



LIBERTY
Professional Services, LLC

FINANCIAL STRATEGIES

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2018 TAX CUTS

2018 is the start of a new era in tax law. Many things have changed. Increased standard deductions. No more personal exemption. Increased child credits. A new 20% deduction for pass-through businesses and self-employed people. My view of the new law is that they give you some good stuff over here and then take away some things over there. Some of it will offset, such as the larger standard deduction but no more personal exemptions. But overall, many people will likely pay less tax starting in 2018.

Please understand that every tax return is different. Some people may pay more tax. And just because you pay less tax doesn't mean you will get a larger refund on April 15th. Withholding tables are being adjusted to try and capture the new rates and deductions. This is a difficult process. It may take a few years and some fine tuning of the withholding system to get people back to the same refund they had in past years.

Be prepared for a surprise when you get to the end of the tax return filing process. Results will be different. Until we actually file a return using the new rules and the new withholding amounts, it is hard to say what the end result will be.

DON'T BE AFRAID TO PAY SOME TAX

Tax rates are as low as they have ever been and rates are going even lower in 2018 with the new tax law. Take advantage of these low rates, especially on the bottom of the scale.

Always be sure you have enough gross income to use up all your deductions. For an average family, the standard deduction is \$24,000. If possible, you want to keep your income and your tax high enough to use up the child credit and the day care credit. These credits are mostly non-refundable and do not carry-forward.

Self-employed people have a great ability to control their taxable income: bonus depreciation; section 179 expense; timing itemized deductions; managing the invoicing and collection

process; and prepaying expenses at year end. All these methods can be used to your advantage to target a certain income range. Roth IRAs or Roth conversions can also be used to shift income.

New businesses are a prime candidate for targeting income. They have too many expenses the first year. Don't waste them!!! Try and break even the first year. The loss may offset other W-2 income, but you are wasting 15% SE tax the second year on the amount of the loss.

FICA TAX

Part 2 of your tax situation is the large amount of FICA, or Self Employment (SE) Tax, that we all pay. For self-employed people, FICA is a much larger amount than income taxes. Eighty percent of self-employed people pay more SE tax than income tax. There are no deductions or exemptions to reduce it. It starts at 15% on every dollar of net income of the business.

Losses on Schedule C may sound good this year, but they will cost you next year. A self-employed person who loses \$10,000 one year and makes \$10,000 the next year pays \$1,500 more in FICA tax than someone who breaks even for two years. These two people have made the exact same amount and will pay the same amount of income tax, but FICA is calculated one year at a time without getting any benefit from negative amounts.

New businesses need to manage their tax situation to avoid this extra tax.

ENTITY SELECTION

When starting a new business (or evaluating an already established business), the question of what type of entity to be is important. The main choices are C-Corps, S-Corps, LLPs, LLCs or unincorporated entities.

Regular Corporations (C-Corps) are not used very much anymore. There are certain types of income that will be taxed twice with a C-Corp. You would need to have a unique situation to justify a C-Corp.

Partnerships, or LLP's, are good. They are sort of forced on you if you have unrelated people as owners. They are taxed similar to sole proprietors.

Most small business people have to choose between becoming an LLC or an S-Corp. They may also choose to do nothing and operate as an unincorporated sole proprietor. The unincorporated sole proprietor is what most business people have operated as for the last 100 years. An LLC is similar to the unincorporated sole proprietor, but is a "disregarded entity" in the eyes of the IRS. There is no tax benefit to a one person LLC. It is taxed exactly

the same as the unincorporated sole proprietor, but it may give you a certain amount of legal coverage.

The S-Corp is more complex and has both legal and tax advantages. An S-Corp has the ability to make money without having all the profit subject to the 15% SE tax. All profits of LLCs, LLPs and unincorporated sole proprietors have 15% SE tax on every dollar. Being an S-Corp sounds good, but you need to have the right type of business to qualify. You need to earn money off your employees and/or because of the financial risk and investment you have made. A restaurant is a good example. They have both employees and a large cash investment, with a great deal of risk. You are allowed to pay the owner a “dividend” for his investment risk. Owners must also be paid a “reasonable wage” for their efforts.

