Specified Service Trade or Business

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Seasons of Change
Will they make you or break you?

By Melissa Bowman, EA

We live in a state of flux. Some changes are more obvious—the seasons, birth, marriage and the death of a loved one come to mind. Each event brings something new to the table: challenge, adventure, adversity. While we may not be able to change our circumstance, we can change how we react to it. Will it have a positive impact on our lives or a negative one? We can learn from it or let it defeat us.

Twelve years ago, my family and I sponsored an exchange student for ten months in our home. Talk about a season of change! This 15 year-old-boy got on an airplane by himself to travel to a new country, a new way of life, a new language, a new family. He had a choice to be frightened or be in awe of the new experience. He chose to embrace it, to learn from it and to cherish the memories. As a result, I gained another son, and this summer my family and I traveled to Finland to be with him as he was married. This is just a small example of how we can deal with change on a personal level.

Change in our professional lives presents its own challenges. Currently, our industry is in a state of change. As is always the case with tax law, we have no choice in how the laws were written. Our job is to follow them. However, you and I do get to decide how we’re going to react to the changes within the industry. We can either embrace the new laws with a positive attitude, or we can grumble and whine about the changes as they are implemented with no regard to our opinion. Keep in mind, our reactions will be conveyed to our clients. Do we want them to leave our offices with a positive or negative mindset? This is the question we all have to ask ourselves.

NATP, as an organization, is also in the process of change—changes that are designed to keep it the number one choice in education and research for tax professionals, give us a presence on Capitol Hill and an opportunity to provide input on tax regulations and policies as we move forward. As the largest membership organization in the country for tax professionals, our combined voice is important. Some of the changes coming down the road are in member benefits. Once again, only you, as a member, can decide whether to embrace these new changes.

It’s also the time of year when we are looking to make changes in our individual practices. My office is opening a new branch in November. We’re currently reviewing office policy and procedures, staffing, hours and client offerings. I’ve been quite busy working on budgets, employee wages and benefit increases, software and equipment upgrades and so much more.

As I write this column, I’m thinking to myself, “Wow! That’s a lot of change happening.” Now, I get to decide how I want to react to all these changes. I’m choosing to be positive and think about all the new things I’m going to learn. Now, it’s your turn to decide how to react. Do you want to look for the positive and get excited, or will you let the changes beat you down? The choice is all yours!
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Implementing the new tax law

Are you ready for the upcoming season?

By Larry Gray, CPA, CGMA

Knowing the law, your clients and your tax software are key.

2018 has been like a horse race. We started the year with the largest tax legislation in over 30 years. In February, NATP was at the IRS round tables for implementation of the new tax law. NATP has provided several webinars, conferences and live presentations on the new law to help all of us get ready.

Now we have turned a corner—our first filing season with the new law. This includes new forms and schedules such as the new Form 1040 (the postcard) and its six new schedules. Two points on the new 1040 format: this format was actually the format prior to 1976 for the Form 1040, and several states have also gone to this block format. Tax software companies say the input screens should look a lot like they have in prior years.

In a recent report, TIGTA warned of anticipated IRS delays to the start of the 2019 tax season. At the time of this article, in some areas of the new tax law, the IRS is waiting for guidance from Treasury in the form of regulations in order to implement the new law. This, along with the number of forms, publications and instructions, is expected to cause some delay this filing season. For example, the IRS may not be able to finalize the worksheets for calculating QBI on the 1040 until the final regulations on §199A are issued. Once issued, software vendors may have to make additional changes also.

In our offices, we will be changing our processes, setting up new due diligence questions, adding additional interview questions and educating our clients on the impact of the new law. This is going to result in additional time with each of our clients, which is an opportunity to build relationships and grow our practices as we assist our clients in understanding the new law and its implications in their personal and professional lives.

While teaching, testifying, attending meetings and speaking over the past year, I’ve compiled the following list of major concerns people within our profession have shared when it comes to implementing the new law:

- **W-2 withholdings.** Because of the rate changes, doubling of the standard deductions, the State and Local Tax (SALT) deduction, miscellaneous deduction limits and elimination of personal exemptions, the calculations of withholding will be all over the board. We’ll have to explain to our clients whether the difference in their tax refund or tax due is from the new law or from the calculation of the withholdings.

- **QBI.** On the business side, the topic of conversation will be qualified business income deduction. Remember, this 20% deduction applies to the smallest schedule C or the largest S corporation or partnership as long as it’s a qualified trade or business.

- **Itemized deductions.** There is a lot of confusion, especially in the area of the SALT deduction. Some states are trying to pass legislation to make taxes a charitable contribution. This may make it difficult to complete a return this tax season.

While speaking on the new law all year, I consistently come back to the same steps to get the right answer: (1) Start with the old law. Know it. (2) New law: Is it a change or a new law? (3) Know your client. (4) Know your tax software. NATP helped us through the summer and fall with education and keeping us current as changes happened. NATP research will be a partner this winter helping us get through our first season with all the new changes. You’re ready.
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When not riding my mountain bike in the Rocky Mountains, I tend to hang out with tax nerds, which is pretty much all the time—to the extent that tax nerds hang out that is. At one of our most recent gatherings, we had a lot of fun indulging in freshly picked peaches and poking holes in the bizarrely nuanced concept of what the U.S. Treasury deems a Specified Service Trade or Business (SSTB). Worth noting is that there were a lot of smart people in the room, many of whom spent their entire adult lives reading and writing about (as well as applying) U.S. Tax Code and Treasury Regulations.

We all generally agreed that no business wants to be deemed an SSTB and that, as a result, there will be all sorts of reprobate behavior from U.S. taxpayers and perhaps our federal government alike.

Nevertheless, after many hours of banter we all left with more questions than answers about SSTBs. While the U.S. Treasury did have an open comment period, by the time this article reaches publication, it was our collective guess that the proposed regulations will be well on their way to becoming permanent with little fanfare or change.
As per proposed U.S. Treasury Regulation 107892-18 (released August 8, 2018) governing §199A, Qualified Business Income, under the newly enacted Tax Cuts and Jobs Act, U.S. taxpayers are now expected to accordingly report ownership of specified service trades or businesses. Why is this significant? If you own an SSTB, that business does not qualify for the new 20% business deduction unless you, as the owner, meet exceptions to the general rules.

So, what exactly is an SSTB? Perhaps it’s best to back into this by first addressing what it is not. The industries that are specifically excluded from being deemed an SSTB include real estate brokers, property managers, architects, engineers and bankers. If your clients own, passively or otherwise, a business in any of these industries, they have been explicitly excluded.

Defining a Trade or Business
Before drilling further down into what classifies as an SSTB, paying homage to the ubiquitous tax concept of “trade or business” seems to be in order.

The proposed regulations assert that deductions are available only with respect to activities rising to the level of a “trade or business.” What does this mean? The Code uses several different standards to define income for tax purposes.

The proposed regulations governing §199A provide that each activity must satisfy §162’s trade or business parameters, which generally requires a business activity to be conducted “regularly and continually” with the primary purpose of making a profit. For reasons that are beyond the scope of this article, this standard could prove problematic for professionals engaging in rental real estate.

Defining Specified Service Trade or Business
An SSTB is defined as any trade or business involving the performance of services in the fields of:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services

- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners
- Any trade or business that involves investing and investment management, trading, and dealing in securities [as defined in §475(c)(2)], partnership interests and commodities

The following guidelines of SSTBs originate from the proposed §199A regulations.

Health
Proposed Reg. §1.199A-5(b)(2)(i). Performance of services in the field of health means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals who provide medical services directly to a patient. This does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient.

The performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices. But, what about:

- Adult day care that provides attention but does not administer medication?
- Non-emergency medical (aka wheelchair facilitated) transportation to a medical appointment?
- Medical transcription or billing services?
- Radiologist who reads screens from afar and has no patient interaction?
Law
Proposed Reg. §1.199A-5(b)(2)(iii). Performance of services in the field of law means the provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals. This does not include the provision of services that do not require skills unique to the field of law including printers, delivery services and stenography services. But, what about:
• Trustees?
• Administrators?
• Personal representatives?

Accounting
Proposed Reg. §1.199A-5(b)(2)(iv). Performance of services in the field of accounting means the provision of services by accountants, enrolled agents, return preparers, financial auditors and similar professionals in their capacity as such. This is not limited to services requiring state licensure (CPA).

The aim of proposed §1.199A-5(b)(2)(iv) is to capture the common understanding of accounting, which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training or mastery of accounting principles as a CPA.

The field of accounting does not include payment processing and billing analysis. But, what about:
• Payroll services providers?
• Accounts payable or billing services?

Actuarial Science
Proposed Reg. §1.199A-5(b)(2)(v). Performance of services in the field of actuarial science means the provision of services by actuaries and similar professionals in their capacity as such. This does not include the provision of services by analysts, economists, mathematicians and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

Performing Arts
Proposed Reg. §1.199A-5(b)(2)(vi). Performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors and similar professionals performing services in their capacity as such. The performance of services in the field of the performing arts does not include:
• The provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.
• Services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts.

But what about:
• Managers?
• Producers?
• DJ’s playing their own mash-ups or playing other artist songs?

Consulting
Proposed Reg. §1.199A-5(b)(2)(vii). Performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. This does not include the performance of services other than advice and counsel.

It’s common for businesses to provide consulting services relating to the purchase of goods by customers. Following are two examples from the proposed regulations:
• A company that sells computers may provide customers with consulting services relating to the setup, operation and repair of the computers.
• A contractor who remodels homes may provide consulting prior to remodeling a kitchen.

Proposed Reg. §1.199A-5(c) provides a de minimis rule, under which a trade or business is not an SSTB if less than 10% of the gross receipts (5% if the gross receipts are greater than $25 million) of the trade or business are attributable to the performance of services in a specified service activity. What if you hit 11% and are under $25 million gross receipts? Does all business become ineligible?

