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FEBRUARY 2023

SECURE 2.0

A new retirement law package was enacted on December 29, 2022. Known as “SECURE 2.0,” the new law includes provisions effective as early as January 1, 2023 and as far out as 2027. Some of the major changes effective for 2023 include:

Start Date – Required Minimum Distribution. The age of owners of traditional IRAs, 401(k)s, etc. for required minimum distribution changes to age 73 from the previous age 72. Participants becoming age 72 in 2022 must take their first required minimum distribution by April 1, 2023. Those becoming 72 in 2023 will have an additional year before the beginning of the force-out taxation of their savings. The start date for required minimum distribution increases in 2033 to age 75.

Failure to Distribute Penalty. The penalty for failure to make the required minimum distribution is lowered by SECURE 2.0 to 25 percent from the previous 50 percent. This penalty reduces to 10 percent if the failure is corrected in a timely manner.

Hardship Withdrawals. Participants residing in federally declared disaster areas will be allowed to withdraw up to $22,000 from an IRA, 401(k), etc. without paying the 10 percent penalty for pre age 59½ withdrawals. The regular tax on these distributions can, at the option of the individual, be paid without penalty over three years beginning with the year of the hardship payout. This hardship relief distribution rule applies retroactively for disasters since January 25, 2021.

In addition to the 2023 changes mentioned above, the new law provides some temporary incentives for employers to offer retirement plans and to contribute for employees, thus improving their retirement security. Hopefully, SECURE 2.0 will help employees and their beneficiaries, owner employees, small businesses, and retirees through easing administrative costs and burdens and reducing penalties for inadvertent mistakes. It will, however, require most plans to be amended within the next few years to comply with its provisions.

BUSINESS V. HOBBY
SMALL FARMS AND THE IRS

A 2022 report by the U.S. Department of Agriculture states that 89 percent of U.S. farms are "small family farms" (defined as having annual gross cash sales of less than $350,000), operating 45.2 percent of total U.S. farm acreage, and accounting for 17.8 percent of the U.S. farm production. The report further states, however, that operators of small family farms often reported losses from farming.

In 2004, Paul Wondries was a successful businessman who owned many profitable businesses, including 23 car dealerships. Wanting to diversify his business interests, he bought a 1,000-acre ranch, hired a knowledgeable full-time manager, made improvements to the property, bought cattle, and lost a fair amount of money over the following years. During the three-year period of 2015, 2016,

(*Continued on reverse*)

and 2017, farm income totaled $24,004 and farm expenses totaled $950,124, for a net loss of $926,120, which Mr. Wondries reported on his tax returns as farm business losses.

The Internal Revenue Service (IRS) disallowed Mr. Wondries's farm net loss deductions claiming that the farm was not an activity engaged in for profit. At trial, the Tax Court reviewed factors that indicate a business (versus a hobby), which include the following: (1) the manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisors, (3) the time and effort expended by the taxpayer in the activity, (4) expectation that assets will appreciate in value, (5) taxpayer's success in other activities, (6) taxpayer's history of income or loss with the activity, (7) occasional profits, if any, (8) financial status of the taxpayer, and (9) elements of personal pleasure or recreation.

Mr. Wondries' maintained that the farm expenses (e.g., repairing fencing and irrigation, clearing brush, renovating structures, maintaining grounds surrounding structures, etc.) improved the value of the land and, as such, the activity was engaged in for profit regardless of the farm operating losses. But, the IRS's position is that farm land appreciation generally should not be considered in the question of whether or not a farming activity is engaged in for profit. However, the Tax Court determined that the potential for appreciation of the land used should, in this case, be considered in the question of whether or not a farming activity is engaged in for profit. Accordingly, in a January 2023 decision, The U.S. Tax Court, in what it said was a close call, ruled in favor of Mr. Wondries and allowed the net loss deductions.

To state the obvious, farming is hard work, but there is no rule that says it cannot also be enjoyable and fulfilling. It is encouraging to see the Tax Court accept a more expansive understanding of the overall objectives of a farm operation than the IRS's customary position.

IRS Form 1099-K

New for 2023

Taxpayers who sell an occasional item or two online in 2023 using a third-party payment network (e.g., eBay, PayPal, Venmo, etc.) might be surprised in January of 2024 when they receive one or more 2023 IRS Forms 1099-K reporting the gross payments they received and the number of their transactions. The Internal Revenue Service (IRS) will, of course, automatically receive its copies of those Forms 1099-K, which will be entered into its records. However, just because one receives a 2023 Form 1099-K does not mean that it represents taxable income, and the IRS understands this. But they also understand that it might.

The new information reporting rules were originally for 2022 transactions. However, in late 2022, the IRS deferred the effective date until January 1, 2023.

