The Norton Tax Bulletin

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August 23, 2019

Business vs. Hobby Activities; Virtual Currencies – IRS attack!; Tax Scams

Dear Clients, family and friends,

Taxpayers are often confused by the differences in tax treatment between businesses that are entered into for profit and those that are not profit-motivated, commonly referred to as hobbies. Recent tax law changes have added to the confusion.

Generally, when a taxpayer is pursuing a genuine business with a profit motive, the net profit or loss (*difference between gross receipts and business expenses*) are mixed with the taxpayer's other income. I am not addressing a passive business (*where the taxpayer does not materially participate in the business*). Rental properties in which the taxpayer hires a company to manage the property(ies) is an example of such a passive business. In those business, losses are generally not currently deductible but are carried forward to subsequent tax years to offset future profits (*income exceeds expenses*).

Hobbies are generally not pursued with a profit motive. Accordingly, the IRS and most states currently do not permit a taxpayer to deduct their hobby expenses but does require the income from the activity to be declared. That hardly seems fair! Before the passage of the recent tax act, a taxpayer pursuing a hobby was allowed to deduct the expenses they incurred in earning the hobby-related income (*limited to the amount of the hobby income)* on Schedule A as a miscellaneous deduction. For calendar years 2018 through 2025, the new Tax Act suspends miscellaneous deductions on Schedule A. As a consequence, taxpayers are required to report their gross hobby income on Schedule 1; however, none of the expenses are deductible on their Federal return. Most states, however, would permit deduction of those expenses (*again – limited to the amount of the gross hobby income reported*).

The effect of the new law makes it very important to carefully operate a business with profitability in mind.

So, *what distinguishes a business from a hobby*? Let's review the nine factors the IRS considers when making the decision. No single factor is decisive, but all must be considered together in determining whether an activity is for profit. The nine factors are:

(1) **Is the activity carried out in a businesslike manner?** Maintenance of complete and accurate records for the activity is a definite plus for a taxpayer, as is a business plan that formally lays out the taxpayer's goals and describes how the taxpayer realistically expects to meet those expectations.

(2) **How much time and effort does the taxpayer spend on the activity?** The IRS looks favorably at substantial amounts of time spent on the activity, especially if the activity has no great recreational aspects. Full-time work in another activity is not always a detriment if a

taxpayer can show that the activity is regular; time spent by a qualified person hired by the taxpayer can also count in the taxpayer's favor.

(3) **Does the taxpayer depend on the activity as a source of income?** This test is easiest to meet when a taxpayer has little income or capital from other sources (i.e., the taxpayer could not afford to have this operation fail).

(4) **Are losses from the activity the result of sources beyond the taxpayer's control?** Losses from unforeseen circumstances like drought, disease, and fire are legitimate reasons for not making a profit. The extent of the losses during the start-up phase of a business also needs to be looked at in the context of the kind of activity involved.

(5) **Has the taxpayer changed business methods in an attempt to improve profitability?** The taxpayer's efforts to turn the activity into a profit-making venture should be documented.

(6) **What is the taxpayer's expertise in the field?** Extensive study of this field's accepted business, economic, and scientific practices by the taxpayer before entering into the activity is a good sign that profit intent exists.

(7) **What success has the taxpayer had in similar operations?** Documentation on how the taxpayer turned a similar operation into a profit-making venture in the past is helpful.

(8) **What is the possibility of profit?** Even though losses might be shown for several years, the taxpayer should try to show that there is realistic hope of a good profit.

(9) **Will there be a possibility of profit from asset appreciation?** Although profit may not be derived from an activity's current operations, asset appreciation could mean that the activity will realize a large profit when the assets are disposed of in the future. However, the appreciation argument may mean nothing without the taxpayer's positive action to make the activity profitable in the present.

There is a presumption that a taxpayer has a profit motive if an activity shows a profit for any three or more years within a period of five consecutive years. However, the period is two out of seven consecutive years if the activity involves breeding, training, showing, or racing horses.

