The Norton Tax Bulletin

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Dear Clients, family, and friends,

I thought I would take a little time to address some topics that I think are of interest and importance, especially for self-employed clients.

What you may notice above is the new address!! Yup! We are officially in our new home in Santa Clarita, CA. I am able (so far) to use the same phone numbers which I will explain in more detail later.

Documenting Business Miles

Being able to write off a portion of the expense of your personal vehicle used for business is a great way to reduce taxes. The IRS, in recognizing that the cost of gas has skyrocketed this year, opted to increase the per-mile optional deduction for business use of a vehicle from 58.5 cents to 62.5 cents per mail for the last 6 months of 2022. In my opinion, that was not enough of an increase.

For *self-employed taxpayers, this business usage is deductible for both the Federal and most all state tax returns against your gross receipts which reduces both income tax and the Federal self-employment tax. However, for employees, the deduction for business use of your personal vehicle (or any other expenses for your employer) is no longer allowed on Federal returns*; many states, including California, did not adopt the Federal rules and as such, employee business expenses (*of which one is personal auto usage*) remains a deduction, although it is taken as an itemized deduction.

There are some rules you need to follow if you are going to be allowed to keep the deduction in an audit. One critically important rule is that you must maintain and be able to present to an IRS examiner contemporaneous records of your business trips. Contemporaneous means "*recorded at the time the expense is incurred*." If you do not keep records of your daily driving of your car or truck, then forget about the deduction.

You can get a mileage log at Staples or other similar stores. There are also apps that can be very useful in tracking your daily usage. Whether you use a manual log or an app, you are going to be recording your commuting mileage, business mileage and personal mileage.

Commuting mileage – this is the miles driven from home to your first job site or office. It is also the miles from your last business stop (or office) back to home.   To record *commuting mileage*, you simply write in your appointment calendar (*or other daily record or digital app*): home to office, 10 miles, commute. Unfortunately, commuting miles are not deductible. But with careful planning, you can change the character of the mileage so that some or all of those miles are deductible as business miles and not deemed commuting miles.

How can we eliminate commuting and make those trips from your home to your office deductible?

The law gives you two ways to eliminate treating those miles from your home to your outside-the-home office or client as commuting miles:

- Make a temporary business stop on the way to the office.
- Establish a home office that qualifies as a principal office.

Temporary Business Stop

The temporary business stop strategy is designed for the home that contains *no home office*. In this case, the stop turns a commute from your home to the office into a partially deductible business trip.

Example 1. Jack, a property and casualty insurance agent, does not claim a home-office deduction. He must photograph a property before the insurance company will issue the policy. Sam's trip from his home to the property is commuting, and from the property to his downtown office are deemed business miles.

Example 2. Jack, the guy from Example 1, drives directly from his home to his downtown office. That's a non-deductible commute. Be careful! This gets tricky. If your only office is in your home and that office does not qualify as a principal office (*for example, you use a common area or a separate room part time as a home office*), then the IRS labels your trip from your home to a business stop as your "first stop," and that trip is a non-deductible commute.

Example 3. You have an office inside your home that does not qualify as a principal office, and you have no office outside the home. You drive 17 miles to a business stop and then return home. Because your only office is inside the home and *it does not qualify as a principal office,* your 34-mile round trip is a personal non-deductible commute under the IRS's first and last stop rule.

Planning your trip so that your first stop is a local supply store to get some supplies will help you be able to deduct the miles from the store to the office as business miles.

Home-Office Solution

If you have both a downtown office and a qualifying principal use office inside your home, you have no commuting mileage from your home to, say, a downtown office that is not a principal office. Some references I have read state that you do not need to actually work (*start your business day*) in your home before you leave for your first stop. You simply need an office in the home that qualifies under the law as a principal office. In fact, the IRS provides this example in Publication 463 that discusses travel, gift, and car expenses:

> *"Example 2. Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business."*

I do not necessarily agree with that. My training was that the individual actually had to start his or her day in the home office – such as dealing with e-mails, or simply printing out the day's calendar for the stops to be made.

Example 4. You have an administrative office in your home that qualifies as a principal office. You drive 11 miles from your home to your non-principal downtown office, work all day in your downtown office, and then drive the 11 miles from your downtown office back home. This 22-mile round trip to and from your downtown office is deductible as business mileage. Key point here – the office downtown is NOT your principal office location. To illustrate this point, consider the activities of a traveling salesman who operates primarily from his home office, but goes to his distributor's office location once a week to do reports, submit orders, pick up items and do other paperwork the distributor requires.

