April 2018 Tax Roundtable

Jim Asked

New client bought a farm house with a few other detached structures in Dec 2017 with a business partner / friend. They are living in the house, renting rooms to two other friends, as well as running their business out of the house (which takes up a substantial portion of the property).

She's not on the Loan; the loan is secured through the friend's property in California.
She clarified they own the house together and she put down half of the down payment.
The business was primarily hers before December, but now they consider themselves partners in both adventures.
The business was not very profitable in the past, but I think that might change, and they are both doing it almost full time and recording all income accurately.
They are thinking about hiring w-2 employees this year.

How does this work?
What's the easy way to deal with this and what's the best way?
My opinion is they should just get platonic married for my convenience.

-Jim

TaxMama Suggests

The best thing to do, without being married is to form a partnership. Since you are in WA, an LLC would be fine. With two owners, it defaults to a Form 1065.

The loan on the property in CA?
The friend can make an election to treat the loan as a business loan made directly to the partnership. Especially if they are paying the mortgage from the funds generated by the current venture. They will need detailed paperwork to support this.

(If they need another solution, we can sit down and sort through this – if they are willing to pay a fee.)

They do need to spell out terms of the partnership – who does what, how income and losses are split, how equity is split. All those percentages can be different. And I would not have the partnership own the property. If it's hers, let it stay hers – just in case the business or the relationship falls apart. The couple can determine a fair rental value to pay to her for the property.

Catherine Asked

Section 965 Calculation - any suggestion for a tool or clever web site? Working through Pub 5292 but it's slow going.

TaxMama Suggests

I honestly have no experience with this.

But, here's an interesting article – and it's recent - https://www.castroandco.com/blog/2018/march/section-965-deemed-repatriation-tax-defeated/

https://www.law.cornell.edu/uscode/text/26/965
https://www.irs.gov/pub/irs-pdf/p5292.pdf

Roger does have experience if your client is willing to pay for his expertise.
Roger B Adams <rogerbadams@gmail.com>

Cindy Asked

Thanks for the opportunity! I have a question regarding deducting contributions to a safe harbor 401k on an individual tax return for a Schedule C filer. My client John is a sole proprietor/schedule C filer with net SE income of approximately 1.5 million.

A few years ago John implemented this plan wherein every year as an employer he contributes 3% of each employee's gross pay as a safe harbor contribution, and an additional 4.5% discretionary contribution for a total of 7.5% (lucky employees - they don't even have to contribute to the plan themselves!)

He also contributes $24,000 for himself as a 401(k) contribution; and as an employer contributed 3% for himself as a safe harbor contribution on his first $265,000 of SE income (this 3% employer contribution on his own income is dictated to us by the plan's actuaries. He isn't eligible for the 4.5% discretionary on himself due to his income level).

Finally, he is able to contribute $300,000 (also dictated by the plan's actuaries) to a tax-deferred "cash management plan" due to the way his 401(k) plan is set up and the level of contributions he makes on behalf of his employees.

Here's how I feel all of these contributions should be deducted on his 1040:

- The 7.5% contributed on behalf of his employees is a deduction from SE income.

- The $24,000 he contributes to his own 401(k) gets deducted on page 1 of the 1040.

- The 3% safe harbor he contributes on his own behalf is a deduction from SE income.

- The $300,000 he contributes to his cash management plan gets deducted on page 1 of the 1040.

The CPA who prepared his tax return last year deducted BOTH the $24,000 and the $300,000 contributions from SE income. Even though John far exceeds the SS threshold, he still has to pay the Medicare portion on his SE income correct?

Thank you Eva!!!! Look forward to the Roundtable.

Cindy Foster

TaxMama Suggests

Oh Kay… your first two steps were correct.
But since he is a sole proprietor, filing a Schedule C, he cannot be on his own payroll.
HE cannot have “employee benefits.” Therefore, none of his contributions should be deducted from his Schedule C.