IRS going after taxpayers identified as having virtual current transactions

I spent time in a prior newsletter discussing the treatment of transactions in virtual currency (*such as Bitcoin).* The IRS considered such "currency" as personal property. When you buy it, whatever you paid for it becomes its "cost basis." When you sell the currency (*which includes giving it up in exchange for other property – meaning that the value of the property or credit received represents the amount received*), the difference between what you paid for the currency and what you received for it is taxable as either a short term or long term gain depending upon whether it was held for more than a year.

So, since there is a belief that many taxpayers have failed to properly account for their virtual currency transactions, the IRS on Friday said it was sending thousands of letters to taxpayers who failed to report virtual currency transactions, saying they may owe taxes. The IRS is

mailing out over 10,000 letters in July and August to taxpayers they have identified as suspecting they have unreported transactions.

Taxpayers who step up and correct their returns before an IRS audit begins generally will avoid the 20% accuracy penalty, or even the 75% civil fraud penalty (*assessed when the IRS deems that a taxpayer's failure to properly report income or deductions was intentional*). The IRS advised taxpayers who receive this letters to take them very seriously. A taxpayer, who is offered the opportunity to correct a prior tax year's filing yet fails to do so could find themselves in very hot water with the agency.

The IRS announced in July 2018 that it would begin a series of compliance campaigns on U.S. taxpayers to "*collect tax on worldwide income from all sources*", including transactions involving virtual currency. If you have been dealing in virtual currencies and have not reported transactions, now it is the time to step up to the plate and amend the returns. Again, amending *BEFORE* the IRS gets involved can avoid penalties in most cases.

Looking ahead to 2019

There were a significant number of new law changes that affected the 2018 returns. There are a number of tax return elements such as the standard deduction, contributions to retirement plans, and tax rates that are annually adjusted for inflation. Other tax law changes are delayed and take effect in future years. Further adding to uncertainty, Congress is considering the retroactive extension of some tax provisions that expired after 2017 as well as proposing new tax legislation. However, Congress has not done much of anything for some time, so I would not hold your breath waiting for these possible changes.

Here are some items that might affect your 2019 return:

1. **Solar Credit** – Although the solar credit remains at 30% for 2019, the credit rate will drop to 26% in 2020. This means that for each $1,000 spent on qualified solar property, the credit will be $40 less in 2020 than if the expense was paid and the credit claimed in 2019. The solar credit is a non-refundable credit. This means that it can only offset your tax liability, but the unused credit can carry over to a future tax year as long as the credit is allowed; it is currently scheduled to end after 2021. Salespeople like to push taxpayers into investing in solar (*and other items*) stressing that there is a credit available. Just be careful as the credit could end up not being fully usable.

2. **Plug-In Electric Vehicle Credit** – Although the credit amounts have not changed, the credit begins to phase-out for each manufacturer after it produces its 200,000th qualifying vehicle. For example, the very popular Tesla vehicle did qualify for the full credit in 2018. However, Tesla has entered the phase-out stage, and for 2019, the credit is only $3,750 for purchases in the first 6 months of the year, then drops to $1,875 for vehicles bought through the rest of 2019 and is zero for post-2019 purchases. If you are contemplating buying a plug-in electric vehicle, check the IRS website for the current credit by manufacturer.

3. **Penalty for Not Being Insured** – The Affordable Care Act required individuals to have health insurance and imposed a "shared responsibility payment" – really a penalty – for those who didn't comply. The penalty could have been as much as $2,085 for most families. That penalty will no longer apply in 2019 or the foreseeable future. However,

California has decided to penalize CA residents who do not have health insurance. So, if you live in California and decide *not* to purchase health insurance, you could be facing a penalty. Other states may follow CA's lead.

4. **Medical Deductions Further Restricted** – Unreimbursed medical expenses are allowed as an itemized deduction to the extent they exceed a percentage of a taxpayer's adjusted gross income (AGI). As part the Affordable Care Act, Congress increased that percentage from 7.5% to 10%. That increase was temporarily rescinded in the most recent tax form. However, starting with the 2019 returns and for the foreseeable years, the AGI medical floor will be 10% of AGI. This is where the "bunching" strategy may benefit your ability to deduct medical expenses. This means paying as much of your medical expenses as possible in a single year so that the total will exceed the AGI floor and your overall itemized deductions will exceed the standard deduction.