This de minimis rule may not provide sufficient relief for certain trades or business that provide ancillary consulting services. A trade or business...
that sells or manufactures goods and also happens to provide ancillary consulting services to facilitate the sale of those goods (not separately purchased or billed) is not a consulting trade or business. Accordingly, Proposed Reg. §1.199A-5(b)(2)(vii) provides that the field of consulting does not include consulting that is embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services. But, what about:
• Trainers or educators?
• Business coaches?
• Mentors & motivators?

Athletics

Proposed Reg. §1.199A-5(b)(2)(viii). The field of athletics is not listed in §448(d)(2), and there is little guidance on its meaning as used in §1202(e)(3)(A). However, athletics has been deemed to be similar to the field of performing arts. Performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field billiards and racing. This does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include broadcasters or otherwise disseminators of video or audio. But, what about:
• Referees?
• Umpires?
• Professional gamers?

Financial Services

Proposed Reg. §1.199A-5(b)(2)(ix). Because §1202(e)(3)(A) includes the term financial services, and banking is separately listed in §1202(e)(3)(B), proposed §1.199A-5(b)(2)(ix) limits the definition of financial services to services typically performed by financial advisors and investment bankers, including:
• Managing wealth
• Advising clients with respect to finance
• Developing retirement plans
• Developing wealth transition plans
• Advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, and restructurings (including in title 11 or similar cases)
• Raising financial capital by underwriting, or acting as the client’s agent in the issuance of securities, and similar services, including those provided by financial advisors, investment bankers, wealth planners and retirement advisors

This does not include taking deposits or making loans (i.e., banks).

Brokerage Services

Proposed Reg. §1.199A-5(b)(2)(x). Brokerage services include services in which a person arranges transactions between a buyer and a seller with respect to securities as defined in §475(c)(2) for a commission or fee. This includes services provided by stock brokers and other similar professionals. This does not include services provided by real estate agents and brokers and insurance agents and brokers.

Reputation or Skill

Proposed Reg. §1.199A-5(b)(2)(xiv). An SSTB includes any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. The idea of “reputation or skill” must be interpreted in a manner that is measurably objective and administrable and is limited to:
• Receiving income for endorsing products or services, including your distributive share of income
or distributions from a relevant pass-through entity (RPE) for which you provide endorsement services
• Licensing or receiving income for the use of your image, likeness, name, signature, voice, trademark, or any other symbols associated with your identity, including your distributive share of income or distributions from an RPE to which you contribute the rights to use your image
• Receiving appearance fees or income including but not limited to (1) reality performers performing as themselves on television, social media or other forums; (2) radio, television and other media hosts; and (3) video game players

Miscellaneous
Section 199A(d)(2)(B) also includes any trade or business that involves:
• Investing and investment management
• Trading
• Dealing in securities as defined in §475(c)(2)
• Dealing in partnership interests, or commodities as defined in §475(e)(2)

Section 1202(e)(3)(A) and §448(d)(2) have scarce regulations in these regards. Section 475(c)(2), however, provides a detailed list of interests treated as securities including:
• Stock in a corporation
• Ownership interests in widely held or publicly traded partnerships or trusts
• Notes, bonds, debentures
• Other evidences of indebtedness
• Interest rate, currency or equity notional principal contracts
• Evidences of an interest in, or derivative financial instruments in any of the foregoing securities or any currency, including option contracts, forward contracts, short positions, any similar financial instruments, and certain hedges with respect to any such securities

Section 475(e)(2) provides a similarly detailed list of property treated as a commodity, including:
• Any commodity that is actively traded [within the meaning of §1092(d)(1)] or any notional principal contract with respect to any such commodity
• Evidences of an interest in, or derivative financial instruments in any of the foregoing commodities
• Certain hedges with respect to any such commodities

Investing and Investment Management
Proposed Reg. §1.199A-5(b)(2)(xi). Performance of services that consist of investing and investment management means a trade or business that earns fees for investment, asset management services or investment management services, including providing advice with respect to buying and selling investments. The performance of services that consist of investing and investment management would include a trade or business that receives a commission, a flat fee or a fee calculated as a percentage of assets under management.

The performance of services of investing and investment management does not include directly managing real property.

Trading
Proposed Reg. §1.199A-5(b)(2)(xii). Performance of services that consist of trading means a trade or business of trading in securities, commodities or partnership interests. Whether a person is a trader is determined by taking into account the relevant facts and circumstances. Factors that have been considered relevant to determining whether a person is a trader include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer’s own account [see King v. Commissioner, 89 T.C. 445 (1987)].

Dealing in Securities, Partnership Interests and Commodities
Proposed Reg. §1.199A-5(b)(2)(xiii). Performance of services that consist of dealing in securities [as defined in §475(c)(2)] means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Loan originators who make negligible sales of the loans are not dealing in securities for purposes of §199A(d)(2).

The performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume,
offset, assign or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

The performance of services that consist of dealing in commodities as defined in §475(e)(2) means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business.

Non-Abuse Measures

Proposed Reg. §1.199A-5(c)(2). SSTB includes any trade or business with 50% or more common ownership (directly or indirectly) that provides 80% or more of its property or services to an SSTB. If a trade or business has 50% or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB).

Example: A dentist owns a dental practice and an office building. She rents half the building to the dental practice and half the building to unrelated persons. Under Proposed Reg. §1.199A-5(c)(2), the renting of half of the building to the dental practice will be treated as an SSTB.

General Rules

To claim the deduction under §199A, a trade or business must be a “qualified trade or business,” which includes all trades or businesses except a specified service trade or business and the trade or business of performing services as an employee.

If you own a business, you really don’t want it to be deemed an SSTB. But if it is, all is not lost as you’ll see from the general rules and subsequent exceptions to those rules.

Unless an exception applies, if a trade or business is an SSTB, there is no qualified business income (QBI) for deduction purposes.

If a pass-through entity (partnership or S corporation) provides an SSTB, none of the income from that trade or business flowing to the owner of the entity is QBI regardless of whether you participate in the activity or you are a passive investor. None of the W-2 wages or UBIA of qualified property will be considered for purposes of §199A either. Example: Athletics is defined as an SSTB. If a partnership owns a professional sports team, the partners’ distributive shares of income from the partnership’s athletics trade or business is not QBI, regardless of whether the partners participate in the partnership’s trade or business, unless the partner’s income on his personal income tax form is below the defined SSTB threshold of $315,000 when filing status is MFJ ($157,500 for all others).

Exceptions to the General Rules

• Individuals with taxable income below the threshold amount ($315,000 MFJ and $157,500 for all others) are not subject to a restriction with respect to an SSTB.
• If an individual or trust has taxable income below the threshold amount, the individual or trust is eligible to receive the deduction under §199A even if a trade or business is an SSTB.
• The exclusion of QBI, W-2 wages and UBIA of qualified property from the computation of the $199A deduction is subject to a phase-in for individuals with taxable income within the phase-in range. The application of this phase-in is determined at the individual, trust or estate level, which may not be where the trade or business operates.
• If a partnership or an S corporation operates an SSTB, the application of the threshold does not depend on the partnership or S corporation’s taxable income but rather the taxable income of the individual partner or shareholder claiming the §199A deduction.
• A relevant pass-through entity (RPE) conducting an SSTB may not know whether the taxable income of any of its equity owners is below the threshold amount of $315,000 when filing status is MFJ ($157,500 for all others). However, the RPE is best positioned to make the determination as to whether its trade or business is an SSTB. Reporting rules under Proposed Reg. §1.199A-6(b) (3)(B) require each RPE to determine whether it conducts an SSTB and disclose that information to its partners, shareholders or owners.
• With respect to each trade or business, once it is determined that a trade or business is an SSTB, it remains an SSTB and cannot be aggregated with other trades or business.
• In the case of a trade or business conducted by an individual, such as a sole proprietorship, disregarded entity or grantor trust, the determination of whether the business is an SSTB is made by the individual.

• There is a de minimis rule under which a trade or business is not an SSTB merely because it provides ‘some’ specified service activity. Proposed Reg. §1.199A-5(c)(1) provides that a trade or business (determined before the application of the aggregation rules in Proposed Reg. §1.199A-4) is not an SSTB if (1) the trade or business has gross receipts of $25 million or less (in a taxable year) and (2) less than 10% of the gross receipts of the trade or business is attributable to the performance of services in an SSTB. For trades or business with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

Salient Points
Following are a few points worth noting about SSTBs listed in §199A(d)(2)(A) as it relates to §§448 and 1202:

• Section 1202(e)(3)(A) also includes “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.”

• Section 199A(d)(2)(A) modifies this clause by adding the words “or owners” to the end, to read as follows: “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.”

• Case law under §448 provides that whether a service is performed in a qualifying field under §448(d)(2) is decided by examining all relevant legislative intent and is not controlled by state licensing laws. States often vary in what they require in terms of licensure or certification. Federal tax law should not treat similarly situated taxpayers differently based on one particular state’s decision that a particular business type requires a license or certification.

• Proposed Reg. §1.199A-5(b) does not adopt a bright-line licensing rule for purposes of determining whether a trade or business is within a certain field for purposes of §199A. This creates peril and consternation for taxpayers. It also creates opportunity for tax professionals.

About the Author
John R. Dundon II, EA is president of Taxpayer Advocacy Services, Inc., which was founded in 2004 and is located in Denver, Colorado. His team of employees provide full service bookkeeping, accounting, tax preparation and taxpayer representation services for U.S. taxpayers worldwide. John has developed a prowess serving nonprofits, trusts and business owners of all sizes. He can be contacted directly at www.JohnRDundon.com.
A rite of passage when reaching age 65 for most Americans is to sign up for Medicare. In fact, there are penalties if you delay signing up for too long past your sixty-fifth birthday if you are not actively covered by another health plan. Tax preparers probably don’t realize it, but the tax returns they prepare for their senior clients may impact how much their clients pay annually for some of their Medicare benefits, possibly increasing their annual premiums by as much as an additional $3,600 a year! This may only apply to perhaps 5-15% of your clients who are collecting Medicare. So, while it will only be for a handful, those it does affect will be grateful if you can help them as an informed tax professional who is looking out for their best interests. As discussed later, Medicare premiums are subject to a surcharge for higher-income taxpayers. Social Security calls this income-based surcharge Income Related Monthly Adjustment Amount (IRMAA). These adjustment amounts are determined based on information reported on the tax return.
As tax professionals, we've all noticed the Medicare insurance charges on the annual 1099-SSA forms that we referred to as we prepared our clients’ returns. You might even have noticed that sometimes the amount is different for different clients. As of 2018, the annual charge for Medicare Part B is $134.00 per month. Additionally, there is a charge for prescription drug coverage, known as Medicare Part D. This charge varies depending on the plan selected. Both these monthly charges can be subject to a surcharge (adjustment) for taxpayers with higher income.