Prior to 2023, Form 1099-K was required only when a person had more than 200 such transactions and proceeds exceeded $20,000 during the year. For 2023, Form 1099-K is required when cumulative proceeds for the year exceed $600 and regardless of the number of transactions. In other words, there will be a lot more Forms 1099-K issued to taxpayers (and filed with the IRS) for 2023 than in the past. This third-party reporting change does not, of course, change what is or is not taxable income to the seller. If an item is sold for more than its cost basis, the gain is taxable regardless of any Form 1099 reporting threshold, and it has always been so. However, the sale of used personal items through such networks are frequently at an amount of less than the taxpayer’s cost basis thus, no income tax is due. However, it is necessary for 2023 to include in your tax return transactions without gain to prevent an IRS assertion of tax, penalties and interest on the gross proceeds reported to the IRS on the Form 1099-K. The form contains a warning to the recipient: “If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.”

If, in 2023, you are a seller receiving payment from a third-party payment network, you will want to be alert for the receipt in early 2024 of a 2023 Form 1099-K and to be certain to include the transactions in your self-prepared 2023 return or to furnish the 1099-K to your tax return preparer.

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Tax & Business Alert

FEBRUARY 2023

PROTECT YOUR BUSINESS WITH METICULOUS RECORDS

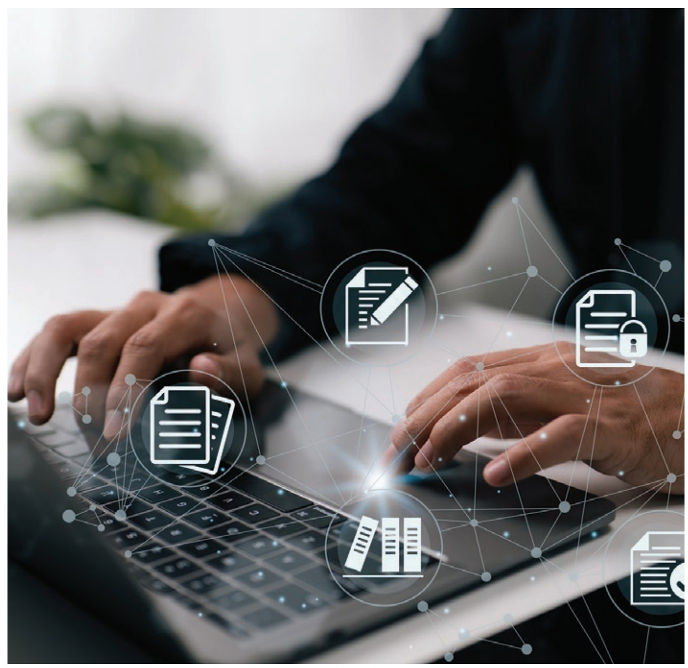
If you run a business, you know that you need to support expenses with detailed records. To be deductible, every expense on your tax return might have to be defended if your company is subject to an audit. Plus, failing to operate in a businesslike manner, complete with good records, might lead the IRS to deem the activity a hobby rather than a business — and your expenses may be limited or disallowed.

While there's no one right way to keep business records, some types of expenses do require more details. For example, records relating to automobile expenses, travel, meals and office-at-home costs are subject to special requirements or limitations.

TO CLAIM DEDUCTIONS, AN ACTIVITY MUST BE ENGAGED IN FOR PROFIT

For a business expense to be deductible, the taxpayer must establish that the primary objective of the activity is making a profit. The expense must also be substantiated and be an "ordinary and necessary" business expense. In one court case *(Gaston v. IRS, 2021)*, a taxpayer claimed deductions that created a loss, which she used to shelter other income from tax.

She engaged in various activities that included acting in the entertainment industry and selling jewelry. The IRS found her activities were more like hobbies than businesses engaged in for profit and it disallowed her deductions.



The taxpayer did, however, have some success when she took her case to the U.S. Tax Court. The court found that she *was* engaged in the business of acting for profit during the years at issue, though not all of the claimed expenses were ordinary and necessary business expenses. The court allowed deductions for expenses including headshots, casting agency fees and lessons to enhance the taxpayer's acting skills. But the court disallowed other deductions because it found insufficient evidence "to firmly establish a connection" between the expenses and the business.

PROPER RECORDS ARE REQUIRED

In another case, a taxpayer worked as a contract emergency room doctor at a medical center. He also started a business to provide emergency room physicians overseas. On Schedule C of his tax return, he deducted expenses related to his home office, travel, driving, continuing education, cost of goods sold and interest. The IRS disallowed most of the deductions.

In U.S. Tax Court, the doctor used charts to illustrate his expenses but didn't provide receipts or other substantiation showing the expenses were actually paid. He also failed to account for the portion of expenses attributable to personal activity.

The court disallowed the deductions, stating that his charts weren't enough and didn't substantiate that the expenses were ordinary and necessary in his business. It noted that "even an otherwise deductible expense may be denied without sufficient substantiation." The doctor also didn't qualify to take home office deductions because he didn't prove it was his principal place of business. *(Elbasha v. IRS, 2022)*

In addition, the court found that that taxpayer didn't prove that she engaged in her jewelry sales activity for profit. She didn't operate it in a businesslike manner, spend sufficient time on it or seek out expertise in the jewelry industry. Therefore, all deductions related to that activity were disallowed.

WE CAN HELP

Contact us if you need assistance retaining adequate business records. Taking a meticulous, proactive approach can protect your deductions and prevent the IRS from viewing your business as a hobby. ■

QUALIFYING FOR THE HOME OFFICE DEDUCTION

In recent years, many people have pivoted to working from home, and that brings up tax questions. If you're one of those people, you might wonder, "Can I claim the home office deduction on my 2022 tax return?"

