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NOVEMBER 2023

ELECTRIC MOTORS, EGG BEATERS, AND PICKING STOCKS

"I like stock picking because it kind of reminds me of hunting and fishing...Most people probably shouldn't do anything other than have index funds...That is a perfectly rational thing to do for someone who just doesn't want to think about it and has no reason to think that he has any advantages as a stock picker. Why should he try to pick his own stocks? He doesn't design his own electric motor or his egg beater."

Charlier Munger (age 99), Vice Chairman of Berkshire Hathaway and long-time partner of Warren Buffett (age 93), was quoted as above in a recent Wall Street Journal article. Like John Bogle, David Swensen, Warren Buffett, and many other highly successful investors, Mr. Munger suggests index funds for most people. The record indicates that, for most of us, buying and holding long-term a broad-based equity index fund is the most likely path to success for a saver/investor. Avoiding unnecessary cost and expense, stock picking, market timing, and current recognition of taxable income generally lead to the best results.

TAX & BUSINESS ALERT CLARIFICATION

The first article in the accompanying *Tax & Business Alert* discusses the different income tax treatments to the recipient of employee disability benefits depending on who paid the disability insurance premium. It is not always clear to some who paid the premium. Premiums paid by an employee through a cafeteria plan are considered to have been paid by the employer. Therefore, disability benefits received by an employee who paid the disability insurance premiums through a cafeteria plan are taxable to the employee. The percentage of the benefit that is taxable is the percentage of the premium that your employer paid.

CASH ON THE HOOD
(ELECTRIC VEHICLE TAX CREDITS TO BECOME INSTANT)

The U.S. Treasury has proposed a rule effective January 1, 2024 that would furnish a point-of-sale purchase payment of $7,500 by the Internal Revenue Service (IRS) directly to the dealer on certain electric vehicles (EV). The rule would allow all eligible EV buyers (regardless of federal tax liability) to immediately enjoy the full tax break (up to $7,500) compared to the current rule, which limits the EV tax credit to the buyer's tax liability. Eligible buyers would, under the proposed rule, be subject to income limits ($150,000 for single individuals and $300,000 for married couples filing jointly). Such buyers would receive the credit as a reduction of the cash due at the dealership rather than having to wait until filing their income tax returns for the year of the

(*Continued on reverse*)

purchase. Buyers must transfer their credit to the dealer who should receive the payment from the IRS within 72 hours. The buyer must file an income tax return for the year in which the vehicle transfer election is made and must furnish VIN numbers and other information with the buyer's income tax return. A buyer must self-attest to income eligibility and will be responsible for repayment of the credit amount with the buyer's tax return if the income limit is exceeded in the year of the purchase.

The Treasury's proposed rule is subject to a 60-day public comment period and may change in its final form. We believe, however, that major changes to the rule are unlikely.

UPDATE ON NEW FINCEN OWNERSHIP REPORT

In our July newsletter available at www.cepcpa.com/our-newsletters, we discussed the new federal small business entity ownership reporting requirement starting in 2024 required by Financial Crimes Enforcement Network (FinCEN). This report will include information about (1) individuals who directly or indirectly own and/or control most small business or investment entities and (2) the company's Applicants. An Applicant is (1) the individual who directly filed the document creating or registering the company (Articles of Incorporation, Articles of Organization, etc.) and (2) the individual, if any, who directed or controlled the filing of that document.

When announced earlier this year, the government furnished only general information about this new report and to whom it will apply. FinCEN and US Treasury have now published a number of documents (over 400 pages with more to come and all available on the internet) explaining this new reporting requirement (e.g., Beneficial Ownership Information Reporting Requirements (330 pages); Beneficial Ownership Information Reporting Requirements Frequently Asked Questions (26 pages); Small Entity Compliance Guide (50 pages)).

Information that must be reported to FinCEN about the owners, those who control the entity, and its Applicants are (1) full legal name, (2) date of birth, (3) current address, (4) unique identifying number (e.g., Social Security number) and (5) an image of one the following documents: U.S. or foreign passport, state driver's license, or other state or local government identifying document. A new report is required to be filed within 30 days following any change in the reported beneficial owners (which includes those who are not owners but have substantial control of the entity).

As mentioned in July, this new report must be electronically filed through a FinCEN website. Filing a paper report will not be allowed. A company that is in existence before January 1, 2024 will have until January 1, 2025 to file its initial report. A company formed on or after January 1, 2024 will have 30 days from the date of formation to file its first report. However, FinCEN is currently proposing a transitional 90-day filing period for companies formed during 2024.