Let’s start with some basics. The annual income figure that Social Security uses comes directly from the individual’s tax return and is called Modified Adjusted Gross Income (MAGI), which is simply regular adjusted gross income from the corresponding line on the tax return plus tax-exempt income. As previously stated, up to 95% of your clients will not be affected by any of this. Table 1 below shows that most retirees will be excluded from any impact on their Medicare premiums.

But what about the other 5%? There is a range of income brackets and surcharges. And, most notably, there are no phase-outs. These income limits are “hard” limits, which means that even if a taxpayer is one penny over a threshold, a monthly additional premium surcharge goes into effect. This can be especially impactful for those taxpayers who file as married filing separately (MFS). For example, our office had a retired married couple with a fairly large amount of income where filing MFS seemed to make sense for them. This was due to the favorable way the state of Rhode Island taxed Social Security and retirement income on an MFS basis. (There are other states where married couples would want to also file separately primarily for state tax purposes.) We did the analysis and, while it cost the clients a little more in taxes to file separately federally, it saved them a lot of money to file separately at the state level. However, we need to factor in what it might do to their Medicare costs (see Table 2 below).

In our example, one member of this married couple did have MAGI over $85,000, thus a hidden cost of filing separately was that, all things being equal, his Medicare premiums were going to jump by nearly $3,600 a year. This pretty much offset the state tax advantage that we were seeking in Rhode Island. Honestly, this was something we had not considered.

For couples not filing separately, the adjustments are more gradual. Note that they are still based on an extra dollar of income pushing a client into a higher MAGI bracket (see Table 3 on page 19).

The numbers in Table 3 are monthly adjustments. So, for example, an individual filing a tax return with a

<p>| TABLE 1 |</p>
<table>
<thead>
<tr>
<th>Modified Adjusted Gross Income (MAGI)</th>
<th>Part B monthly premium amount</th>
<th>Prescription drug coverage monthly premium amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals with a MAGI of $85,000 or less</td>
<td>2018 standard premium = $134 per month</td>
<td>Your plan premium</td>
</tr>
<tr>
<td>Married couples with a MAGI of $170,000 or less</td>
<td>2018 standard premium = $134 per month</td>
<td>Your plan premium</td>
</tr>
</tbody>
</table>

<p>| TABLE 2 |</p>
<table>
<thead>
<tr>
<th>Modified Adjusted Gross Income (MAGI)</th>
<th>Part B monthly premium amount</th>
<th>Prescription drug coverage monthly premium amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals filing MFS with a MAGI of $85,000 or less</td>
<td>2018 standard premium = $134 per month</td>
<td>Your plan premium</td>
</tr>
<tr>
<td>Individuals filing MFS with a MAGI over $85,000</td>
<td>2018 standard premium + $294.60 per month</td>
<td>Your plan premium + $74.80 per month</td>
</tr>
</tbody>
</table>
MAGI of $90,000 (or a married couple with a return showing $180,000) is going to pay an additional monthly premium of $53.90 in their Medicare Part B insurance and $13 in their prescription drug coverage (Part D) if they have it. In the case of a married couple with both of them on Medicare, they each pay the additional $53.90 per month.

**So, what's a tax professional to do?**
The first thing you could do is watch these threshold points when preparing taxes. Later in the article, there are practical tips on how to implement this in your practice. Remember AGI can typically be lowered by a small amount of dollars in a given year and is worth the effort if the resulting impact is significant. If a taxpayer is still working, they might be able to contribute to a SEP-IRA or an IRA. Other possibilities include going back and doing a better job with their self-employment deductions, considering if possibly there is a worthless security or a bad debt that could be written off, etc. There are certainly other possibilities.

**The timing of the IRMAA determination**
Next, it’s important to understand how the timing of the tax filing works in relation to Social Security’s determination of the IRMAA. Social Security is typically looking at data that is two years old. For example, let’s say it’s coming up on January 2019, and Social Security will be sending a letter in December 2018 or January 2019 explaining that a recipient’s monthly Medicare Part B premium will change for the 2019 calendar year. Obviously, in December 2018 or January 2019, Social Security will not have access to the 2018 tax figures, so it will use the 2017 tax return information that was filed the year prior.

Social Security always bases its information on lagging two-year-old information. In our office, we did an analysis of our 2017 clients and found two clients whose income was within $1,000 above the MAGI threshold. We carefully considered if it was possible to file an amended return for 2017 to reduce their income to within the next lower MAGI limit. We elected not to, but filing an amended return would have saved them from an increased Medicare premium for 2019.

Also, if for some reason your client is late filing 2017 taxes, and Social Security uses 2016 data to make an unfavorable IRMAA determination against your client for the 2019 Medicare year, your client can always go back and file a 2017 return, belatedly, and request that Social Security use the 2017 information—once again, assuming that the 2017 rate makes a positive outcome for the client.4

**TABLE 3**

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>MAGI Range</th>
<th>Part B IRMAA</th>
<th>Part D IRMAA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single, Head of Household, or Qualifying Widow(er)</td>
<td>$0–$85,000</td>
<td>No additional</td>
<td>No additional</td>
</tr>
<tr>
<td></td>
<td>$85,001–$107,000</td>
<td>$53.50</td>
<td>$13.00</td>
</tr>
<tr>
<td></td>
<td>$107,001–$133,500</td>
<td>$133.90</td>
<td>$33.60</td>
</tr>
<tr>
<td></td>
<td>$133,501–$160,000</td>
<td>$214.30</td>
<td>$54.20</td>
</tr>
<tr>
<td>MFS (and lived apart)</td>
<td>$0–$85,000</td>
<td>No additional</td>
<td>No additional</td>
</tr>
<tr>
<td></td>
<td>$85,001 and above</td>
<td>$294.60</td>
<td>$74.80</td>
</tr>
<tr>
<td>Married Filing Joint</td>
<td>$0–$170,000</td>
<td>No additional</td>
<td>No additional</td>
</tr>
<tr>
<td></td>
<td>$170,001–$214,000</td>
<td>$53.50</td>
<td>$13.00</td>
</tr>
<tr>
<td></td>
<td>$214,001–$267,000</td>
<td>$133.90</td>
<td>$33.60</td>
</tr>
<tr>
<td></td>
<td>$267,001–$320,000</td>
<td>$214.30</td>
<td>$54.20</td>
</tr>
<tr>
<td></td>
<td>$320,001 and above</td>
<td>$294.60</td>
<td>$74.80</td>
</tr>
</tbody>
</table>
So far, we’ve considered the direct-tax aspects of the IRMAA calculation. The first step is simply watching the AGI thresholds as you prepare returns for clients who are 65 and older. You might consider this a daunting task, but, at the end of this article, I describe a manageable way to introduce this procedure into your practice. There’s also a way to introduce a new variable when filing for a married couple over 65 separately—the impact on their Medicare premiums. Alternatively, filing an amended return, if applicable, is another way of managing IRMAA when it comes into play. A taxpayer can “amend” themselves into a lower MAGI bracket and SSA will accept an amended return as prima facie proof of the lower MAGI. Of course, this approach needs to make legitimate sense, but no doubt it will for some.

The life-changing event exception

Now we come to a more pragmatic rule that Social Security has. It’s an equitable and fair rule, yet, at times it can be an inflexible rule. First off, Social Security does not have a general equitable relief exception to these rules. If you start discussing these IRMAA rules with your clients, you’ll undoubtedly run into situations where the income is abnormally high in one year only to drop back a year later. This can happen if a client wins the lottery or sells stock. So, you shouldn’t get anyone’s hopes up.

Example: Your clients sold their vacation home and had a one-time temporary gain in income in 2017. Furthermore, the proceeds from the sale were used to pay significant medical expenses for one of the spouses. Don’t waste time arguing for a reduction in IRMAA or that the increase in MAGI is temporary. This is not one of the accepted reasons, and your clients will not be granted relief.

Social Security has a limited number of acceptable reasons that justify a subsequent decrease in MAGI. For example, if we are looking at 2019 Medicare rates, Social Security is making use of 2017 tax information, and the client had a life-changing event (LCE) in 2017, this would allow the client to then substitute 2018 or even 2019 income information (which would have to be estimated) for the 2017 MAGI Social Security is using. Just because your clients incur an LCE, they aren’t entitled to a reduction in their premiums if their MAGI doesn’t change and remains high. If eventually (in the next year or two) MAGI declines, they can claim a reduced premium based on the revised MAGI. If your client forecasts a MAGI that proves to be too low, Social Security will come back and retroactively assess the missed premiums.

The life-changing events that Social Security will accept (for either spouse) are:
- Marriage, divorce or death of a spouse
- Work stoppage or reduction in hours
- Loss of income-producing property because of a disaster or event beyond the client’s control
- Reduction or loss of pension income
- Receipt of settlement from employer’s closure, bankruptcy or reorganization

When viewing this list, the most typical events that might affect a senior citizen are the death of a spouse, other change in marital circumstances, and work stoppage or reductions in hours, otherwise known as retirement. Note that gains from sales of property are explicitly not included unless they are accompanied by one of the other events. Also note that the events above don’t directly have to relate to the change in income, but the client’s income must have gone down in the subsequent year.

Example: A 68-year-old widower with MAGI of $100,000 marries his high school sweetheart and together their MAGI in 2017 is $190,000 because they withdrew money to go on their honeymoon. In 2018, their joint MAGI is $145,000. The marriage is a life-changing event. The marriage itself really didn’t trigger any financial abnormality; however, marriage qualifies as a life-changing event, which allows Social Security to base their 2019 Medicare premium on the 2018 MAGI of $145,000 as opposed to their 2017 MAGI of $190,000. The couple, therefore, qualifies for reduced premiums.