The only place that really makes a difference is in the amount of Medicare tax he pays. Since he is well over the SS threshold as you so aptly point out.

I would love to see the CPA’s justification for deducting “BOTH the $24,000 and the $300,000 contributions from SE income.”

Perhaps he’s right? I cannot imagine how.
Incidentally, why did this fellow leave his CPA and come to you?

Krista Asked

Regarding paying my children from the company instead of giving an allowance. What if you're a DBA not running payroll? Is there a max amount each year? IS there a min or max age?

Can you take mileage deductions on a car that is owned by the company and on the depreciation schedule? I thought you had to take straight deductions like gas, repairs etc instead of mileage.

TaxMama Suggests

First of all, the children have to be old enough to do work for you.
So, if they are old enough to drive, that's probably fine.

- If you're talking about a 5 year old who empties trash – that's not a job.
- If the child is 3 months old and the Gerber baby and is generating income for the business – that's a job. So it all depends.

(Please don't be vague when you ask questions. I could spend hours giving all possible answers and we don't have time for that.)

Next, they actually have to DO WORK for your business – not run personal errands.
Then, they must keep track of the work they do – via a time log or other tool to show that they are working or performing substantive tasks.

Then, if you pay them, you WILL set up a payroll. If they are under age 18, you don't have to withhold (or pay) for FICA, MEDI or FUTA – but they still have to be on payroll, get W-2s – and you still have to file form 941 each quarter.
https://www.irsvideos.gov/Business/Employers/EmployingFamilyMembers

As to the car, if the company is depreciating it and taking actual expenses, you cannot ALSO deduct mileage.

Terry asked

Here is my question:

I have a new client who is a trucking company. They also buy and sell product (gravel, dirt, etc.).

Setting aside the $10 mil average, can you discuss UNICAP for these types of companies?

I've found the old IRS audit manual for trucking (they don't list one on the site now). It recommended COGS include subhauler fees, dentention/demurrage fees, handling, truck/trailer rentals, and trip permits.

What other things should be considered for COGS? What about damages or losses to the loads?

If they are below the $10 mil average, what would be the pros and cons for following UNICAP? Or, is it best to forget UNICAP and book only the product as COGS?

I see benefit in both scenarios, but that is looking at it from an accounting point-of-view. Tax is another situation.

Thank you!

TaxMama Suggests

OK, what you're describing here is all about cost of goods sold (COGS).
Uniform Capitalization Rules about taking production costs out of COGS and capitalizing them.

These guys are not building anything. They are not creating a product. They are buying wholesale – and selling it with a mark-up. This is a pure COGS scenario.

As to the trucks – they are not making anything to attach to the trucks.
They are buying things that attach to the trucks. Now, those things should properly be capitalized. But they can be depreciated, if necessary, using Bonus depreciation or Sec 179.

What are you trying to accomplish?

Jami Asked

Decedent trust in Massachusetts with Dividends and Capital gains.

1041 shows Federal nothing due - on K1 10K due on 1040 return I think is correct
1041 shows 3k due MA amount due plus same 3k also due on the MA return with the 1040 - not correct

Shouldn't the 1041 be like a pass through with zero due and the k1s put the income on the 1040 for federal and state?

TaxMama Suggests

Who prepared the Form 1041?
Have you read the trust?
The trust defines if the estate's annual taxes are paid at the trust level or at the beneficiary level. When working with trust returns, you need to read the will and the trust documents.

Without that – in a vacuum, there is no way to know if this is correct or not.
Make friends with whoever prepared the trust return and have them mentor you a little bit.