The stated purpose of this new reporting requirement is "to assist the U.S. government's efforts to make it harder for bad actors to hide or benefit from their ill-gotten gains through shell companies or other opaque ownership structures." While most small entity owners will agree with the goal, FinCEN is imposing a significant burden (cost) on law-abiding small businesses and individuals and is subjecting them to onerous penalties for mistakes. Civil penalties are provided for non-compliance of up to $500 per day that the violation continues and criminal penalties include a $10,000 fine and/or up to two years of imprisonment.

Larger businesses with more than 20 employees and $5 million of gross receipts are generally exempt from this new FinCEN requirement. There are 22 other exemptions, which are much narrower. Owners of small businesses will want to understand their exemption or attend to the timely filing of the required report during 2024.

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Tax & Business Alert

NOVEMBER 2023

IS DISABILITY INCOME TAXABLE?

Many Americans receive disability income. If you're one of them or know someone who is, you may wonder whether it's taxable. As is often the case with tax questions, the answer is "it depends."

KEY FACTOR

The key factor is who paid it. If the income is paid directly to you by your employer, it's taxable to you as ordinary salary would be. Taxable benefits are also subject to federal income tax withholding — though, depending on the disability plan, they sometimes aren't subject to Social Security tax.

Even if your employer arranges for the coverage (in other words, it's a policy made available to you at work), the benefits aren't taxed to you if you pay the premiums.

Frequently, the payments aren't made by an employer but by an insurer under a policy providing disability coverage or under an arrangement having the effect of accident or health insurance. In such cases, the tax treatment depends on who paid for the coverage. If your employer paid for it, the income is taxed to you, as if paid directly to you by the employer. But if you paid for the policy, the payments you receive under it aren't taxable.

Even if your employer arranges for the coverage (in other words, it's a policy made available to you at work), the benefits aren't taxed to you if you pay the premiums. For these purposes, if the premiums are paid by the employer but the amount paid is included as part of your taxable income from work, the premiums are treated as paid by you.

TWO EXAMPLES

Let's say your salary is $1,000 a week ($52,000 a year). Under a disability insurance arrangement made available to you by your employer, $10 a week ($520 for the year) is paid on your behalf by your employer to an insurance company. You include

HOW MUCH COVERAGE IS NEEDED?

In deciding how much disability coverage you need to protect yourself and your family, take tax treatment into consideration. If you're buying the policy, you need to replace your after-tax, "take-home" income because your benefits won't be taxed. On the other hand, if your employer pays for the benefit, you'll lose a percentage to taxes. If your current coverage is insufficient, you may wish to supplement an employer benefit with a policy you take out personally.

$52,520 in income as your wages for the year: the $52,000 paid to you plus the $520 in disability insurance premiums. In this case, the insurance is treated as paid for by you. If you become disabled and receive benefits, they aren't taxable income to you.

Now, let's look at an example with the same facts as above. Except in this case, you include only $52,000 in income as your wages for the year because the amount paid for the insurance coverage qualifies as excludable under the rules for employer-provided health and accident plans. In this case, the insurance is treated as paid for by your employer. If you become disabled and receive benefits, they are taxable income to you.

Note: There are special rules in the case of a permanent loss (or loss of the use) of a part or function of the body, or a permanent disfigurement.

ANY QUESTIONS?

This discussion doesn't cover the tax treatment of *Social Security* disability benefits, which may be taxed under different rules. Contact us to discuss this further or if you have questions about regular disability income. ■

HOW TO SECURE A BUSINESS BAD DEBT DEDUCTION

Is your business having trouble collecting payments from clients or vendors? Years after the onset of the pandemic, some operations continue to feel the impact on business activity. It may be small solace, but at least you might be able to salvage a bad debt deduction on your tax return.

Caution: This tax treatment isn't automatic. Essentially, you must be able to show that the debt is worthless. That means you may have to ramp up your collection efforts. Fortunately, that could help your cash flow. If, however, it turns out that the debts are uncollectible, you may be able to secure a deduction. If you hope to take the deduction on your 2023 tax return, you'll have to get busy.

First, a cash-basis taxpayer may claim a business bad debt only if the amount that's owed was previously included in gross income. Second, as explained, a business must establish that the debt is legitimate and can't be recovered from the debtor. To this end, you must make a "reasonable" effort to collect the amount that's due.

This doesn't necessarily mean you have to file a lawsuit against the debtor. But you can't just make a single phone call either. Give it your best shot.