In the right situations, an S-Corp is great. Some businesses, like mine for example, don't fit the correct profile for an S-Corp. I have very little cash invested and I don't have employees. Most consulting businesses will not qualify as an S-Corp. They do not make money unless they put in the time and brainpower.

LLCs

LLCs have no tax meaning. LLCs are taxed as sole proprietors, partnerships or corporations, just as they would have been taxed if you had not formed the LLC. The key to an LLC is the legal protection you get. In order to make this protection stand up in court, you must do everything in your power to keep the LLC “clean.” It must be treated as a separate entity and all business finances must be treated as separate and distinct from the individual's finances. Too many people muddy up the books by paying personal expenses from the LLC checkbook. Keep it clean!!!

Please note that forming an LLC or partnership, or incorporating, involves a certain amount of legal work. I encourage all clients to get appropriate legal advice. I am not an attorney and do not help with legal issues.

UNREPORTED CASH

Some people do work for cash, cash that never shows up on their tax return. This may seem like a good thing since you don't have a big tax hit on this money. For a sole proprietor, that can mean a tax savings of 35% or more, but I do not recommend this. Forgetting the fact that it is illegal, wrong and dishonest, there are three other reasons that I discourage unreported cash.

The first reason is the bank and your attempt to borrow money from the bank. They look at your tax return, and financial statements, to determine your potential. If you are not showing all your income, you don't look as good.

The second reason is similar to the first. If you ever want to sell your business, the value will be based in part on the old financial statements. It is hard for me to go to the banker, or potential buyer, and say that "We have a whole bunch of other income. It just doesn't show up here." If it is my client doing the buying, I don't put much stock in statements like that. There is no way to know if they are true.

The third reason I dislike unreported cash is the negative appearance it gives to the outside world. It tells everyone who knows about it that I cheat. I do things that are wrong. If you are working with someone who does this, doesn't it make you stop and wonder what else they do wrong? Do they cut corners on materials in a construction job? Do they charge you for hours that they never worked? Do they lie when you discuss problems?

I do not want any of these negatives associated with me or my business. I pay more tax, but I don't have to worry about getting caught or about having a negative image. It is just not worth it.

HOME OFFICE DEDUCTION

The IRS and the Tax Courts have recently made the Home Office deduction much more attractive. They have eliminated most of the extra tax you pay when you sell your home. You still must recapture the depreciation you took in prior years, but there is no other taxable gain. Recapturing the depreciation is not so bad. The good news is you do not have to pay back the FICA tax you previously saved. There is also the time value of money on the income tax savings and a new simplified method for Home Offices.

Claiming the Home Office also documents and legitimizes your mileage expense. Business miles for a person working out of their house start when you leave the driveway. IRS has argued in Tax Court that business mileage, without the home office, does not start until you reach the client's office. To be on the safe side, I am advising people to claim the Home Office whenever possible, even if it is for a small amount. The business mileage deduction is usually a large amount and I want as much support for that deduction as possible.

Be sure you meet the rules for Home Office, exclusive use being the big one. You must have a room or designated area used exclusively for business. Be sure to watch out for insurance problems if customers come to your house. Does your insurance cover you if customers slip on the ice or trip on the carpet in the hallway?

HIRING YOUR SPOUSE

Certain sole proprietors are in a situation where they can justify having the spouse on the payroll. There are some tax savings to be had in these situations. Large amounts of money can be put away for retirement since, in some cases, you have doubled the allowable limits. A SIMPLE plan just by itself creates \$9,000 in retirement savings on a spouse earning \$10,000. Other, more extravagant, retirement plans can allow even higher amounts.