When you compare the two methods for eliminating commuting, you can see that establishing the administrative (principal) office in the home is the easy answer.

Other Trips

What happens to those trips that begin and end at your downtown office?

If your trip from your downtown (principal) office is to a business stop, you have deductible business mileage. If it's to a personal stop, you have personal mileage. If the trip from your office involves both business and personal stops, *and if the personal stops are not too far out of the way*, you can ignore the personal stops and count all the mileage as business.

Example 5. You drive 10 miles to Staples to buy office supplies, but on the way, you take a 1-mile detour to pick up your dry cleaning. Thus, the direct trip to this business stop was 9 miles and your round trip on this day is 19 miles. The 1-mile detour is considered de minimis (*in other words, minor*). You may count the entire 19 miles as business miles.

In your mileage record, you would write something like this: *round trip to Staples for office supplies, 19 miles (1- mile side stop at dry cleaners, minor).*

Sampling Method

You should make your notations as to business and personal miles for a minimum of *three consecutive months* during the year so that you can comply with the easy requirement for mileage log sampling under IRS Regulation 1.274-5T(c)(3)(ii). However, here is something to consider. Keeping the mileage log for three months may be sufficient for surviving an audit, but keeping the mileage log for the entire year is far more persuasive – and may actually yield a higher deduction.

Quick Checklist

You have deductible mileage when you drive from your home to a business stop (*such as visiting a prospect or colleague*) and then drive from that stop to your downtown office; drive from your home, which contains a "principal office" to your downtown office; drive from your downtown office to a business stop; drive from one business stop to another business stop; or drive from one business stop to another business stop and make a de minimis (*minor*) out-of-the-way personal stop.

You have personal, *non-deductible mileage* when

(a) you drive from your home to a business stop and return home (*assuming no principal office inside the home);*
(b) drive from your home to your first business stop and from your last business stop back home (*assuming no principal office inside the home and no stop at your downtown office*); or
(c) drive from your home to your downtown office (*assuming that you have no principal office at your home*).

Clearly, you eliminate a big chunk of personal mileage when you establish a principal office in the home. Having an administrative office is an easy way to build a principal office in your home

Keeping detailed records of the trips you make will be key in being able to support your business mileage deduction in an audit. As I mentioned before, there are apps that can make this task a bit easier. However, remember to download or print out from the app all records of your trips frequently as cell phones have a habit of dying or being lost or stolen.

This category of expense is a highly targeted item for IRS Agents. So, be prepared to substantiate (support) the deduction you claim on a tax return.

Quick Overview on Home Office Requirements

I talked a lot about having a Home Office. There are special rules concerning a qualifying home office. Most importantly, that office space (*generally a separate room, like a converted bedroom*) must be used REGULARLY and EXCLUSIVELY for your business. You cannot qualify common spaces like a dining room, living room or kitchen table as a "home office" because they are mixed-use spaces. The home office must be easy for the IRS (*in an audit*) to see and measure.

The time is ripe for sharing the IRS guidance on a qualifying home office:

> *If the exclusive use requirement applies, you can't deduct business expenses for any part of your home that you use both for personal and business purposes.*

For example, if you're an attorney and use the den of your home to write legal briefs and for personal purposes, you may not deduct any business use of your home expenses.

Further, under the principal place of business test, you must determine that your home is the principal place of your trade or business after considering where you perform your most important business activities and where you spend most of your business activity time, in order to deduct expenses for the business use of your home.

A portion of your home may qualify as your principal place of business if you use it for the administrative or management activities of your trade or business and have no other fixed location where you conduct substantial administrative or management activities for that trade or business.

Here is something to remember: if you set up a home office, *be sure to take pictures of it and save them!!* Remember that the IRS has 3 years to audit a federal return; most states have 4 years. You may sell or reconfigure your space between the time you file your return and you receive the dreaded audit notice! If you no longer have access to a former home office, your deduction is in danger of being disallowed.

You should expect that if your return is selected for audit, that any claimed home office deduction will be investigated by the agency since there has been a lot of abuse with taxpayers claiming the deduction when they do not meet the requirements. That is why having pictures of the home office – *together with its measurements as well as the total square footage of your property (including the home office*) – will be critical in an audit.

Here is a question I have been asked more than once.