Debi Clem Asked

I have 3 situations I need help with. first one Client tried to move his LLC with S election from Colorado to Mo because he moved to Mo a few years ago and no longer does any business in CO. Mo wouldn't accept the LLC transfer so he went online his self and started a corporation under the same name. I just found this out (after filing an extension with the previous LLC ID. He has now started a new bank acct with the new EIN. After speaking to his attorney he thought he should open a new S corp in Mo and start over leaving the C corp open until we find out which way is his best choice. I think he would be a Personal service corp. I know the rules are changing but haven't had time to read up on it. He has had almost no income yet but 2-3 million expected this year. We had already done boat loads of paperwork for a defined benefit plan under the previous name and ID. most of the people I have spoken to are leaning toward starting a new LLC S corp in Mo under the same name that he closed in Colorado and closing the C corp. The C corp was opened in Nov 2017.
Do I do a final year for the S corp formed in Co., file a zero information return for the C corp from Nov to April (or can we just contact someone to say it was opened in error?) Then start the new S corp for April of 2018.
What a mess things become when someone tries to make changes their self.
Debi Clem

TaxMama Suggests

I am totally confused.

You start out by saying he had an S corp in CO, then you keep saying it's a C Corp. Which is it?

After moving to MO, he filed for his own LLC – and didn't elect any entity yet? Just has an EIN?

Was the MO LLC already designated as a C corp? Is THAT what you're saying? He already made the election?

Did he have activity in the MO C corp from Nov – April?

And did he establish that as fiscal year entity starting in Nov?
IS an S corp the best entity for him to use?

OK, let me try to sort this out.

1) File a final tax return for the CO entity, whatever it is.
2) Put the MO C corp on extension for calendar year 2017 until you can figure out what it should be.
3) Schedule a planning appointment with him and his attorney as soon as possible after April 17th (after giving yourself a critical break) to sort out what to do this year, before he earns all that money.

Rudy Asked

I have a client who started a C Corp without notifying me. Of course, he did not pay himself any compensation during the year. Since he had no compensation how would I treat the earnings for the business after deductions? Can they be reported to him as dividends or is it too late for that? He will be left with about $20,000 net revenue after deductions. Also, he was still operating this business as a sole proprietorship and would just use the revenue for business expenses and spend the rest for personal use even though you aren't supposed to with a C Corporation. I know, very bad :(I would appreciate any help.

TaxMama Suggests

Well, you don't say how much the gross income was.
But the net was only $20,000. Is that after removing all the money he drew to cover his personal expenses?

The right thing to do is to add up all the funds used for personal bills and turn them into payroll. Do a late payroll tax return for Q4, along with a late W-2/W-3.

However, that involves penalties and attracts attention.

Two other ways you can go:
1) Issue a late 1099-MISC for 2017 for all the personal funds used – the late penalty is low.
Put the amount on the Officer Compensation line on the 1120.
And file a Schedule C on his personal return.

2) Easiest – call the personal funds a loan to officer.
Start a payroll in 2018 and add that amount to his 2018 payroll to wipe out that officer loan.
This will attract the least audit attention.

Not having compensation in the first year, with a profit of $20,000 won't draw too much IRS audit grief. Just read him the riot act.

Larry Asked

TaxMama replies will be threaded into the questions.

I have two scenarios.

1st This past week I had a client provide their documents to prepare their 2017 return. As many clients do, they had word doc and excel spreadsheet summary pages.

One section stated my fiance and I created a LLC to flip houses in August of 2017.

We found and bought a house to flip in September and we got married in November.

They summarized all the costs to start the LLC and costs to rehab, stating that they sold the house in February of 2018 so there shouldn't be anything taxable till 2018.

As you might imagine several things came to mind as I was reading this and I would appreciate any confirmations and any advice form the group.