Taxpayers report any life-changing events to the Social Security Administration using Form SSA-44, Medicare Income Related Monthly Adjustment Amount—Life-Changing Event. We included two of the eight pages at the end of this article to show you the five-step process (see pages 22–23).

Appealing Social Security decisions vs. requesting new initial determinations

The formal appeals process is beyond the scope of this article. In fact, Social Security explains that taxpayers need not appeal their IRMAA determinations, as there are strict deadlines for appeals. Rather, they recommend requesting a new initial determination.
as opposed to an appeal. To request a new initial determination, use Form SSA-44. This form includes the various proofs for which Social Security is looking. Note that it will be looking for proof of the LCE as well as proof of income (or an estimate) in a subsequent year. A client could simply initiate the process by calling 800-772-1213. A client can both request a new initial determination and file an appeal.

Implementing a MAGI-watch inside your practice

It's not easy adding another review step to the process of preparing tax returns during tax season. However, implementing a process that would identify any client, aged 65 or older, whose AGI is between $85,000 and $160,000 (double these numbers if filing jointly) is worth it. It would only involve carefully scrutinizing returns where the AGI is slightly above the MAGI thresholds. Remember, these clients will be getting a notice in a year or two (see page 24 for a sample of what one page from this letter might look like).

We took this one step further in our practice, which simplified the process. Realizing that the income of senior citizens typically doesn’t vary significantly from year to year, of our 100 clients who are 65 or older, we have identified 15 who are in the MAGI zone. Remember, these clients will be getting a notice in a year or two (see page 24 for a sample of what one page from this letter might look like).

When we prepare returns for any of these 15 clients, we simply make a quick mental note if they are close to a MAGI threshold and bring it to their attention if they can still act to reduce their AGI for the preceding tax year. Or, they may possibly want to manage down their AGI for the current tax year. Focusing on these 15 clients is easy. Remember, most of the time, they won’t even be close to a threshold, and it becomes a non-issue. It doesn’t require a lot of effort, and knowing we are doing the best for our clients feels great!

If you want to do more general research on the topic of Medicare Income Related Monthly Adjustment Amounts, you’ll find an entire online reference manual on the many facets of the topic at https://secure.ssa.gov/apps10/poms.nsf/lnx/0601100000.

End Notes

1. Social Security publication, “Medicare Premiums: Rules for Higher-Income Beneficiaries,” Pub No. 05-10536, available at www.ssa.gov, page 1, “This affects less than five percent of the people with Medicare, so most people don’t pay a higher premium.”
2. Ibid, page. 5.
3. As an exception to this rule, note that if your married clients live apart the entire year and file as MFS, they are treated as single for these purposes. But it is also pretty clear that this will require some sort of redetermination to get straightened out by Social Security, which will initially misclassify it. Social Security Program Operations Manual System (POMS), HI 01120.060 Married, Filing Separately – Lived Apart All Year https://secure.ssa.gov/apps10/poms.nsf/lnx/0601120060.
8. Appeals can be filed online www.socialsecurity.gov/disability/appeal or in writing by completing a Request for Reconsideration (Form SSA-561-U2).

About the Author

Charles R. Markham, MST, EA, USTCP has been solving his clients’ tax problems for nearly 28 years. He can be reached via his website at www.markhamandcompany.com.
**STEP 1: Type of Life-Changing Event**
Check **ONE** life-changing event and fill in the date that the event occurred (mm/dd/yyyy). If you had more than one life-changing event, please call Social Security at 1-800-772-1213 (TTY 1-800-325-0778).

- Marriage
- Divorce/Annulment
- Death of Your Spouse
- Work Stoppage
- Work Reduction
- Loss of Income-Producing Property
- Loss of Pension Income
- Employer Settlement Payment

Date of life-changing event: ________________

**STEP 2: Reduction in Income**
Fill in the tax year in which your income was reduced by the life-changing event (see instructions on page 6), the amount of your adjusted gross income (AGI, as used on line 37 of IRS form 1040) and tax-exempt interest income (as used on line 8b of IRS form 1040), and your tax filing status.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Adjusted Gross Income</th>
<th>Tax-Exempt Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>20____</td>
<td>_________<strong><strong>·</strong></strong></td>
<td>_________<strong><strong>·</strong></strong></td>
</tr>
</tbody>
</table>

Tax Filing Status for this Tax Year (choose **ONE**):
- Single
- Head of Household
- Married, Filing Jointly
- Married, Filing Separately

**STEP 3: Modified Adjusted Gross Income**
Will your modified adjusted gross income be lower next year than the year in Step 2?
- No - Skip to STEP 4
- Yes - Complete the blocks below for next year

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Estimated Adjusted Gross Income</th>
<th>Estimated Tax-Exempt Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>20____</td>
<td>_________<strong><strong>·</strong></strong></td>
<td>_________<strong><strong>·</strong></strong></td>
</tr>
</tbody>
</table>

Expected Tax Filing Status for this Tax Year (choose **ONE**):
- Single
- Head of Household
- Married, Filing Jointly
- Married, Filing Separately

- Qualifying Widow(er) with Dependent Child
Form SSA-44 (12-2017)  

STEP 4: Documentation  
Provide evidence of your modified adjusted gross income (MAGI) and your life-changing event. You can either:  

1. Attach the required evidence and we will mail your original documents or certified copies back to you;  

OR  

2. Show your original documents or certified copies of evidence of your life-changing event and modified adjusted gross income to an SSA employee.  

Note: You must sign in Step 5 and attach all required evidence. Make sure that you provide your current address and a phone number so that we can contact you if we have any questions about your request.  

STEP 5: Signature  

PLEASE READ THE FOLLOWING INFORMATION CAREFULLY BEFORE SIGNING THIS FORM.  

I understand that the Social Security Administration (SSA) will check my statements with records from the Internal Revenue Service to make sure the determination is correct.  

I declare under penalty of perjury that I have examined the information on this form and it is true and correct to the best of my knowledge.  

I understand that signing this form does not constitute a request for SSA to use more recent tax year information unless it is accompanied by:  

• Evidence that I have had the life-changing event indicated on this form;  
• A copy of my Federal tax return; or  
• Other evidence of the more recent tax year’s modified adjusted gross income.  

<table>
<thead>
<tr>
<th>Signature</th>
<th>Phone Number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mailing Address</th>
<th>Apartment Number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>City</th>
<th>State</th>
<th>ZIP Code</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Each year, to decide if you must pay IRMAAs, we use your Federal income tax information for the most recent tax year that is available. However, we do not use any information that is more than three years old. We ask the Internal Revenue Service (IRS) for your tax filing status, your adjusted gross income, and your tax-exempt interest income. We then add your adjusted gross income together with your tax-exempt interest income to get an amount that we call modified adjusted gross income (MAGI). We compare your MAGI with the income thresholds set by Medicare law.

MAGI may include one-time-only income such as capital gains, the sale of property, withdrawals from an Individual Retirement Account (IRA) or conversion from a traditional IRA to a Roth IRA. One-time income will affect your Medicare premium for only one year.

**How We Figured Your IRMAAs**
The IRS told us that for tax year 2016, you filed your taxes as married, filing jointly. You had an adjusted gross income of $173,183.00 plus $0.00 in tax-exempt interest income. We added these amounts together to get your MAGI of $173,183.00.

We used the following table to decide IRMAAs for the Medicare Part B and Part D premiums:

<table>
<thead>
<tr>
<th>If you filed as:</th>
<th>With MAGI of:</th>
<th>Part B IRMAA is:</th>
<th>Part D IRMAA is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single, Head of Household or Qualifying Widow(er)</td>
<td>$85,001–$107,000</td>
<td>$53.50</td>
<td>$13.00</td>
</tr>
<tr>
<td></td>
<td>$107,001–$133,500</td>
<td>$133.90</td>
<td>$33.60</td>
</tr>
<tr>
<td></td>
<td>$133,501–$160,000</td>
<td>$214.30</td>
<td>$54.20</td>
</tr>
<tr>
<td></td>
<td>More than 160,000</td>
<td>$294.60</td>
<td>$74.80</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>$170,001–$214,000</td>
<td>$53.50</td>
<td>$13.00</td>
</tr>
<tr>
<td></td>
<td>$214,001–$267,000</td>
<td>$133.90</td>
<td>$33.60</td>
</tr>
<tr>
<td></td>
<td>$267,001–$320,000</td>
<td>$214.30</td>
<td>$54.20</td>
</tr>
<tr>
<td></td>
<td>More than $320,001</td>
<td>$294.60</td>
<td>$74.80</td>
</tr>
<tr>
<td>Married, filing separately (if you lived apart throughout 2016, see below about some special situations)</td>
<td>More than $85,000</td>
<td>$294.60</td>
<td>$74.80</td>
</tr>
</tbody>
</table>

These IRMAAs are effective for 2018 only. Next year, when we receive updated information from the IRS, we will make a new decision about any IRMAAs owed.
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In international taxation, there are two different tax systems. The first one is the worldwide tax system where the foreign-source income is taxed in its own home country. However, the tax paid to the host country can be claimed as a tax credit against the tax in its home country to the extent of the tax attributable to the foreign-source income. The second one is the territorial tax system where the foreign-source income is not taxed in its own home country. Instead, it’s taxed only in the host country. From the government’s point of view, the former has a greater tax base than the latter. On the contrary, from a multinational corporation’s viewpoint, the latter results in less tax liability, if the tax rate in the host country is lower than that of the home country.
Historically, only a handful of industrialized countries in the world adopted the worldwide tax system, such as the U.S. (pre-TCJA), China, Mexico, South Korea, Ireland, etc., while the rest employ the territorial tax system, such as France, the U.K., Japan, Australia, Germany, Canada, Italy, Luxembourg, the Netherlands, etc.

**Consequences of the worldwide tax system**

If income is maneuverable between two countries, the difference between these tax systems shall create a tax loophole. A multinational corporation will undoubtedly take advantage of it. The best strategy is to simply move a company’s tax home from a high-tax country to a lower-tax country. This is known as corporate inversion. In fact, a total of 76 U.S. multinational corporations have done so in the past decade.