   To illustrate, let us assume that you are considered some procedure that will cost you $15,000. The provide will allow you to pay this in installments over several years. If you accept the opportunity, you will spread the payments out over several years and may not exceed the medical AGI floor in any given year. However, by paying all at once, you will exceed the floor and get the benefit of a medical deduction.

5. **New Alimony Rules** – For divorces and separation agreements entered into after 2018, the alimony paid by one ex-spouse is not deductible, and the alimony received by the other ex-spouse is not taxable. In addition, the alimony recipient can no longer make an IRA contribution based on the alimony received.

   It is important to understand that this treatment of alimony only applies to alimony payments paid under agreements entered into *after 2018* or under prior agreements modified after 2018 that include this new provision. For agreements entered into before 2019 that haven't been modified, the old rules continue to apply: the alimony paid is deductible, and the alimony received is included in income. Also, an IRA deduction can be made based upon the taxable alimony received.

6. **Standard Deduction** – The standard deduction, which is inflation adjusted annually, is used by taxpayers who do not have enough deductions to itemize. For 2019, the standard deductions have increased as follows:

   • **Single:** $12,200 (up from $12,000 in 2018)
   • **Married filing jointly:** $24,400 (up from $24,000 in 2018)
   • **Married filing separately:** $12,200 (up from $12,000 in 2018)
   • **Head of household:** $18,350 (up from $18,000 in 2018)

   Individuals who are blind and/or age 65 or over are allowed standard deduction add-ons. These add-ons are for the taxpayer and spouse but not for dependents. The add-on amounts are $1,300 for those filing jointly (*unchanged from 2018*) and $1,650 for all others (*up from $1,600 in 2018*).

7. **Increased Retirement Contributions** – All IRA and retirement contributions are subject to inflation adjustment, meaning the allowable amounts may be increased each year. This gives you the opportunity to increase your retirement savings in 2019.

• **Simplified Employee Pension (SEP) Plans** – The maximum amount for 2019 is $56,000 (up from $55,000 in 2018).

• **Individual Retirement Accounts (IRAs)** – For both traditional and Roth IRAs, the maximum contribution has been increased to $6,000 (up from $5,500 in 2018). This is the first change to IRAs since 2013. The additional amount taxpayers age 50 and over can contribute remains unchanged at $1,000.

• **401(k) Plans** – The maximum employee contribution has been increased to $19,000 (up from $18,500 last year). The additional amount for taxpayers who've reached age 50 remains unchanged at $6,000.

• **Simple Plans** – The maximum elective contribution is $13,000 (up from $12,500 in 2018). The additional amount for taxpayers age 50 and older remains unchanged at $3,000.

• **Health Savings Accounts (HSAs)** – Although meant to be a way for individuals covered by a high-deductible health plan to save money for future medical expenses, these plans can also be used as a supplemental retirement plan. Contributions are deductible, earnings accumulate tax-free, and if distributions are used for qualified medical expenses, they are tax-free. However, when used as a supplemental retirement plan, the distributions would be taxable. The following are the contribution limits for 2019:

o Self-only coverage: $3,500 (up from $3,450 last year)
o Family coverage: $7,000 (up from $6,900)

8. **Federal Tax Brackets** – The tax brackets were inflation adjusted (by approximately 2% over the 2018 brackets), meaning more of your income is taxed at a lower bracket in 2019 than it was in 2018. As an example, here are the brackets for 2019 for taxpayers using the single filing status:

• **10%:** $9,700 or less
• **12%:** More than $9,700 but not more than $39,475
• **22%:** More than $39,475 but not more than $84,200
• **24%:** More than $84,200 but not more than $160,725
• **32%:** More than $160,725 but not more than $204,100
• **35%:** More than $204,100 but not more than $510,300
• **37%:** Applies to taxable incomes of more than $510,300

These are the brackets for married taxpayers filing jointly:

• **10%:** $19,400 or less
• **12%:** More than $19,400 but not more than $78,950
• **22%:** More than $78,950 but not more than $168,400
• **24%:** More than $168,400 but not more than $321,450
• **32%:** More than $321,450 but not more than $408,200
• **35%:** More than $408,200 but not more than $612,350
• **37%:** Applies to taxable incomes of more than $612,350

For other filing statuses, see Revenue Procedure 2018-57.

