PKHB CPAs, P.C.

Tax-Saving Tips

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IRS Says TCJA Allows Client and Prospect Business Meal Deductions

In Notice 2018-76, the IRS states that client and prospect business meals continue as tax deductions under the Tax Cuts and Jobs Act. This is very good news indeed.

Under this new IRS guidance, you may deduct 50 percent of your client and prospect business meals if

1. the expense is an ordinary and necessary expense under Internal Revenue Code (IRC) Section 162(a) and is paid or incurred during the taxable year in carrying on any trade or business;
2. the expense is not lavish or extravagant under the circumstances;
3. the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
4. the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
5. in the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

To prove your business meals, follow the two easy steps below:

1. Keep the receipt that shows the name of the restaurant, the number of people at the table, and an itemized list of food and drinks consumed.
2. On the receipt, record the name or names of the person or persons with whom you had the meal and also record the business reason for the meal.

In the event the receipt is not available, such as with the purchase of hot dogs and drinks at a baseball game while sitting in the stands, make sure to make a written note of the expenditures immediately after the game.

If you charge a business meal to a credit card, the credit card statement provides your proof of payment. When possible, always pay by credit card or write a check so that you have clear proof of payment.

Proof of payment is not proof of what you purchased, so in addition to proof of payment, keep the receipt with the notations as described earlier. With this combination of proof of payment and receipt with notations, you have what we call audit-proof documentation.

Tax Reform and the Cannabis Industry

You won't get a Section 199A tax deduction for your cannabis business. But some of the other tax reform changes may make the C corporation a more attractive choice of entity than before.

Let's look at an example. Say the cannabis business has the following financials:

	Cash	Tax
Gross Receipts	$500,000	$500,000
Cost of Goods Sold	-$325,000	-$325,000
Gross Income	$175,000	$175,000
Business Expenses	-$100,000	-$0
Taxable Income	$75,000	$175,000

If the business is an S corporation and you are in the 32 percent federal income tax bracket:

- You'll pay $56,000 in federal income tax on the taxable net income (32 percent of $175,000).
- You'll need to distribute 75 percent of the $75,000 net cash income just to cover the federal income tax bill.
- Your adjusted gross income increases by $175,000, not only causing you to lose various tax benefits but also subjecting you to possible additional taxes (such as the net investment income tax).

If the business is a C corporation:

- Your corporation pays $36,750 in federal income tax on the net income (21 percent of $175,000).
- Your after-tax profit is $38,250, which you can retain in the C corporation or distribute as a dividend. For every $1,000 you distribute as a dividend, you take a $150 tax hit on your individual tax return. If you distribute the entire $38,250, your tax on the dividends would be $5,737 and your total tax would be $42,487 (significantly less than the $56,000 as an S corporation owner).
- Your personal Form 1040 adjusted gross income is unaffected by the C corporation's net income (unless you distribute dividends). The key is that the "phantom" income created by Section 280E doesn't impact your individual tax return—only the corporation's.

Because Section 280E creates "phantom" income for tax purposes (that is, the income doesn't exist in real cash), it makes the S corporation and other pass-through entities less attractive overall for the cannabis business.

Defining "Real Estate Investor" and "Real Estate Dealer"

The first good news is that you can be both real estate investor and real estate dealer with respect to your real estate portfolio.

The next good news is that you are in control, and by knowing just a few rules about dealer and investor classifications, you can do much to increase your net worth.

Let's take a quick look at how big a difference you can make in the tax bite. Say you have a $90,000 profit on the sale of a property.

- **Dealer taxes** could be as high as $46,017.
- **Investor taxes** could be as high as $18,000.

The investor potentially saves a whopping $28,017 in taxes.

You, the individual taxpayer, can be both a dealer and an investor! The law does not cut you in half or anything.

No, the law simply looks at each property in its respective light. But you need to make the light shine on your properties by making a clear distinction in your books and records as to which properties are investment properties and which are dealer properties.

Should you fail to make the distinction, you place yourself at the mercy of the IRS. (The word "mercy" does not exist in the tax code, so expect a very unhappy result if you rely on mercy.) The courts look at your intent in buying and holding the property. Your books and records help establish that intent.

Dealer property is property you hold for sale to customers in the ordinary course of a trade or business. The more properties you buy and the more properties you sell during a calendar year, the greater the chances that you are a dealer with respect to those properties.

Properties that you buy, fix up, and sell generally are dealer properties. Also, properties that you subdivide have a great chance of being dealer property, except when those subdivisions are done under the very limited rules of Section 1237.

Where the dealer's principal purpose for owning property is to sell it to customers in the ordinary course of business, the investor's purpose in owning property is to

- have it appreciate in value, and/or
- produce rental income.