Take Medtronic as an example. In 2015, it merged with Convidient and moved its tax home to Ireland. From here, Medtronic’s income from all the world, other than that of the U.S., is no longer subject to the U.S. tax jurisdiction. The tax savings between the U.S. and Ireland at that time before TCJA were as much as 22.5% (35% – 12.5%). The merger has seriously eroded the U.S. tax base. There are many other consequences, such as misallocation of economic resources, unfair competition among multinational corporations, etc. Basically, this is caused by income shifting, and clearly indicates that the worldwide tax system in the past has resulted in tremendous losses to the U.S. Treasury. There definitely was an urgent need to change it. It indeed has changed under TCJA.

**Tax under the territorial tax system**

The purpose of a territorial tax system is to make U.S. multinational corporations more competitive in the international marketplace.

IRC §245A(a) provides that “in the case of any dividend received from a specified 10% owned foreign corporation by a domestic corporation which is a United States shareholder with respect to such foreign corporation shall be allowed as a deduction an amount equal to the foreign source portion of such dividend.” This means that the cash dividends received from foreign-source income shall be granted a 100% dividend-received deduction (tax free). This tax rule carries many implications.

**Dividend-received deduction (DRD).** It is true that, if an individual shareholder owns a C corporation, the corporate income may be subject to double taxation when a cash dividend is distributed. However, when a parent company owns another domestic company, double taxation should not occur. In other words, double taxation happens only between a company and an individual shareholder, but not between two companies. DRD is intended to alleviate the unfairness of double taxation between two companies.

Under TCJA, if the parent owns at least 80% of a domestic subsidiary company, the DRD is 100%. If the ownership is below 80% but at least 20%, the DRD is 65%. If the ownership is below 20%, the DRD is 50%. Again, this is the tax rule for a domestic subsidiary company, not for a foreign subsidiary company.

Now, new §245A(a) stipulates that if the U.S. parent corporation owns at least 10% of a controlled foreign corporation (CFC), the DRD is a flat 100% of the cash dividend received, regardless of the size of the ownership. It should be noted that this rule applies to only a CFC, not a domestic corporation. In that sense, TCJA is in favor of a CFC over a domestic counterpart. Nor does it apply to an individual shareholder. It implies that it is indeed more beneficial to operate a business abroad than domestically, and in the form of a corporation rather than an individual.

**Current earnings and profits (E&P).** The above tax rule applies to the current year’s E&P that are distributed as cash dividends, not to the E&P that are not distributed. Are the current year’s undistributed
E&P also tax-free under the territorial tax system? According to the above tax rule, the answer is negative, because the above tax rule grants 100% DRD specifically only to the current year’s E&P that are distributed as cash dividends.

This tax rule is purposefully intended to encourage a CFC to distribute cash dividends back to the U.S. If the current year’s E&P are not distributed, no tax benefit should be given, even if the tax policy has switched to the territorial tax system. In this sense, it is more appropriate to call this new tax policy a modified territorial tax system. If so, did the U.S. actually change from the worldwide tax system to the territorial tax system? It’s ambivalent.

If the current year’s E&P will never be distributed, what will happen to it eventually? At the time of dissolution of this CFC, the amount of E&P shall become capital gain on the disposition of an investment. Unfortunately, as such it will be taxed as ordinary income at 21%, rather than as dividends, which enjoy 100% DRD. This tax rule further implies that TCJA encourages a CFC to distribute cash dividends as much as possible, not waiting until the time of disposition of the investment. A taxpayer should seriously take this aspect into account when dealing with a CFC. It becomes important when implementing a tax planning strategy.

**Tax on undistributed earnings and profits.** The new tax law took effect after December 31, 2017. The current E&P hereafter are taxed under the territorial tax system. It is tax free. It should be noted that the previous years’ E&P before this date were still taxed under the old worldwide tax system. Did TCJA also change the tax rate? Surprisingly, the answer is yes.

**Tax Rate.** IRC §965(c)(1) and (2) describes the computational details as to what assets should be taxed at what rate. It states that the previous years’ undistributed E&P held in the form of cash position are taxed at a rate of 15.5%. “Cash position” means cash, stock, bonds, marketable securities, notes, etc. The remaining assets held in the non-cash position are taxed at a rate of 8%. “Non-cash position” means inventory, equipment, machinery, factory, land, etc.

Clearly, the cash position and the non-cash position are taxed at two different rates: 15.5% for the former versus 8% for the latter. Evidently, there is a tax loophole. The latter yields more tax savings than the former by as much as 7.5% (15.5%–8%). This means it is more beneficial to hold the previous years’ E&P in non-cash position than that of the cash position. Can a taxpayer move assets from a cash position to a non-cash position? Unfortunately, the cash position is determined at the greater of the cash position on average for the last two years or on January 1, 2018. Unless a taxpayer could have foreseen the enactment of TCJA, there was little chance that the taxpayer could have maneuvered the cash position. Nevertheless, a taxpayer must be aware of the existence of this tax loophole.
So, are the previous years’ E&P still taxed under the old worldwide tax system? The answer is yes, but the tax rate has been substantially reduced from a maximum 35% to 15.5% or 8%. Unfortunately, the tax liability is now due and payable under TCJA, rather than deferred under the old worldwide tax system. The purpose of this tax rate reduction is to compensate for the loss of timing of the tax payment. It encourages a taxpayer to participate in this tax reduction program. This is considered a participation exemption, and a taxpayer should seriously consider the trade-off of this tax incentive program. 

**Installment payment.** Is the tax liability on the previous E&P due and payable immediately? The answer is negative. There is another tax incentive program. IRC §965(h)(1) provides that, “in the case of a United States shareholder of a deferred foreign income corporation, such United States shareholder may elect to pay the net tax liability under this section in eight installments of the following amounts: 
- 8% of the net tax liability in the case of each of the first five such installments,
- 15% of the net tax liability in the case of the sixth such installment,
- 20% of the net tax liability in the case of the seventh such installment, and
- 25% of the net tax liability in the case of the eighth such installment.”

This means that the tax liability on the previous years’ E&P is due but not immediately payable. Instead, it can be deferred in the next eight years on installment payments. The tax rule under TCJA has become too complicated, but it can be summarized in Exhibit 1 on page 31. This table shows how the current and previous E&P are taxed. The following example demonstrates a case.

**Example: Tax on undistributed earnings and profits.** In 2017, Ed Corporation earned $100,000 in E&P from a CFC in the form of cash and received $60,000 in cash dividends. Ed was under the worldwide tax system at a maximum tax rate of 35%. In 2018, Ed earned an additional $200,000 in E&P and received $120,000 in cash dividends. Ed is under the territorial tax system at a maximum tax rate of 21%. What is Ed’s tax liability due and payable in 2017 and in 2018, respectively, under the new tax law?

In 2017, the $60,000 cash dividend is taxed at 35%, but the remaining $40,000 ($100,000 - $60,000) in E&P is not taxable. So, the tax liability due and payable in 2017 is $21,000 ($60,000 x 35%). In 2018, the remaining $40,000 of E&P is still not distributed as cash dividends, but its tax liability is due and payable in the amount of $496 (40,000 x 15.5% x 8%).

This example explains the aspect that the $40,000 undistributed E&P from 2017 is taxable and due in 2018, even though it was earned under the worldwide tax system. This is the special feature of TCJA. A taxpayer may be surprised to realize it.

**Imposing base erosion and anti-abuse tax**

The new tax law imposes a brand-new tax regime called base erosion and anti-abuse tax (BEAT). It has its own tax base, tax rate and tax rules that are different from any other tax regime. It is a part of Form 6251, Alternative Minimum Tax. 

**Income-shifting strategy.** A U.S. multinational corporation has many advantages over a domestic counterpart in many ways. The vehicle to carry out this advantage is a CFC. If the U.S. tax rate is higher than that of a foreign country, it is beneficial to move the U.S. income to a lower-tax foreign country. Likewise, it’s also valuable to move a foreign expense to the U.S., because it generates greater tax savings. Both directions of the traffic yield the same benefit. This is a tax loophole of an international transaction. The U.S. multinational corporations always take advantage of it. In the last decade, this practice has become so abusive that it has contributed to the erosion of the U.S. tax base and misallocation of economic resources resulting in unfair competition among multinational corporations.

For example, in 2014, Burger King merged with Tim Hortons in Canada and moved its tax home from the U.S. to Canada. Thereafter, Burger King’s income from Canada is no longer subject to the U.S. tax jurisdiction. In 2015, Medtronic merged with Covidien in Ireland and moved its tax home to Ireland. All income in the world other than the U.S. is no longer subject to U.S. taxation. The purpose is the same. Both cases attempt to shift U.S. taxable income abroad to avoid the higher tax in the U.S.
Then there is SAP, the biggest industrial software development company in Germany. It set up a subsidiary company in the U.S. to sell its software. But, the U.S. subsidiary company must pay a huge amount of royalties to SAP. The royalty fee is deductible in the U.S. The purpose is to shift foreign expenses to the U.S. to yield greater tax savings for SAP.

The above examples illustrate various tax loopholes U.S. multinational corporations are using. They result in income shifting from the U.S. to foreign countries. This is one of the reasons TCJA came into being. Now, a new tax regime has been enacted.

**BEAT.** The base erosion and anti-abuse tax is intended to penalize companies that are engaged in income-shifting strategies, but not regular business transactions. The most commonly abused intercompany transactions for income-shifting purposes are royalty fees for trade names and patents, interest expenses for intercompany loans, management fees for intercompany consulting services, depreciation and amortization for properties purchased from a subsidiary company, etc.

The parent and the subsidiary company are referred to as related parties. These intercompany payments are called base erosion payments. The BEAT is basically targeting this amount. It doesn’t come from the ordinary cost of goods sold, wage expenses, rent expenses, travel expenses, etc., and it’s imposed only on a large company with at least $500 million in gross receipts a year on average for the last three years. The BEAT rate is 10%.