Other employee benefits, such as health insurance, can also be assigned to the spouse. You can save the 15% SE tax by having these employee benefits assigned to the spouse. HSAs or Medical Reimbursement Plans can also be used. Watch out for rules and paperwork. You need to follow the rules carefully to get the deduction. Having other employees can also add confusion, as they may have to be treated the same as the spouse. Examples of this are the Medical Reimbursement Plan or complex retirement plans. Health insurance plans can no longer discriminate. Health insurance companies have their own rules about who gets covered.

It's also important to treat the spouse as a regular employee. Wages must be justified for the amount of work being performed. W-2s are required, along with all the related paperwork. Workers Comp Insurance may also be required. If you already have other employees, these costs and hassles may be negligible. If the spouse is the only employee, be sure you are saving enough in other areas to cover the added costs.

Try not to be too creative. It is hard to justify paying a spouse \$40,000 when he/she already has a full-time job elsewhere. Wages must be appropriate for the work performed.

Children on the payroll are similar to the spouse. SE tax and income tax can be saved on minor children. You need to prove that they earned it. Four-year-old kids cannot answer the phone or file paperwork. Use common sense. The children and the spouse need to work for and earn whatever you pay them.

REDUCE AND ELIMINATE INTEREST EXPENSE

I have worked on thousands of tax returns in my 40+ years. The people who do well financially are the people who earn interest income rather than paying out interest expense. Credit card interest and car loans are both terrible and should be avoided at all costs. They are at a high interest rate and are nondeductible. Student loans aren't so bad. They can sometimes be at very low rates and are deductible. The rules have been changed allowing you to deduct more of your student loan interest.

Mortgage interest is hard to avoid, but can be minimized. Make extra principal payments, even small amounts. The interest expense saved on just one \$50 dollar extra principal

payment at 5% for 30 years is \$75. That is without compounding. Paying early each month can also help. Splitting payments where you pay half on the 1st of the month and half on the 15th of the month can cut years off a 30 year mortgage. Be sure your lender understands what you are doing and approves it. Some lenders have rules that do not allow these types of payments. Of course, 15 year mortgages are better than 30 year. But the monthly payment goes way up too. Some people can't afford that large of a payment.

Please note that interest paid on a home equity line of credit is no longer deductible starting in 2018.

RENTAL INCOME

Rental income is the best income there is. There is no FICA tax. Increasing property values are not taxed until you sell, and then at low rates. Rentals can be set up to make money cash-wise each year, but show a loss on paper. This generates tax savings each year. All that being said, I could never be a landlord. There are frustrations and hassles that I could not handle. Be sure you are up to the challenge.

If you use a management company to avoid the hassles, they will make money, but you may not. Owner occupied rentals, such as a duplex where you live in half, can work well. On-site landlords get better tenants. Problems are minimized because you are there every day. Stay on the high end of the rental scale. You get better tenants and have less problems.

Put money back into the property each year. Find things to fix and improve. It gives you a tax deduction. It is a good excuse to get inside the apartments to see how well the tenant is taking care of things. It also shows that you care about the condition and upkeep. Tenants will show the same respect for the property that you do.

RETIREMENT

Roth IRA's are tremendous. Pay tax today on a small amount, have no tax later on a large amount. Try to get some money in Roth each year, even if it means cutting back on the 401(k) at work or using a Roth 401(k). Not all employers offer it but it can be an attractive retirement tool for certain people. It will be nice at retirement time to have two separate piles of cash. One is fully taxable. One is not. You will be able to control your tax life better if you have these options.

I envision a time in the not too distant future where they will stop letting you put new money into Roth. The old stuff will still be good, but they won't allow any new money. The government is giving away future tax revenue to get a small amount now. At some point they will realize their mistake.

Converting old IRA money into Roth can also be a good idea. It depends on your individual tax situation. Partial conversions can be done, especially in years when other income is low. Conversions can be painful today, but can pay off nicely in the long run. Be sure your tax situation is appropriate for a conversion.