Note: These are step functions, so for example, the first $9,700 of taxable income is taxed at 10%, the next $29,775 ($39,475 − $9,700) is taxed at 12%, and so forth.

IRS Tax Scams

The Internal Revenue Service is warning taxpayers and tax practitioners about an email phishing scam in which criminals are impersonating the IRS, sending unsolicited emails with subject lines like "*Automatic Income Tax Reminder*" or "*Electronic Tax Return Reminder*" that appear to come from the IRS. This appears to be a variation on a prior e-mail scam. By the way – in case you are unfamiliar with the term "*phishing,*" it is the process of attempting to acquire sensitive information such as usernames, passwords and credit card details by masquerading as a trustworthy entity using bulk email which tries to evade spam filters. The IRS is reminding taxpayers that it doesn't send unsolicited emails and never emails taxpayers about the status of their tax refunds.

These phishing emails include links that show an IRS.gov-like website with details purporting to be about the taxpayer's refund, electronic return or tax account. The emails contain a "*temporary password*" or "*one-time password*" to "access" the files to submit the refund. But when a taxpayer takes the bait and clicks on the link, it turns out to be a malicious file that can install itself on the unsuspecting taxpayer's computer.

IRS Commissioner Chuck Rettig stated, *"The IRS does not send emails about your tax refund or sensitive financial information. This latest scheme is yet another reminder that tax scams are a year-round business for thieves. We urge you to be on-guard at all times."*

The new scam illustrates the growing sophistication of cybercriminal organizations. The scam now relies on dozens of compromised websites and web addresses that pose as the real IRS website – *www.irs.gov* - making it a challenge to shut down. By infecting computers with malware, these impersonators can get control of a taxpayer's computer or secretly download software that tracks every keystroke, eventually giving them access to passwords to sensitive accounts, such as financial accounts. This illustrates why it is so important to install effective anti-virus software to help prevent malicious files from being downloaded and installed on your computer!

This is important! The IRS will never initiate contact with taxpayers via email, text message or social media to ask for personal or financial information. That includes requests for PIN numbers, passwords or other access information for credit cards, banks or other financial accounts.

The IRS also doesn't call taxpayers to demand immediate payment using a specific (*and most often a very unusual*) payment method such as a prepaid debit card, gift card or wire transfer. The IRS typically will first mail a bill to a taxpayer who owes taxes. If you get a suspicious call, get the caller's contact information and give it to me. I can easily chase it down to see if it is legitimate or a crook.

As I covered in the past, the IRS has contracted with several private collection agencies to assist with the collection of the smaller, older delinquent accounts. In all cases, the taxpayer first will

be sent a letter advising them that their account has been assigned to a private collection agency and tell them which agency. These agencies have limited authority – and no enforcement capability (*meaning, they cannot levy financial accounts or employers, seize personal property, or file Federal tax liens*). The collection agency will try to get the delinquent taxpayer to enter into an installment agreement (*payment plan*) to address the outstanding liability.

If you have not received a letter advising you of the assignment of your account to such an agency, *and* you get an unsolicited call from someone alleging to be from a private debt collection company, your best action would be to get the company and employee's contact information, then hang up and call the IRS to find out for sure if this company does have the authority from the IRS to negotiate with you. As mentioned above, you can always call me. If it is bogus, I will submit the information through channels.

For more information and to report attempts to steal your information, you can google the IRS's web page on how to report phishing and online scams.

I hope that you find the information in this newsletter of value to you.

Very truly yours,

Dick Norton

> ***This newsletter is not intended or written by me to constitute written advice that you may rely upon to avoid penalties that may be imposed by any taxing authority. An attorney should always be consulted in matters involving legal issues such as those inherent in estate planning or other matters where an attorney is best qualified and authorized to provide such guidance.***