My first thought was

- They should have filed a partnership return by March 15th because they have deductible items pertaining to the start up of the LLC, correct?
    - TaxMama – yes. Since they are late – file the partnership return ASAP to avoid more late filing penalties. Use the First Time Penalty Abatement when the penalty invoice arrives.
- This had me thinking do they really need to use a LLC to flip houses as long as they are not buying and holding to create rental income. Do they need the limited liability?
    - TaxMama - They have it. They can file as a partnership. Leave it as is.
      Do they hire workmen to handle the repairs and improvements? They have liability.
      You're in IL so you don't have the outrageous LLC fees we have in CA. Leave it as is.
- I also believe as a partnership their loses may be limited where they may not be if they were a QJV. I also believe since IL is a common law state, they do not qualify for Qualified Joint Venture status because 1. they were not married when they formed the partnership and 2. LLCs do not qualify for Qualified Joint Venture status, correct?

  - TaxMama - They are not going to have losses, generally. Their expenses will be capitalized as part of the cost of the home, even the mortgage. There won't be deductions, except perhaps things like mileage. They will flip and sell quickly. Their sales MIGHT be ordinary income – as inventory, if they do this several times a year – OR if this is their primary source of income, once they become adept at this.
    In the meantime, they might get away with short-term capital gains treatment for the first flip.
    I thought there was something about flipping houses in the recent tax bills, but cannot find it right now.
    Here's an interesting article - https://fitsmallbusiness.com/taxes-on-flipping-houses/ .

- If all they want to do is buy and flip, any thoughts on not doing this through the LLC? Do they need the protection of the LLC? After doing some reading, I saw a lot of individuals use a LLC with Sub S election? I am not sure that would make sense for real estate, any thoughts?
  - TaxMama – NO! No Sub S, no C corp. A partnership is the best vehicle for these two.

- My final thought was, with the exception of any expenses that pertain to the LLC itself, all other costs are added to the inventory, (the house) and considered in the year it was sold. What about holding costs, i.e. interest, property taxes, and homeowners insurance?
  - TaxMama – See notes above. If they keep flipping the house in 6 months or so – capitalize everything.

Can anyone in the group provide some resources go into great depth about partnership accounting and return preparation?

TaxMama - The TaxBook has a tab for partnerships and it includes a complete example of how to prepare a partnership tax return. Start with that. If you need more, there are 5 courses at CPELink - http://www.cchcpelink.com/product/detail/?p=12545&s=85iz6kg

Larry Asked

2nd scenario for discussion purposes / war story.

This past week at the VITA site we had a client slip through the cracks and was admitted with income that was way out of scope for the VITA program.

Our Non-Profit, is one of the best. They allow staff to use the CCH software to prepare staff, staff family and staff friends returns even though they we will not get any VITA credit. Since this client had been waiting several hours and we had time, we prepared her return as a staff return.

Among other things, She had $770,000 on a 10099-R with $146,000 withheld. She was going to owe $116,000. Of course she was in tears and as a VITA manager and paid preparer, we sometimes find ourselves part counselor of some kind.

Without prying too much, I was able to ascertain she had no money left, no other sources of net worth. She was unemployed, no new cars and an average to below home. I knew there was probably an all too common back story but since we would not be helping with her collection problem, I just assured her the IRS would work with her.

Our non-profit is not only a VITA site but does financial coaching and has a tax clinic staffed with EAs and attorneys that work pro bono. We refereed her to the tax clinic hoping they might help since she had no net worth and was currently unemployed.

As we were consoling her, my thoughts which I kept to myself were, she is probably a good candidate for CNC status and maybe an OIC. We do have one person at our site that works for the IRS in the business audit division, she stated, she didn't think the client would qualify but could support that thought.

I thought it might be a topic worthy of a short discussion.

TaxMama Suggests

We will come back to this is we have time.
But, what did she do with over $500,000 in cash that, now, she has nothing?

After the deadline, if we have time – I have not had time to read these questions:

Catherine Asked

From 2018 - CA Couple with $50k Mortgage interest, etc....

Better off MFJ or MFS considering limitations to Sch A Deductions?

TaxMama Suggests

Sorry Catherine. That's not enough information.
The mortgage interest is deductible, as long as the mortgage is under $1 million
Their property taxes will be limited. But filing MFS won't increase their deductions.

Getting divorced will.