**Base erosion and anti-abuse tax formula.** How is the BEAT computed? It’s quite complicated and involves many new terms. Basically, it’s described in §59A. It starts with the regular taxable income that leads to the regular tax liability at a flat rate of 21% under TCJA. Next, it determines the base erosion payment, as pointed out above, such as royalties. The modified taxable income is the sum of the regular taxable income and the base erosion payment. The modified tax liability is modified taxable income times a statutory base erosion and anti–abuse tax rate of 10% (5% in 2018) minus allowed tax credit, such as foreign tax credit. The base erosion and anti–abuse tax is equal to modified tax liability minus the regular tax liability, if any. The final total tax liability is equal to the sum of the regular tax liability and the base erosion and anti–abuse tax.

As a result, the BEAT is an added-on tax on the top of the regular tax liability, which can only be increased, but not decreased.

**Example:** American Corporation is a U.S. registered company. Foreign Corporation is American’s 100%-owned CFC. In the current year, Foreign has $900,000 in sales revenue and $400,000 in cost of goods sold. However, American rents a patent from Foreign paying $300,000 in royalties. Foreign can claim $6,000 in foreign tax credit for the tax paid to its host foreign government. Following are the numbers used to calculate American’s final tax liability:

- American’s regular taxable income is $200,000 ($900,000 - $400,000 - $300,000).
- It’s regular tax liability is $42,000 ($200,000 x 21%).
- It’s base erosion payment is $300,000.
- It’s modified taxable income is $500,000 ($200,000 + $300,000).

<table>
<thead>
<tr>
<th>Exhibit 1: Tax Rate on Current and Previous Undistributed E&amp;P</th>
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<tbody>
<tr>
<td><strong>Current E&amp;P</strong></td>
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<tr>
<td>Dividend distributed</td>
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<tr>
<td>Undistributed</td>
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<td><strong>Previous Undistributed E&amp;P</strong></td>
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<td>Years 1–5</td>
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<td>Year 7</td>
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<td>Year 8</td>
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• It’s modified tax liability is $44,000 \[\left(\$500,000 \times 10\% \right) - \$6,000\] = \($50,000 - \$6,000\).
• It’s base erosion and anti-abuse tax is $2,000 \($44,000 - \$42,000\).
• American’s final tax liability is $44,000 \($42,000 + \$2,000\).

This example illustrates that the $300,000 in royalty fees is an intercompany transaction employed by American to shift its income from the U.S. to Foreign’s host country. It is now denied a deduction. The tax penalty is the $2,000 of base erosion and anti-abuse tax, which is added back to the $42,000 regular tax liability, resulting in a final tax liability of $44,000.

Taxpayers must be aware of this kind of tax penalty. The change from the worldwide tax system to the territorial tax system certainly brings a benefit to the taxpayer. Nevertheless, the BEAT may neutralize this benefit.

Conclusion
The Tax Cuts and Jobs Act has far-reaching consequences for individuals and corporations, and on domestic and foreign transactions. Nevertheless, tax loopholes created under the new law provide many opportunities for individual and business taxpayers to reduce their tax liabilities.

References
1. Internal Revenue Code §904(b).
5. IRC §245A(a).
7. Ibid §965(c)(1) and (2).
8. Ibid §965(c)(3).
9. Ibid §245A(a).
10. Ibid §965(b)(1).
11. Ibid §59A.
15. IRC §59A(g)(1).
18. Ibid §59A(b)(1).

About the Authors
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Tax-Free Income

Entering the taxable realm

By James A. Fellows, Ph.D., CPA

Taxpayers normally expect tax-free income to remain so in all circumstances. Unfortunately, this rosy scenario isn’t always the case.
Many items that taxpayers call tax-free are only tax-free under certain circumstances. Generally, as the taxpayer’s other income increases, the tax-free income often enters the taxable realm. In working with college students at income tax clinics for lower and middle-income taxpayers, I’ve personally seen incidences of surprise taxation on so-called tax-free income. Usually these surprises are due to large one-time increases in income resulting from retirement distributions, stock sales or gambling winnings.

Normally, it’s Social Security income that enters the world of positive taxation. Many taxpayers have also found that they must repay most or all of their Affordable Care Act health insurance subsidies due to their unexpected income. And, of course, some or all of the earned income tax credit (EITC) may be lost to the unplanned income. These latter two incidences of surprise taxation really are, in effect, a second-tier tax on income already subject to tax.

This article explores some of these situations and cautions tax professionals to be alert for them, especially in providing tax planning advice. Each scenario is based on actual situations I’ve encountered during recent tax seasons. All taxpayer names are fictitious, though the fact-patterns are real. The 2018 tax rules and rates are used in the computations.

Scenario 1
Debt forgiveness causes taxation of Social Security income. Susan, aged 55, files as a single individual. She owns a second residence that has never been used as a personal residence nor held for rental income. As such, it’s classified as a capital asset and any gain or loss on its disposition is taxable. During the year, the bank foreclosed on the residence. Susan’s tax basis in the residence is $40,000, but the mortgage on the property is $60,000, so Susan has a $20,000 capital gain. Her only other income is $24,000 in Social Security benefits.

Susan had owned the residence for more than one year, so the gain is a long-term capital gain. However, the capital gains tax is zero, because Susan’s taxable income, even with the capital gain, still left her in the 12% tax bracket on her ordinary income. Without the $20,000 capital gain, Susan has no tax liability. Social Security is taxable for single taxpayers only if “provisional income” is greater than $25,000. Provisional income is the sum of (1) the taxpayer’s adjusted gross income from items other than Social Security, (2) tax-exempt interest, and (3) one-half of Social Security benefits. If provisional income is less than $25,000, then none of the Social Security benefits are taxable. In Susan’s case, without any capital gain, her provisional income is only $12,000, one-half her Social Security. In this case, none of her Social Security is taxable and she has no tax liability.

But what happens when the $20,000 capital gain is added? Her provisional income is now $20,000 + $12,000 = $32,000. Because this exceeds $25,000, a percentage of her Social Security is now taxable. Based on an IRS formula, one-half of the $7,000 excess of Susan’s provisional income above $25,000 is taxable. This amount is $3,500. Her adjusted gross income is now $23,500. After subtracting her standard deduction of $12,000, her taxable income is $11,500. Based on 2018 tax rates, her tax liability is $1,190 [(9,525 x .10) + (1,975 x .12)]. Because Susan is in the 10% to 12% bracket for all her income, there is no tax on long-term capital gains. But note that it is the capital gains that caused the Social Security to be taxed, so in effect you could say there is a surprise hidden tax on the capital gains. In our real fact-pattern, we had to explain to the taxpayer, who had never had taxable Social Security, the mechanics of how it came to be in this case.

Scenario 2
Gambling winnings cause taxation of Social Security income. Virtually the same result occurs with Robert, a single taxpayer who “struck it rich” playing the Florida lottery. Robert normally has only Social Security income. However, during the year, he won $10,000 playing the lottery. His only other income is $20,000 in Social Security benefits.

Without the lottery win, Robert has no tax liability, because his Social Security benefits are not taxable. With the lottery win, his provisional income is $30,000. Because this exceeds $25,000, a percentage of his Social Security is now taxable. Based on an IRS formula, one-half of the $5,000 excess of Robert’s provisional income above $25,000 is taxable. This amount is $1,250. His adjusted gross income is now $18,750. After subtracting his standard deduction of $12,000, his taxable income is $6,750. Based on 2018 tax rates, Robert’s tax liability is $675 [(5,000 x .10) + (1,750 x .12)]. Because Robert is in the 10% to 12% bracket for all her income, there is no tax on long-term capital gains. But note that it is the capital gains that caused the Social Security to be taxed, so in effect you could say there is a surprise hidden tax on the capital gains. In our real fact-pattern, we had to explain to the taxpayer, who had never had taxable Social Security, the mechanics of how it came to be in this case.
Security disability income of $10,000 annually. This is all tax-free since it's below the $25,000 threshold for Social Security taxation. However, this year Robert has $40,000 of gambling winnings. His provisional income is $45,000 ($5,000 (half his disability income) plus $40,000 gambling winnings). Because this exceeds $34,000, Robert’s Social Security enters the 85% taxability realm. In fact all $10,000 is affected, causing $8,500 to be taxable. His adjusted gross income is $48,500 and after subtracting his $12,000 standard deduction, his taxable income is $36,500. Based on 2018 tax rates, his tax liability is $4,190 ($9,525 x .10) + ($26,975 x .12)].

Because Robert’s taxable Social Security was added to his already taxable gambling winnings, the effective tax rate on the Social Security was 12%, so he winds up paying $1,020 tax on his disability income ($8,500 x .12). As in the previous case, we had to provide the taxpayer with a lengthy explanation as to why his disability income was suddenly subject to a surprising income tax.

Scenario 3
Tax-exempt interest causes taxation of Social Security income. The most surprising result comes when two normally tax-exempt items combine to create a tax liability. This anomaly occurs if tax-exempt interest pushes Social Security provisional income into the taxable range. Albert and Mildred are both retired and age 70. Their only sources of income are a combined Social Security of $40,000, traditional IRA distributions of $24,000 and tax-exempt bond interest of $6,000. For married couples filing jointly, provisional income must be greater than $32,000 before benefits are taxable. Between $32,000 and $44,000, one-half of Social Security above $32,000 is taxable. Once a taxpayer reaches $44,000 of provisional income, 85% of Social Security becomes taxable.

Without considering the tax-exempt interest, the couple’s provisional income is one-half their Social Security income, $20,000, plus their $24,000 in IRA distributions, for a total of $44,000. At this point, one-half of their Social Security above $32,000 is taxable. This taxable amount is $6,000. But now look what happens when the tax-exempt interest is added to the mix. Provisional income is now $50,000. Because this exceeds the $44,000 threshold by $6,000, 85% of this additional $6,000, or $5,100, is now taxable. The total amount of Social Security that is taxable is now $11,100 ($6,000 + $5,100). 

