the information to both employees and independent contractors no later than **January 31, 2018** for the 2017 tax year. In addition, the forms must also be submitted to the government by **January 31, 2018**. If your employer does not provide you with your **W-2** form by **January 31, 2018** then you need to request the form immediately so that your **Form 1040** can be properly filed.

If you are an "independent contractor" and haven't received your **Forms 1099-MISC** from all the parties for whom you provided services then you need to contact them right a way. Your compensation as an "independent contractor" is included in your **Form 1040** as ordinary income subject to the **Federal Income Tax** and also subject to **Self-employment Tax** subject to a Social Security tax at a rate of **12.4%** and the Medicare tax at a rate of **2.9%** for a total of **15.3%**. "Independent contractors" are deemed to be both the employee and employer for purposes of paying Social Security Tax and Medicare Tax.

If you are an employer and/or the payer to an "independent contractor" and **fail to report** the compensation to the workers then there is a **$270** penalty for each failure to report the information. In addition, there is a separate **$270** penalty for **failure to file** the required documents with the government. **Contact me ASAP on these issues to discuss further**.

There are other documents which you should be receiving and gathering from third parties involving the inclusion for gross income as follows:

- **Form 1099-INT** from banks, credit unions, individuals holding personal loans, brokerage houses, etc. for reporting interest income.

- **Form 1099-DIV** from brokerage houses and other financial institutions for reporting dividends earned. These include direct holdings with the corporation if they do not use an administrator to account and report the dividends that you earn. Note that many taxpayers are under a "dividend reinvestment" program and the dividends are earned and paid, but are not received by the taxpayer in the form of cash because the cash is used to purchase and reinvest in additional shares of the company's stock. Many times taxpayers are surprised to learn that they have to include the income when they don't actually receive a check. **We can discuss this further if you have questions**.

- **Form 1099-G** This form is generally received from your State government when you receive a refund for your prior year's State Income Tax payments. If you elected to itemized your deductions on **Schedule A** in a previous tax year and deducted State income taxes in that year and overpaid, then the amount refunded is included in the gross income in the year received to the extent of the tax benefit received in the previous year(s). State taxes are *either* withheld by employer on Form **W-2**, or IRA plan administrators or other retirement fund administrators on **Form 1099-R**. They are also paid by way of quarterly estimated taxes to a State, whether a resident or non-resident of that State.

In addition, you could receive a **Form 1099-G** from the Internal Revenue Service or a State when you are paid interest by the IRS or a State when you have a claim for refund and it is paid to you *more than* **45** days after April 15 or after the date the IRS or State receives the claim for refund whichever date is later. In many cases this will happen when there is an amended return on IRS **Form 1040-X** or when the IRS has held a return back in processing the claim for refund. The same is true for States.

- **Form 1099-B**: Another report that taxpayers need to make sure they receive is the reporting of all sales of stocks, bonds and other securities. These reports are going to separate short-term and long-term transactions and are going to also separate them in what is classified as "Covered" and "Noncovered" transactions. "Covered" transactions are those where the securities were purchased *after* the year **2010** and the brokers are required to track all of the purchases, sales, dividend reinvestments, short sales, wash sales, etc.

- However, many securities were purchased *prior to* **2011** and the brokerage houses were not required by law to account for the investment basis in these holdings. As a result, you as the taxpayer are required to substantiate the investment basis for all the **pre-2011** transactions. It is important that you keep the details so that they are available for when these holdings are disposed. In addition, if these holdings were received in a manner other than purchase, such as by gift, inheritance, divorce or distributions of any other type then you need to have that detail available for when the security is sold. If **you would like to discuss further just contact me.**

- **Schedule C Sole-Proprietorship Income**: We previously discussed the issues pertaining to the **Form 1099-MISC** and **Box 7 Nonemployee Compensation** and now it is time to discuss the importance of reporting Self-Employment income and the allowable business expenses that are paid and incurred in operating the trade or business. As a reminder, a sole proprietor includes all the sources of business receipts whether or not an IRS **Form 1099-MISC** is actually received from the payor. The law requires that the record keeping be done which accurately reflects the operations of the trade or business and reports the proper taxable income or loss from those operations. The law does not require any specific method of record keeping, it only requires that records be kept in a format reflecting the true tax liability.

The expenses of the trade or business are allowed to be deducted if they are "ordinary and necessary" for the specific business being operated. Each trade or business must provide a Standard Industry Code (SIC) on the **Schedule C**, so we will need to discuss exactly what the business that you operate actually does to earn the revenue and incur the allowable "ordinary and necessary" business expenses. In addition, you are required to substantiate your allowable deductions. You must keep **all** canceled checks, bank statements, purchase orders, actual receipts, credit card statements, bills, etc.