If you have a large master bedroom or other room, and you purchase *tall dividers* to separate the business space or area from your sleeping or other personal space, *can you designate and use that space as a home office?*

Well, if it is done properly (*where there are room dividers with a space to enter and exit the specific area designated for your home office*), you *may* be allowed the deduction if that business space is used regularly and exclusively for your business (*no personal dresser or other non-business items located within that space*). But this type of space is clearly not as persuasive as having a separate room or structure that serves as your home office.

Here are a few examples of common space divided into a home office section:



In each of these examples, it is fairly straight forward to see and measure the square footage of the area designated as the home office. *Is this an ideal scenario?* No, of course not. The IRS could argue about your placement of the divider – believing that it could be moved to make the space smaller and more reasonable (*thereby reducing the percentage of the home office space as compared with the entire space of the home*). But for those self-employed taxpayers who work from home and have a small home or apartment, this may be the only means to set up and deduct home office space. Again – take and keep pictures of the space!!! Measure the space as well and keep that information with the pictures along with information on the total square footage of the apartment or home.

A friend of mine had built a 1-room office on his property (*about 20 x 20 – double garage size*) where he met with clients and conducted his work. Clearly, that structure met the separate business space requirement, and he used that

1-room space exclusively and regularly for his business. He would have little difficulty prevailing in having that space designated as a qualified home office.

<u>Number Barn</u>

So, you are asking yourself, *what the heck is number barn?*
Here is the scenario. We lived in Burbank for 52 years and had the same land-line phone number for over half a century. That number is everywhere – medical providers, family, friends, etc. Now that we are in Santa Clarita (*area code 661 vs 818*), ATT told me that we cannot transfer our existing land line number to our new home. Bummer. The area codes are physical barriers – you cannot drag an 818 number across the barrier into 661 territory. So, I told my wife that will be a major headache changing our home number with dozens and dozens of people and service providers.

I went to Spectrum to see if VOIP (*voice over internet protocol*) could handle crossing the area code invisible barriers. They first told me yes, and then when I told them let's do it (*give me a VOIP number the same as my Burbank number*), it turned out they had the same barrier.

Sheesh – it appeared I was stuck. So, I started doing a bit of research and discovered that I could "port" (*means move and park in Internet lingo*) my Burbank number to ***<u>Number Barn</u>***, and then they can do a *"forever forwarding"* to our number here in Santa Clarita (*a 661 home phone number with Spectrum VOIP).* To the caller, they are doing what they have for 50+ years – calling our existing home phone number – but behind the scenes, that call is being re-routed to our new area code 661 home number here. Problem solved.

Now, if we initiate a call out from here on this VOIP *(area code 661 line*), the Caller ID will show the "661" area code number which could be confusing to some. But I can live with that for now. I have not figured out how to override Spectrum's VOIP for a custom Caller ID. That may well be possible. I plan to do the same with the area code 818 business line in Burbank. But I can't do it yet since I need to keep that number active as the ATT UVERSE for that house – *which is the Internet that runs security cameras, etc)* – has to be left alone until the house is sold.

So, I canceled the old Burbank ATT land line yesterday since the phone number is now ported and active. I no longer need to spend $80 a month on that land line for Burbank. The Number Barn fee is $6 a month, and the Spectrum, VOIP line is less than $20. In my mind, it is not a big deal to be able to keep our existing Burbank home phone number. And with the combination of the Number Barn and VOIP cost, my new home number is costing me about a 1/3 of the hard wired ATT landline.

Before you run out and cancel your landline, you need to realize that in the case of a major earthquake or event that interrupts power or internet service, the VOIP will not work *(unless you have a UPS (uninterruptable power supply – a battery backup).* Even still, Internet could still be down. When we experienced the Northridge earthquake, VOIPs were down, and cell phone service was spotty due to system overload. But I was able to immediately call my mom on the landline. We both had an ATT landline – and it was not dependent on the Internet or 110V. One additional caveat – if you have an electronic phone connected to the landline, then you are up a creek if you lose power. So, we always had an old fashion manual pushbutton dialer phone in the garage attached to that landline just for an emergency. No 110V required.

I share this information with you in case in the future, you hear that a family member, friend or co-worker who is moving to another area code and would like to keep their number. It can be done using Number Barn. I will share that there are other companies that do a similar job as Number Barn of porting numbers, but Number Barn appeared (*from my research)* to be the best option. I can tell you it was a very smooth process. From the time I signed up until it went active, it took about 5 days. The delay was on ATT's end doing the porting of our Burbank number.