Often, the specific charge-off method (also called the direct write-off method) is used for writing off bad debts. In this case, you can deduct business bad debts that become either partially or totally worthless during the year.

For tax purposes, partially and totally worthless are defined as follows:

Partially worthless. The deduction is limited to the amount charged off on your books. You don't have to

charge off and deduct your partially worthless debts annually, so you can postpone this to a later year. However, you can't deduct any part of a debt after the year it becomes totally worthless.

Totally worthless. If a debt becomes totally worthless in the current tax year, you can deduct the entire amount (less any amount deducted in an earlier tax year when the debt was partially worthless).

Note that you don't have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. But if you don't record a charge-off and the IRS later rules the debt is only partially worthless, you won't be allowed a deduction for the debt in that tax year. Reason: A deduction of a partially worthless bad debt is limited to the amount actually charged off.

If you haven't started your collection efforts yet, time is short if you hope to claim a business bad debt deduction for 2023, so spring into action. For instance, you might start collection efforts through phone and email contacts. If that doesn't work, you may want to follow up with a series of letters — or even hire a collection agency. Finally, if all else fails, ask your tax advisor about the prospects of claiming a business bad debt deduction on your 2023 return. ■

ONE-TIME THING: IRA TO HSA TRANSFERS

Did you know that you can transfer funds directly from your IRA to a Health Savings Account (HSA) without taxes or penalties? According to the IRS, you're permitted to make *one* such "qualified HSA funding distribution" during your lifetime.

Typically, if you have an IRA and an HSA, it's a good idea to contribute as much as possible to both to maximize their tax benefits. But if you're hit with high medical expenses and have an insufficient balance in your HSA, transferring funds from your IRA may be a solution.

CALLING IN THE CAVALRY

An HSA is a savings account that can be used to pay qualified medical expenses with pre-tax dollars. It's generally available to individuals with eligible high-deductible health plans. Currently, the annual limit on tax-deductible contributions to an HSA is $3,850 for individuals with self-only coverage and $7,750 for individuals with family coverage. If you're 55 or older, the limits are $4,850 and $8,750, respectively. Those same limits apply to an IRA-to-HSA transfer, reduced by any contributions already made to the HSA during the year.

Here's an example illustrating the potential benefits of a qualified HSA funding distribution from an IRA: Joe is 58 years old, with a self-only, high-deductible health plan. In 2023, he needs surgery for which he incurs $5,000 in out-of-pocket costs. Joe is strapped for cash and only has $500 left in his HSA, but he does have a $50,000 balance in his traditional IRA. Joe may move up to $4,850 from his IRA to his HSA tax- and penalty-free.

CONSIDERING OTHER FACTORS

If you decide to transfer funds from your IRA to your HSA, keep in mind that the distribution must be made directly by the IRA trustee to the HSA trustee, and the transfer counts toward your maximum annual HSA contribution.

Also, funds transferred to the HSA in this case aren't tax deductible. But, because the IRA distribution is excluded from your income, the effect is the same (at least for federal tax purposes).

EXPLORING THE OPPORTUNITY

IRA-to-HSA transfers are literally a once-in-a-lifetime opportunity, but that doesn't mean they're the right move for everyone. If you're interested, our firm can help you explore taking this step in the context of your tax and financial circumstances. ■

FOLLOW IRS RULES TO NAIL DOWN A CHARITABLE TAX DEDUCTION

Donating cash and property to your favorite charity is beneficial to the charity, but also to you in the form of a tax deduction. However, to be deductible your donation must meet certain IRS criteria.

First, the charity you're donating to must be a qualified charitable organization, with tax-exempt status. A tool on the IRS website — the Exempt Organizations Select Check — allows users to search for a specific tax-exempt organization, check its federal tax status and see information returns the charity may have filed that are up for public review.

To be deductible in a given year, contributions must be actually paid, not simply pledged. So, if you pledged $5,000 but only paid $1,500 by the end of the year, you can only deduct the $1,500 on that year's tax return.

If you donate property and receive something in return, you need to know the fair market value (FMV) of the item donated and the item received. Suppose you donate a flat screen TV to your child's school, and in return receive event tickets. You must deduct the FMV of the tickets from the FMV of the TV to arrive at your tax deduction.

Substantiation rules also apply when giving cash or property to charity, and they vary based on the type and amount of the donation. For example, some donated property may require you to obtain a professional appraisal of value. Before you implement a course of action, consult your tax advisor. ■

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