Upon an audit, the auditor will require that these documents are provided in order to verify the accuracy of your tax returns. If documents are not provided then the auditor will not allow the deductions and there will be an increase in income tax and self-employment tax as well as the assessment of interest *and penalties* from April 15 when the tax was due until the date paid. If the amount of the understatement of the tax liability is *more than the greater* of **$5,000** or **10%** of the liability which should have been reported, then there is an additional penalty of **20%** for "substantial understatement" of tax. This **20%** penalty is assessed for "negligence and or disregard for the law."

Not keeping proper records to substantiate your deductions is deemed "negligence and disregard for the law," so proper record keeping and substantiation is a must. It is important to note that this **20%** penalty is a "statutory assessment" and cannot be waived by the auditor. The penalty can only be waived by the IRS when the taxpayer can prove that they have "reasonable cause" for the penalty to be removed. The penalty can only be removed, however, by an Appeals Officer after the taxpayer has submitted a petition to the U.S. Tax Court. An Appeals Division Conference will take place about 18 to 24 months after this petition is filed. If that fails to remove the penalty then only the U.S. Tax Court Judges can remove the penalty at trial. If **you would like to discuss your sole-proprietorship operation more please contact me**.

**Schedule E Rental Real Estate Property**: If you have real estate property that you are renting out then all the rules that were discussed under **Schedule C** above apply as far as properly reporting all of your income and substantiating all of your deductions.

There are a few differences for rental real estate in that there is *only* an income tax on the net profit from the rental activities and no self-employment tax is assessed. In addition, rental real estate is considered to be a "passive activity" and is subjected to very specific rules as far as the deductibility of losses is concerned. Under the general rules, the maximum loss that the taxpayer can deduct in the current tax year is **$25,000** which is subject to a phase-out when the taxpayer's *modified* adjusted gross income is between **$100,000** to **$150,000**.

Any losses that are *greater than* **$25,000** and phased-out because of the modified adjusted gross income being *greater than* **$100,000** are "suspended" and are not allowed to be deducted *until* the taxpayer has *either* net rental income in a subsequent tax year or disposes of the rental real estate in a totally taxable event. If **you would like to discuss the tax advantages and specialties of rental real estate contact me**.

- **Other Sources of Gross Income**: There are various sources of income which must be included on your **Form 1040**. They include but are not limited to the following items:
  - Alimony received vs. a property settlement receipt
  - IRA distributions on **Form 1099-R**
  - Pension Distributions on **Form 1099-R**
  - Sales of Real Estate on **Form 1099-S**
  - Gambling Winnings on **Form W-2G**
  - Farm Income and Rental of Farm Land
  - Unemployment Compensation on **Form 1099-G** from the State that paid the Unemployment Compensation
  - Social Security Benefits on **Form 1099-SSA**
  - Other Income from whatever source derived, which actually includes "found money" and "bartering transactions," is required to be reported. The value of services that others provide to you in exchange for services you provide to them is income. **If you have any free services given to you we need to discuss!**

#### Reporting Allowable Deductions

The Internal Revenue Code allows many costs that are paid or incurred to be deducted on your **Form 1040** such as the following:

- Under current law **personal** and **dependency exemptions** are permitted at **$4,050** for each qualifying person on the tax return. There is an exemption for the taxpayer, spouse, qualifying children and qualifying relatives. Let's discuss what that means when you contact me. **Note that this provision is being discussed for repeal beginning in 2018.**
- If you are **classroom teacher** and worked 900 hours or more during the year then you can have up to **$250** to reduce adjusted gross income. **The House of Representatives is thinking about repealing this provision and the Senate is thinking about increasing it to $500**.
- **Health Savings Account** (HSA) deduction is available if you have a high deductible heath plan.
- **Moving Expenses** deductions are allowed if you meet the distance and

time test related to employment. **The House of Representatives is thinking of repealing this benefit except for the military.**

- **Pension deductions** are available if you are self-employed.
- **IRA deductions** are available if you do not have a plan with your employer or if you do, your *modified* adjusted gross income is *below* specified thresholds based on your filing status at the end of the tax year.
- Alimony paid is deductible. A property settlement distribution or child support payments are not deductible. **Note that the proposed tax legislation is calling for repeal of the alimony deduction beginning in 2018**.