Each property stands alone with respect to its status as a dealer or an investment property. Thus, you (the individual taxpayer) or your corporation may own both dealer and investment properties. If you have both types of properties, make a clear distinction in your books and records as to which properties are investment properties and which are dealer properties.

Claiming the New Employer Tax Credit for Family and Medical Leave

You compete for employee talent in a variety of ways, including perhaps by implementing a medical and family leave policy.

The good news on this front is that your federal government may have given you a tax credit (yes, that lovely dollar-for-dollar offset to your taxes) for what you wanted to do anyway. The Tax Cuts and Jobs Act (TCJA) establishes a new federal income tax credit for employers that provide qualifying paid family and medical leave benefits to their employees.

This new tax credit is available for two employer tax years only—those beginning between January 1, 2018, and December 31, 2019. If your business operates on a calendar year for tax purposes, you can put your business in a position today to claim the tax credit for both the 2018 and 2019 tax years. But you will need to hurry.

If eligible, you can claim a credit equal to 12.5 percent of wages paid to "qualifying employees" (defined later) who are on family and medical leave, as long as the leave payments are at least 50 percent of the normal wages paid to those employees.

You can increase the credit beyond the 12.5 percent. For each 1 percent increase in medical leave payments over the 50 percent threshold, the credit rate increases by 0.25 percent, up to a maximum credit rate of 25 percent. A qualifying employee is one who has been employed by your company for at least one year and whose compensation last year was less than $72,000.

For purposes of qualifying for the credit, "family and medical leave" is defined as leave taken by a qualified employee for any of the following reasons:

- The birth of the employee's son or daughter, in order to care for the son or daughter.
- The placement of a son or daughter with the employee for adoption or foster care.
- A serious health condition of the employee's spouse, son, daughter, or parent.
- A serious health condition that makes the employee unable to perform the functions of his or her position.

- Any qualifying exigency arising out of the fact that the employee's spouse, son, daughter, or parent is a member of the US Armed Forces (including the National Guard and reserves) who is on covered active duty or has been notified of an impending call or an order to covered active duty.

- A serious injury or illness of a covered service member who is the employee's spouse, son, daughter, parent, or next of kin.

Employer-provided vacation leave, personal leave, or medical or sick leave (other than qualifying leave as defined above) is not considered leave eligible for the credit. Also, leave that is paid by a state or local government or that is required by state or local law does not create leave eligible for the credit. The maximum length of paid family and medical leave taken by a specific employee who can qualify for the credit is 12 weeks per tax year of the employer.

When Must Your Company's Family and Medical Leave Policy Be Established?

Good question. The general rule is that to claim the credit for your company's first tax year that begins after December 31, 2017, you must have your written family and medical leave policy in place before you pay the family and medical leave for which the credit will be claimed.

But under a favorable transition rule for the first tax year beginning after December 31, 2017, your company's written leave policy (or an amendment to an existing leave policy) will be considered in place as of the effective date of the policy (or amendment) rather than the later adoption date.

So if you make the effective date of the policy January 1, 2018, your company can claim the credit for qualifying family and medical leave payments made on or after that date. This transition rule is available if

1. the policy or amendment is adopted on or before December 31, 2018; and
2. you bring your leave practices into compliance with the terms of the retroactive policy (or amendment) for the entire period covered by the policy (or amendment), including making any retroactive leave payments by no later than the last day of the tax year.

Example. Your company uses the calendar year for tax purposes. Back in January, Eve took two weeks of unpaid family and medical leave for the period beginning on January 15, 2018.

On November 15, 2018, your company adopts a written policy that satisfies the family and medical leave policy requirements explained earlier and makes that policy effective retroactively as of January 1, 2018. On or before December 31, 2018, the company pays Eve for two weeks of leave at 50 percent of her normal pay, as specified by the new policy. Assuming all the other requirements for the family and medical leave credit are met, your company can claim the credit for the 2018 leave payments made to Eve.

Can You Deduct Defunct S Corporation Expenses?

Let's say you dissolved your corporation, and then some unexpected corporate expenses arrived. You paid them personally because the corporation was no longer in business.

Guess what? No deduction. The corporation can't pay the expenses because it no longer exists. The owner can't pay the expenses and then deduct them because he didn't incur those expenses inside a business that he operates in his personal name.

If you are going to shut down your S corporation, consider keeping the business open for an extra period of time to ensure you receive all income and pay all expenses, or make sure to resolve all potential accounts payable prior to closing the business.

Since you incur costs for keeping the S corporation open (tax return filings, state franchise taxes, etc.), you need to weigh the additional costs against any lingering accounts payable or other expense issues that could arise. If you are considering shutting down your S corporation, let's talk before you do it.