Technically, it’s an extra $5,100 of Social Security that becomes taxable. But you could argue that it’s the tax-exempt interest that is, in effect, now taxable. Either way, the inclusion of tax-exempt interest in the formula for provisional income causes an otherwise non-taxable amount of income to become taxable to the tune of $5,100. Using 2018 tax rates, Albert and Mildred have adjusted gross income of $35,500, equal to the $24,000 IRA income plus $11,500 of Social Security income. After subtracting their standard deduction of $24,000, plus the $2,600 additional standard deductions for aged taxpayers, their taxable income is $8,900. Their tax liability is $890 ($8,900 x .10). All of this was caused by having Social Security become taxable. And, in a theoretical sense, you could say that, of this amount, $510 was in effect a tax on the tax-exempt interest.

Scenario 4
Gambling winnings eliminate the EITC. Tax professionals know the earned income tax credit (EITC) is a negative tax, a refundable credit based on the taxpayer’s earned income. But this negative tax can be reduced or even eliminated (in effect the same thing as a tax increase) by one-time increases in other income. In this example, Juan and Maria are married with two children. Their only income on their joint return is $35,000 of wages. Using the EITC schedule for 2018, this results in a credit of $3,473. But the EITC for 2018 is eliminated for Juan and Maria if their adjusted gross income exceeds $51,492. Indeed, this is what happens when Juan reports $20,000 of gambling winnings. The joint AGI is now $55,000, so the entire EITC is eliminated. In effect, the additional gambling income is taxed at more than the $2,400 tax using their 12% marginal rate. By eliminating the negative tax (EITC), the surprisingly effective tax on the gambling winnings is $5,873 ($3,473 + $2,400). This is, in essence, a tax rate of almost 30%. It was not an easy task for us to inform the taxpayers that there would be no EITC this year.
Scenario 5

Capital gain eliminates the EITC. In another case the taxpayers had their entire EITC eliminated because of a one-time sale of stock. Harvey and Mary file a joint return and have two children. They have wages of $35,000, which normally is their only source of income. Like Juan and Maria in the preceding scenario, they tentatively have an EITC of $3,473 using 2018 tax rules. However, Mary had inherited some stock from her mother in November 2017 and sold it in July 2018 for a long-term capital gain of $5,000. Unfortunately capital gains are considered investment income for purposes of the EITC. If the taxpayer’s investment income is greater than $3,500 for 2018 there is no EITC whatsoever. Because Harvey and Mary are in the 12% tax bracket, there is no actual tax per se on the capital gains. However, they lose their entire EITC of $3,473. Essentially, the effective tax on the $5,000 capital gain is $3,473. This is a tax rate of almost 70%! Although this seems harsh, it is nonetheless the letter of the law. We had to explain the tax policy behind the rule. Mary had inherited the stock when its fair market value was $40,000, and this was her tax basis. When Mary sold it for $45,000 cash, the government assumed that she didn’t need any EITC credit for this year; the extra $45,000 cash should be enough without any additional help from the government.

Scenario 6

Retirement plan distribution causes refund of entire Affordable Care Act (ACA) subsidy. Jack and Sue are a married couple with no children, filing a joint return. The couple qualified for a health insurance subsidy from the ACA for virtually all their insurance premiums. The total subsidy was $4,000. They had projected income of $25,000 for the year because Jack had recently retired from working and only Sue was earning income. The ACA insurance subsidy is based on what the taxpayers project their income to be when obtaining coverage. If their actual income is less than projected, they are entitled to an additional premium tax credit. If their actual income turns out to be higher than projected, they must refund to the government any excess subsidy payments.

As it turned out Jack decided to take a $70,000 one-time distribution from his IRA. This was not included in the couple’s original projection of income. This caused their actual AGI for the year to be over $90,000, well above the point where no insurance subsidies should be paid. Jack and Sue must pay back the entire $4,000 subsidy when they file their tax return. In effect, this is an additional tax on the $70,000 IRA distribution.

As tax professionals who have ever had to explain to clients the mathematics behind the computation of the subsidy repayment know what a painful process this can be. Although many taxpayers are understanding about the whole affair, many refuse to accept that they must pay back some of their health insurance premium subsidy. This seems to be one of the more upsetting events that some taxpayers encounter. Form 8962, Premium Tax Credit, is a difficult form for anyone to work through. Explaining it to disappointed, and often angry, clients is never a pleasant experience.

Conclusions and recommendations

The surprising taxation of so-called tax-free income, as well as the elimination or reduction of the EITC or the ACA subsidy due to sudden increases of income, is something tax professionals often encounter. It’s not something that the taxpayer can plan around. Many times, the client presents the tax professional with a fait accompli. For example, in Scenario 6 above, it would have been advisable to spread out the IRA distribution over two or more years. We can certainly
provide advice for future tax years, of course, even if nothing can be done about the present one. It’s important to educate clients who are receiving Social Security benefits as to how this income can become taxable. It’s also important to caution EITC clients about receiving any investment income (capital gains) that would eliminate their credit. Perhaps the sale of the capital asset, especially if it is stock, can be accomplished over the course of a few years. Even borrowing money using the stock as collateral would be preferable to losing the EITC or causing Social Security to become taxable.

Endnotes
1. Worksheet 1 in IRS Publication 915 provides a manual computation for determining how much Social Security is taxable. This worksheet is useful if the tax professional needs to show the taxpayers why their Social Security is suddenly taxable.
2. The computation is again taken from Worksheet 1 of Publication 915 or any tax software program.
3. Worksheet 1 of Publication 915 is an excellent exercise in how to derive this $11,150. It is also good practice for tax professionals to “do the math” without the aid of tax software, since it is helpful in explaining the taxability process to taxpayers.
4. This is equal to the maximum credit of $5,716 for two children, reduced by the phase-out of .2106 x ($35,000 - $24,350) = $2,243. The result is a credit of $3,473. The 2018 figures for maximum credit and initial phase-out income can be found at irs.gov. Another useful site for tax professionals who deal with individuals and small businesses is smbiz.com, the website for Small Business Taxes and Management. See its Reference Section for all 2018 tax rate updates and credit updates.
5. The holding period for inherited property is automatically more than one year, and is therefore long-term, regardless of when the beneficiary sells it. See §1223(9).
6. The tax basis of inherited property is its FMV at the date of the decedent’s death. See §1014(a).
7. It’s found on Line 46 of the 2017 Form 1040, just below the line for AMT. The actual computation is done on Form 8962. (Note: On the draft 2018 Form 1040, it’s reported on Schedule 5 and carried to Form 1040, page 2.)

About the Author
James A. Fellows, Ph.D., CPA is Professor Emeritus at the University of South Florida St. Petersburg.
Over the past several years, many high-ranking S corporation shareholders have asked me about paying benefits for their employees, especially health insurance. In fact, this is a question I also get from other tax professionals, especially when it comes to how to handle it for income tax return and payroll tax purposes. To complicate matters, things are handled differently if the shareholders are related employees.
Let’s go back a decade or so. If you were a 2% or more shareholder of an S corporation (and that percentage seems to be the same for many other provisions related to S corporations), you could pay for your health insurance premiums out of company funds without having to offer it to other employees. The general rule was that if you had employees, you had to offer benefits to all if they worked an average of 30 hours per week over the course of the year. To avoid this cost, many employers required that their employees stay under this threshold. They would hire two individuals to work under the requisite 30 hours per week; therefore, the employer didn’t have to offer them benefits. However, health insurance was different. In fact, this benefit was really the only one in which you could “discriminate” against other employees by not offering it to them while still being able to pay the premiums for the shareholder-employee.

It was a great cost-saving ideology, but it was not a good way to retain employees. Unless your workforce consists of teenagers (i.e., fast food joints or grocery stores, etc.), even part-time employees want more than 29 hours. Depending on the needs of the company and the position that the company needs to fill, not offering benefits makes finding qualified candidates difficult.

At first, the caveat was that the policy had to be in the name of the company, not the actual insured shareholder-employee. That caused a major problem because insurance companies stopped offering health insurance in a company’s name if there were not at least two to three employees. It happened to me when United HealthCare cancelled my company’s policy because it was just me; I needed two. I had to get the policy in my individual name.

Not only did insurance companies stop offering single-person policies to corporations, the insurance laws in some states did not allow a corporation to purchase group health insurance when the corporation only had one employee. Therefore, if the shareholder was the sole corporate employee, the shareholder had to purchase his health insurance in his own name.

The IRS issued Notice 2008-1, which ruled that under certain situations the shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder. Notice 2008-1 provided four examples, including three examples in which the shareholder purchased the health insurance and one in which the S corporation purchased the health insurance.

The bottom line is that for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation on the shareholder’s W-2.

Notice 2008-1 states that if the shareholder purchased the health insurance in his own name and paid for it with his own funds, the shareholder would not be allowed an above-the-line deduction; rather the cost had to be included with other medical expenses and deducted on Schedule A.

On the other hand, if the shareholder purchased the health insurance in his own name but the S corporation either directly paid the premiums or reimbursed the shareholder and included the premium payment in the shareholder’s W-2, the shareholder would be allowed an above-the-line deduction.

As we all know, medical expenses are limited to 7.5% of adjusted gross income (at least for the next couple years, per the recently passed TCJA). As such, by not deducting as an adjustment to gross income, the amount paid may not be deductible depending on other factors.

Deducting it as an adjustment to gross income lowers adjusted gross income when other deductions are applied (medical expenses and casualty and theft losses, to name a couple).

The bottom line is that for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation on the shareholder’s W-2.

So how does this work? The total premiums paid or reimbursed are reclassified as wages and not health insurance expenses on the books and records of the corporation. So far, there’s really no change to the corporation’s bottom line. However, the amount paid or reimbursed now must be included as wages on the shareholder’s W-2. However, these additional wages
are not subject to Social Security, Medicare (FICA) or unemployment (FUTA) taxes if the payments of premiums are made to or on behalf of the shareholder-employee. The additional compensation is included in the shareholder-employee’s Box 1 (Wages) of Form W-2, Wage and Tax Statement, but is not included in Boxes 3 and 5 of Form W-2.