The short answer is: only if you're self-employed. Employees can't currently claim home office expenses, and even self-employed taxpayers must follow strict rules to claim deductions.

NUMEROUS WRITE-OFFS

If you qualify, you can deduct the "direct expenses" of a home office. This includes the costs of painting or repairing the home office and depreciation deductions for furniture and fixtures used there. You can also deduct the "indirect" expenses of maintaining the office. This includes the allocable share of utility costs, depreciation and insurance for your home, as well as the allocable share of mortgage interest, real estate taxes and casualty losses.

In addition, if your home office is your "principal place of business," the eligible costs of traveling between your home office and other work locations are deductible transportation expenses, rather than nondeductible commuting costs.

TESTS FOR DEDUCTIBILITY

You can deduct your expenses if you meet any of these three tests:

1. Principal place of business. You're entitled to deductions if you use your home office, exclusively and regularly, as your principal place of business. Your home office is your principal place of business if it satisfies one of two tests. You satisfy the "management or administrative activities test" if you use your home office for administrative or management activities of your business, and you meet certain other requirements.

You meet the "relative importance test" if your home office is the most important place where you conduct business, compared with all the other locations where you conduct that business.

2. Meeting place. You're entitled to home office deductions if you use your home office, exclusively and regularly, to meet or deal with patients, clients or customers. The patients, clients or customers must physically come to the office.

3. Separate structure. You're entitled to home office deductions for a home office, used exclusively and regularly for business, that's located in a separate unattached structure on the same property as your home. For example, this could be in an unattached garage, artist's studio or workshop.

You may also be able to deduct the expenses of certain storage space for storing inventory or product samples. If you're in the business of selling products at retail or wholesale, and if your home is your sole fixed business location, you can deduct home expenses allocable to space that you use to store inventory or product samples.

KNOW THE LIMITATIONS

The amount of home office deductions for self-employed taxpayers is subject to various limitations. Proper planning is key to claiming the maximum deduction for your home office expenses. Contact us if you'd like to discuss your situation. ■

MOVING OUT OF STATE? LEARN ALL THE TAX IMPLICATIONS FIRST

With so many people working remotely these days, it's become common to think about moving to another state — perhaps for better weather or to be closer to family. Many retirees also look at an across-the-border move to better control living expenses. If you've found yourself harboring such notions, be sure to consider taxes before packing up your things.

WHAT TAXES APPLY?

It may seem like a no-brainer to simply move to a state with no personal income tax, but you must consider *all* taxes that can potentially apply to state residents. In addition to income taxes, these may include property taxes, sales taxes, and estate or inheritance taxes.

If the states you're considering have an income tax, look at what types of income they tax. Some states, for example, don't tax wages but do tax interest and dividends. And some states offer tax breaks for pension payments, retirement plan distributions and Social Security payments.

WHAT ARE THE DOMICILE REQUIREMENTS?

If you make a permanent move to a new state and want to escape taxes in the state you came from, it's important to establish legal domicile in the new location. Generally, your domicile is a fixed and permanent home location where you plan to return, even after periods of residing elsewhere.

Each state has its own rules regarding domicile. You don't want to wind up in a worst-case scenario: Two states could claim you owe state income taxes if you established domicile in the new state but didn't successfully terminate domicile in the old one.

Additionally, if you die without clearly establishing domicile in just one state, both the old and new states may claim that your estate owes income taxes and any state estate tax due.

The simplest and most obvious way to establish domicile is to buy or lease a home in the new state and sell your previous home (or rent it out at market rates to an unrelated party). Then, change your mailing address on passports, insurance policies and other important documents. Getting a driver's license in the new state and registering your vehicle there also helps. Be sure to take these and other steps as soon as possible after moving.

NEED HELP?

When looking into whether the grass is greener in another state, do some research and contact us. We can help you avoid unpleasant tax surprises. ■

THROWING SNOWBALLS AT A MOUNTAIN OF DEBT

Many people start the year intending to get out of debt, yet end the year owing just as much, if not more. One approach that might yield success is called "throwing snowballs."

Under this method, you organize your debts from the lowest balance to the highest balance and begin paying off the debt on top of the list. The idea is to throw as many "snowballs" as you can at that first creditor until the debt is gone.

While you hurl these snowballs, pay the minimum amount to your other creditors. With this strategy, you should avoid trying to send an extra $20 or so a month to each one. If you want to contribute extra money, throw it at your primary target.

Once the first debt is paid off, you should have even more money to send to the next one. Over time, you can start heaving bigger and bigger snowballs at the remaining targets because, as you pay off each debt, you'll have more money to pay toward remaining debts.

The objective is to start an avalanche of payoffs until your debts disappear. Under this method, the best predictor of success isn't the number of dollars you pay off but rather the number of accounts that you close.

Please note: There's some debate on the practicality of throwing snowballs. Opponents argue that you should first pay off debts with the highest interest rates. We can help you plan a debt-reduction strategy that's right for you. ■