YEAR-END TAX PLANNING

Self-employed people can delay taxes due by postponing income until after the end of the year and writing checks for as many business expenses as possible before year end. Cash basis means that whatever happens in the checkbook is the deciding factor. Bill people late in December so that they will not pay you until early January. Stock up on postage and office supplies. By doing this every year, you keep pushing back the deadline for paying your tax.

QUICKBOOKS

I think QuickBooks is the best computerized bookkeeping software on the market. It works well for many businesses. Businesses need to keep financial records for IRS. Someday you may need these records for the bank or to show to a prospective buyer of your business. It is hard, if not impossible, to create three years' worth of profit and loss statements if you haven't been doing it as you go along.

QuickBooks keeps track of income and expenses. It balances your checkbook. It gives you credible profit and loss statements. It tracks assets, loans, payroll taxes payable and amounts owing on credit cards. It allows you to do analysis of your business operation, such as comparing income and expenses for the first six months of this year to the first six months of last year. Or perhaps to the last six months of last year. Or to your budgeted amounts. This can be a very valuable exercise.

TAKING ADVANTAGE OF ANNUAL GIFTING AND YOUR LIFETIME EXCLUSION

Not very many people end up paying estate taxes when they die. You need an estate of at least several million dollars. That amount is referred to as your Lifetime Exclusion. It is getting bigger each year, so less and less people have to worry about this rather large tax. For those of you who do fall into this group, there are ways to minimize the estate tax.

Annual gifting is a technique whereby the taxpayer gifts to each of his children \$14,000 each year. His spouse is also allowed to give \$14,000 to each child. They both can come along and give another \$14,000 each to the spouse of their child. That is a total of \$56,000 to each of the siblings. There is no tax on this. There are no tax forms to fill out. The best part of this

strategy is that it actually reduces the estate by more than \$56,000 because it also takes away any future appreciation of that cash, or stock, as the case may be.

Using up the Lifetime Exclusion is more complicated. This involves filing a gift tax return to report the gift. There is no tax, but you need to show IRS that you have used up part of your Exclusion. Some people are hesitant to use this up, but in reality you have nothing to lose. You either use it up now, or use it up later. My philosophy is that it is worth more now because you are also gifting away the future appreciation. A gift of \$1 million today reduces your estate by \$1.5 million or even \$2 million, depending on how much longer you live.

I have only touched the surface in this discussion. There are much more complicated methods available for reducing estate taxes.

AUTO EXPENSES: MILEAGE VS. ACTUAL

Taxpayers are allowed to deduct 53.5¢ for all business miles driven in 2017. The 2018 rate is 54.5¢. Taxpayers are also allowed to keep track of actual auto expenses and deduct whichever is greater. My analysis has shown that the mileage method almost always comes up with the greater deduction.

No matter which method you choose, you must keep a mileage log. Actual expenses need to be reduced by the personal use percentage. Depreciation is also very limited, and must be reduced for personal use. The limit on depreciation is why the mileage method comes out greater.

Please note that recordkeeping for the mileage method is much simpler. The mileage method also helps out people like me. I sometimes use my wife's car for business. Business miles are business miles, no matter which car I drive.

SALE OF RESIDENCE

The IRS changed the sale of residence rules several years ago. The old rule said you had to reinvest the proceeds of the sale into a new home. That is no longer true.

The new rule is that all profit is tax free, up to \$500,000. You must have lived in the house for at least five of the previous eight years. It doesn't matter if you buy another house or not. Also, you don't have to be 55 or older, like in the old days.

THE FUTURE

Congress makes the tax laws we live with. They use tax law to encourage certain behavior. The trends recently have been to encourage retirement savings, saving and spending for college and families with children. Retirement and education are both nice ways to reduce your tax bill. Review the different options and you may find a way to save yourself some money.

Please note that everything discussed does not apply to everyone. Each taxpayer is different. You need to look at each topic in the context of your own financial situation. I have tried to generalize my ideas to show what works for many people. Please be careful when translating these ideas to your own tax return.

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