The additional wages are also reported on line 2 of the quarterly Form 941, Employer's Quarterly Federal Tax Return. Line 3, federal income taxes, may or may not be affected. Since there generally isn’t a tax impact to a 2% shareholder-employee, withholding income taxes is not needed. However, if there’s more than one shareholder-employee and both have health insurance premiums paid, there could be a taxable detriment to one or both of the shareholder-employees depending on the amounts reimbursed.

The shareholder-employee is eligible for an above-the-line deduction in arriving at adjusted gross income (AGI) for amounts paid during the year for medical care premiums if the medical care coverage was established by the S corporation and the shareholder met the other self-employed medical insurance deduction requirements.

Under the Patient Protection and Affordable Care Act of 2010 (PPACA), this valuable benefit (at least to the shareholder-employee) was changed and a $100 per day penalty could be assessed if the company was taking advantage of the rule. This caused a lot of angst to shareholders and their tax professionals.

On February 18, 2015, the IRS issued Notice 2015-17, providing relief for S corporations that had health insurance plans covering 2% shareholders. The notice provided that S corporations and shareholders may continue to rely on Notice 2008-1 with regard to the tax treatment of 2% shareholder-employees and their healthcare arrangements for all federal income and employment tax purposes. As such the $100 per day penalty would not be asserted for any failure to satisfy the market reforms by a 2% shareholder-employee healthcare arrangement. Also, an S corporation that pays for health insurance premiums for a 2% shareholder-employee will not be required to file IRS Form 8928 (regarding failures to satisfy requirements for group health solely as a result of having a 2% shareholder-employee healthcare arrangement).

Rev. Proc. 2014-41 provides guidance on computing the above-the-line deduction and rules regarding the premium tax credit.
pursuing this revenue stream on audits. There is a slew of court cases on reasonable compensation.

One must also realize that the same rules apply to family members of the 2% shareholder-employee employed by the company. For example, Dad owns 100% of the company and pays for his health insurance. He also has a health reimbursement plan for his other employees as long as they provide proof that they have insurance. These reimbursements are a tax-free benefit (which was taken away by the original wordings in the PPACA, then reversed) to the employee. If the company employed Daughter and she was reimbursed for her health insurance, the same rules apply to her as they do to Dad. As such, communication is key so that there are no surprises when Daughter receives her W-2. While the S corporation can reimburse under this method, the employer should keep in mind the penalties for creating a group health insurance plan that does not meet the minimum essential coverage standards.

Notice 2013–54 provides guidance on the use of health reimbursement plans (HRAs) and group health plans. HRAs generally are considered to be group health plans within the meaning of Code §9832(a), §733(a) of the Employee Retirement Income Security Act of 1974 (ERISA), and §2791(a) of the Public Health Service Act (PHS Act) and are subject to the rules applicable to group health plans.

Notice 2013–54 basically reverts to the rules as noted in Revenue Ruling 61–146. Q&A #5 states the reimbursements are tax free. In short, if employers don’t offer health insurance as a benefit, they can reimburse employees for the cost as long as they show proof that they are paying for insurance with after-tax dollars.

In summary, tax professionals must remember to communicate the rules as they relate to the 2% shareholder-employee, especially if there is more than one or if there is a family member employed when health insurance is paid for or reimbursed. Without proper planning and recordkeeping, there can be tax consequences to all involved.

About the Author
Jeffrey A. Schneider, EA, CTRS, NTPI Fellow is the principal in SFS Tax & Accounting Services and SFS Tax Problem Solutions in Stuart, FL. He has been in the field of taxation for over thirty-five years working for multinational companies and has been in private practice full time since 1999. Jeffrey became an enrolled agent in 2005 and earned a Certified Tax Resolution Specialist designation by the American Society of Tax Problem Solvers in 2015. He received a certification in college planning in 2007, and became a Certified Divorce Financial Analyst in 2004.
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Text Your Tax Knowledge
By Cindy Hockenberry, EA

1. John is a wealth management planner and likes to entertain his best clients by taking them out for dinner at a nice restaurant. Before, during and after dinner, John discusses the latest investment strategies he believes would benefit his clients. Considering the changes made under the Tax Cuts and Jobs Act, can John deduct the cost of this meal as a business expense?

2. Jim is a huge Milwaukee Brewers fan and has tickets to the playoff game. He invites his best client Phil to join him at the game. During the game, Jim buys beer and hot dogs for each of them. Can Jim deduct any of these entertainment expenses as a business expense?

3. Jeanie is a business woman with tickets to a Lakers game. The tickets include access to a game suite at the stadium where food and beverages are included with the ticket price. Jeanie invited a business associate to a game. Can Jeanie deduct the costs incurred for the game as a business expense?

4. Mark’s employee is an undocumented alien who does not have a green card, ITIN or Social Security number. Mark has requested that the employee provide a Social Security number but the employee has failed to do so. How should Mark fill out the Form W-2 for this employee?

5. Henry, age 85, died during 2018 prior to taking a required minimum distribution (RMD) from his IRA. The investment company will distribute the RMD to the IRA beneficiaries, and the beneficiaries will pay the tax. The attorney claims the RMD is paid to the estate and reported on Form 1041. Is the attorney correct?

6. Nolan rents a retail store space and made improvements that he depreciated over 39 years. Upon termination of his lease, he moved to another space and left the improvements behind. Can he write off the remaining basis in the improvements?

7. Bob is concerned about whether he will be able to claim his 26-year-old son in 2018 as a qualifying relative. He knows that, among other things, his son cannot have gross income in excess of the personal exemption amount for the tax year. Under the Tax Cuts and Jobs Act, the personal exemption amount is $0 for tax years 2018–2025. Bob wants to know if this means his son cannot have any gross income in 2018 to meet the gross income test for qualifying relative. What do you tell him?

8. In June 2018, Lyra, a U.S. citizen, inherited her grandmother’s house, which is located in Greece. Her grandmother was a nonresident alien so the property was not included in her grandmother’s estate for U.S. estate tax purposes. What is Lyra’s basis in the house?

9. Under §267(a)(1), losses on sales to related parties such as family members are disallowed. Are in-laws considered family members under the related party rule?

10. Amy is a sole proprietor who expensed the entire cost of a copier that she purchased and placed in service in 2016 using the $2,500 de minimis safe harbor. If Amy sells the copier in 2018, how is the gain on the sale taxed?

Answers

1. Yes. Taxpayers may continue to deduct 50 percent of the cost of business meals if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered lavish or extravagant. The meals may be provided to a current or potential business customer, client, consultant or similar business contact.

2. The baseball game is entertainment as defined in §1.274-2(b)(1)(i); thus, the cost of the game tickets is an entertainment expense and is not deductible by Jim. The cost of the hot dogs and drinks, which are purchased separately...
from the game tickets, is not an entertainment expense and is not subject to the §274(a)(1) disallowance. Therefore, Jim may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.

3. No. The basketball game is entertainment as defined in §1.274-2(b)(1)(i); thus, the cost of the game tickets is an entertainment expense and is not deductible by Jeanie. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the §274(a)(1) disallowance. Therefore, Jeanie may not deduct any of the expenses associated with the basketball game.

4. Wages paid to an undocumented alien employee should still be reported in the normal manner on a Form W-2, without showing any TIN in the payee TIN block. Treas. Reg. §301.6109-1(c) authorizes a procedure whereby a withholding agent who cannot secure the TIN of a payee may attach an affidavit to the information returns he is filing with the IRS stating that the withholding agent has asked for the TIN of the payee (or a list of payees) and that the payee or payees have neglected or refused to provide a TIN. The attachment of such an affidavit to the information returns will be grounds for non-assertion of the penalties authorized by IRC §§6721 and 6722 against the withholding agent for failure to supply a payee TIN on an information return or payee statement.

5. No. The RMD for the year of a taxpayer’s death is not avoided because the account owner dies before actually taking it. Instead, the RMD is computed as if the IRA owner lived all year using the RMD rules that apply before death and must be distributed to the account beneficiary before the end of the year of the owner’s death. The income related to the RMD in the year of death is taxed to either the account owner or beneficiary, depending on who received it.

6. Yes. The abandonment of leasehold improvements is reported as a sale on Form 4797, Part II, with $0 as the gross sales price. The remaining basis is deducted as an ordinary loss. An abandonment loss deductible under §165 must be evidenced by a completed transaction that is established as an identifiable event [Reg. §1.165-1(b)]. Nolan met this requirement when the lease terminated and he left the leasehold improvements behind in the lessor’s retail store space.

7. The fact that the actual deduction for the personal exemption is suspended or $0 for years 2018–2025 did not impact the gross income test. Therefore, even though the 2018 personal exemption amount of $4,150 is suspended, the gross income test is still met as long as Bob’s son does not have gross income in excess of $4,150 [§151(d)(5)(B)].

—continued on page 48
8. Lyra’s basis in the foreign real property is the FMV of the house on the date of her grandmother’s death. Since the property was acquired by inheritance under §1014(b)(1), it’s treated as property acquired from a decedent. Thus, its basis is the FMV on the date of death, even though the property was not included in her grandmother’s estate for U.S. estate tax purposes [Rev. Rul. 84-139].

9. No. Section 267(c)(4) defines family members as, “only his brothers and sisters (whether by whole or half-blood), spouse, ancestors, and lineal descendants.” In Stern v. CIR, 215 F2d 701, the sale to a taxpayer’s daughter and son-in-law as tenants by entirety was treated as a sale to the son-in-law, who furnished the consideration; therefore, loss was not disallowed by §267(a)(1). In Saul v. CIR, 6 TCM (CCH) 734 (1947), the sale to the brother’s sons-in-law allowed the loss even though there was a gift of funds by the brother to the daughters, who then deposited the funds into joint accounts with their spouses to finance purchase; it was not treated as a sale to the brother followed by gifts from him to his sons-in-law.

10. Property to which a taxpayer applies the de minimis safe harbor is not treated upon sale or other disposition as a capital asset under §1221 or as property used in the trade or business under §1231 [Reg. §1.263(a)-1(f)(3)(iii)]. Since the de minimis safe harbor applied to the copier, any proceeds from the sale result in ordinary income [Audit Techniques Guide, Capitalization of Tangible Property, Chapter 5, De Minimis Safe Harbor].

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