There is another caveat. The number you want to port ***<u>must still be active with the carrier so it can be ported</u>***. So, if you cancel your home phone service and then try to port the old number, you are out of luck. That is why I waited to cancel my monthly billing for the home number in Burbank until the process was complete. I confirmed that the process was done by calling the old home number from my cell phone while sitting in my office in Santa Clarita and the phone here (*connected to Spectrum VOIP*) rang. It worked as advertised.

Is Spectrum VOIP any good? Well time will tell. I know that VOIP used to be scratchy at times and had dropped calls and other issues. I would expect that has ISPs upgraded their equipment that it would have improved. So far, calls I have made on the VOIP Spectrum line have been as clear as with the ATT landline in Burbank.

For my office, I opted to use the ATT U-verse VOIP service as with the Internet, U-verse is (*in my experience*) a more solid connection. I have spent a number of hours on my U-verse VOIP and it has been flawless (*so far*). Time will tell whether it can continue to perform as well. I am anxious to terminate that 2nd landline in Burbank, but alas – that will have to wait until the house is sold.

Since I am on the topic of communication, I want to say a few words about faxing. I used to have a third landline in Burbank dedicated to my fax machine. Most people know that you generally cannot fax over VOIP, so I was stuck paying about $60 a month for nationwide calling on the fax landline. Then I discovered a service called **HELLO FAX**. It is a service that lets you receive faxes in your e-mail box and send faxes through their online portal. They were able to port my fax existing fax number, so I did not have to change it on business cards, letter heads, etc. I think I am paying $15 a month. The only trick is that you need to be able to scan what you want to send into a PDF format. Then you upload it and send it as a fax. The receiving party has no clue that it was electronically sent. It is working well, and of course, nothing was required to continue using it when we relocated to Santa Clarita.

That was a fun diversion from a tax topic. But since I have been dealing with this, it seemed appropriate to share what I have learned with all of you.

Massive IRS Hiring

You have read or heard the news – the staff of the IRS will exceed in size the armed forces of Great Britain. Then there are rumors that these are armed agents with AR 15's that are going to hunt down wayward taxpayers!! We, we will have to see where this all goes and how it gets implemented. There are some myths I want to address. Revenue Agents and Revenue Officers – *the largest groups of field personnel visiting taxpayers for audits and collection activities* – are not armed. Yes, they carry a sharp pencil, but that is it. These two categories of field employees are expected to get a big boost in hiring.

Special agents – another category of field personnel - by contrast are armed – usually with a 9MM semi0automatic handgun (*not an AR 15*). They carry a badge (*like a police officer or sheriff)* instead of a pocket commission that is carried by Revenue Officers and Revenue Agents. They often work in pairs, and if they knock on your door, once they identify themselves to you and you spot their weapon, chances are you are going to need a change of underwear. That is especially true if they start out by giving you your Miranda rights. There will be more of these armed guys (and gals) hired by the IRS. However, the average taxpayer will never come in contact with a Special Agent unless they do something really stupid.

It takes months to hire and train new agents. So, I do not expect much change in IRS operations for close to a year. But after that, notwithstanding what you hear in the media, I expect audits and collection activities to increase across the board – not just for the high-income earners. For those of us in my profession, we consider this the *Accountants Full Employment Act*. Yup – I expect the phones will be ringing off the hook beginning in about a year!

When I worked for the IRS, the average audit coverage was around 3% (that means 3 out of 100 returns were reviewed on the average). Certainly, lower income returns had a lower percentage of audit, and highly compensated taxpayers had a higher percentage of their returns audited. In recent years, the audit coverage has been less than 1% due in part to loss of staffing.

Doubling the size of the IRS means a dramatic increase in the number of returns that can be examined as well as delinquent accounts dealt with and collected. I recall decades ago – may have been during the Nixon era – where Forbes Magazine did a study on the IRS and made a projection that the IRS could be quadrupled in size (4 times….) and still not hit the point of diminishing marginal productivity *(where it is costing more to have an agent than he or she brings into the treasury from their efforts).* So, I think the current administration came across that article and opted to at least double the size of the IRS to provide revenue for their spending programs. We will see if the projected additional revenue exceeding the cost of their many programs plays out.

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

Very truly yours,

Dick Norton

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