If you elect to itemize deductions then the following items are allowed for 2017 but scheduled for repeal by proposed tax legislation **beginning in 2018**:

- **Medical and Dental Costs** including after tax dollars paid for health insurance, long-term care insurance, medicare payments, doctors, etc.
- **State and Local** Income taxes and Sales taxes.
- **Personal Property** taxes based on the value of personal property such as cars, boats, trailers, etc.
- **Real Estate** taxes on all property including land: **The House bill proposes a $10,000 limit beginning in 2018 while the Senate bill completely repeals it**.

**Note**: The items above are currently proposed to be repealed under current legislation in both the House of Representatives and the U.S. Senate.)

- **Home Mortgage Interest** on Acquisition Debt of up to **$1,000,000** and Home Equity Debt up to **$100,000** on a first and second home. The House bill limits **post 11/2/2017** acquisitions to **$500,000** of debt and no second homes. The Senate bill removes the deduction for Home Equity Debit Interest.
- **Points** on the acquisition of homes.
- **Investment Interest** on Net Investment Income.
- **Charitable Contributions** with very strict substantiation rules for currency and non-cash contributions as well as rules for a single contribution of **$250** or more, accumulated non-cash contributions of *more than* **$500** and accumulated non-cash contributions of **more than $5,000**.

**Alert**: Any single contribution of **$250** or more must be acknowledged by the charity, that "no goods or services were exchanged for the contribution except for religious purposes," by the time the return is filed.

- **Miscellaneous Deductions Subject to 2% of Adjusted Gross Income**: This currently includes, tax preparation fees, investment expenses, employee business expenses and allowable job related education. Contact me on all of these items. **The current tax reform package calls for the repeal of these benefits beginning January 1, 2018**.
- **Casualty Losses** which are personal in nature or thefts are also allowed as a deduction on **Schedule A:** The taxpayer must absorb the first **10%** of the loss based on their adjusted gross income, plus **$100**. **Presidentially Declared** Disaster Losses have different rules and are not subject to the **10%** rule, but do have a **$500** deductible floor amount. If you are a hurricane victim of Harvey, Irma or Maria then there are special rules for you, so contact me as soon as possible. **The proposed legislation repeals all personal casualty losses except Presidentially Declared Disasters.**
- **Gambling Losses** are deducted but only to the extent of Gambling Income. Therefore there is no allowance for excess gambling losses.

### Credits Against the Tax

There are several credits against the tax. A credit reduces your tax dollar-for-dollar, where as a deduction only reduces your tax based on your marginal tax bracket. Here are some of the credits available to you if you qualify. They are classified as *either* Refundable Credits or Nonrefundable Credits:

- **Refundable Credits**
  - Taxes withheld from **W-2**'s and **1099's** and estimates made on **Form 1040-ES**
  - Earned Income Credit (EITC)
  - Additional Child Tax Credit
  - American Opportunity Credit for education limited to **$1,000**

**Note**: These credits all require that the taxpayer provide strict substantiation and **I am required** to perform due diligence testing or face a penalty of **$510** from the IRS for each failure to do so. **As a result, I will require you to provide me with specific documents in order to prepare your return**.

- **Other Refundable Credits Include:**

  - Net Premium Tax Credit (Health Insurance) if you obtain your insurance through the Marketplace
  - Taxes paid with any extension to file your return
  - Excess Social Security Tax withheld on a **Form W-2** when you have more than one job as an employee

- **Non Refundable Credits** do not reduce your tax *below* your total income tax liability and include the following items:

  - Foreign Tax Credits paid to Foreign Countries
  - Child and Dependent Care Credit
  - Education Credits (including the Lifetime Education Credit up to $2,000 and up to **$1,500** for the American Opportunity Credit)
  - Child Tax Credit for a qualifying child who has not reached age 17 by the end of the year (Maximum **$1,000** per child.)
  - **Contact me on all of the above.**

- **Additional Taxes Assessed:**

A taxpayer can have other taxes for items such as the following:

  - **Self-employment at 15.3%**
  - Premature Withdraw of IRAs and Pensions at **10%**
  - Household Employer Taxes at **15.3%**, plus Federal Unemployment Tax
  - Health Care Shared Responsibility Payment for not having Minimal Essential Coverage. This is assessed as *either* a flat dollar amount or at **2.5%** of your gross income *greater than* your filing threshold amount.
  - Net Investment Income Tax at **3.8%**
  - Medicare Tax at **.009** on wages *greater than* **$200,000** if single and **$250,000** if married filing jointly, and **$125,000** if married filing separately

- **Conclusion:**

There is a lot of information here and I ask that you review your 2017 transactions and contact me on any and all questions, issues and comments that you may have for 2018 and beyond.

Have a Wonderful Holiday and Happy New Year!