Wander CPA

Tax-Saving Tips

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Tax Reform Cuts Business Tax Deductions for Charity Golf Outings

You likely know that the recent reform did away with business tax deductions for prospect and client golf. But did you know that charity golf is gone too? Buried in tax reform is the elimination of the 100 percent business deduction for charity golf and other special charitable sporting events.

To put this into perspective, let's say you are going with three clients to a charity golf event that's put on by a school, church, or registered 501(c)(3) organization such as the Red Cross or a cancer society. Your package cost for the foursome is $1,000.

Before tax reform, your tax deduction was $1,000, assuming you discussed business before, during, or after the event. The event was considered a business event not subject to the business entertainment tax deduction cut of 50 percent. Further, the deduction was not a charitable contribution for tax purposes, and thus you did not have to reduce your deduction under the charitable rules. This stopped on January 1, 2018.

Now you have no business deductions for participating in or attending a charitable sporting event. You have to claim charitable deductions instead, and that gives you a far smaller deduction than before.

Tax Reform Allows 100 Percent Deductions for Presentation Expenses

Tax reform did much damage to tax deductions for business entertainment and meal expenses. But meals served at business presentations survived the entertainment and prospect and client meal bloodletting. And not only did presentation expenses survive as deductions, but they also continue as 100 percent business expense deductions.

A good number of small businesses are going to rejoice over this. Let's look at some examples:

Example 1. Sam, a financial advisor, mails prospects an invitation to an educational dinner seminar. He does a one-hour presentation and then serves dinner to the participants. He spends $3,000 on the dinner and, as the tax code stands now after the new tax reform, deducts 100 percent of that $3,000 cost as a presentation expense.

Example 2. Linda, a real estate sales professional, holds an open house and serves wine and hors d'oeuvres. Under current tax law as before the new tax reform, Linda's expenses for the wine and hors d'oeuvres are 100 percent deductible as presentation expenses.

Example 3. George markets and sells real property near Phoenix to residents of Arizona. He acts as a broker for the owners of the real property and receives commissions based on sales. To find his prospects, George uses telemarketing and holds drawings for free trips to Hawaii at trade shows,

conventions, and the Arizona State Fair. George does not engage in any other form of advertising. He provides the dinners free of charge regardless of whether attendees purchase any property. The attendees must stay for the presentation. George does not eat free; nor do any of his employees. They are busy schmoozing and selling. The IRS ruled that George's dinners are not entertainment but 100 percent deductible presentation expenses.

Example 4. In Matlock, the court ruled that Matlock could deduct 100 percent of the refreshments he served to prospects during sales seminars he conducted in his home, because the refreshments were a cost of his sales seminar and not entertainment. Matlock sold solar heating and cooling systems. He installed a unit in his home and used the sales seminars in his home to demonstrate the system.

Example 5. IRS regulations state that the cost of a fashion show is not entertainment when put on by a manufacturer of dresses for its prospective store buyers. On the other hand, the IRS notes that an appliance distributor who conducts a fashion show for the spouses of his or her retailers incurs entertainment expenses.

Example 6. The IRS says that although attending a theatrical performance is generally entertainment, this is not true for a professional theater critic who attends in his or her professional capacity.

The key to this is the public. IRC Section 274(e)(7) exempts the presentation expense from classification as entertainment when it is an expense for goods, services, and/or facilities that you make available to the general public. Robert Matlock paid a telemarketing service to locate prospective customers. George found prospects at trade shows, conventions, and the state fair.

The first step to the 100 percent presentation expense deduction is that you are making your presentation to the general public.

If your audience is made up of relatives and close friends, they are not the public, but if your audience is made up of prospects with whom you have no personal relationship, they are obviously the public.

Tax Reform Really Did Eliminate Prospect and Client Meal Deductions

You likely have heard conflicting information on the deductibility of business meals with clients and prospects. We have spent time researching this issue, and our conclusion is that tax reform eliminated tax deductions for business meals with clients and prospects.

Before enactment of the Tax Reform Act of 1986, the business meal requirement, according to the Joint Committee on Taxation's Blue Book, allowed what we called a "quiet business meal" because you could deduct the meal and beverages without discussing business. Newspapers in New York and Washington, D.C., among other places, were calling this the "three-martini lunch" to highlight the fact that business need not be discussed.

The Tax Reform Act of 1986 did three things to client and prospect meals:

1. Reduced tax deductions for meals from 100 to 80 percent
2. Required you to establish that the meal was directly related to or associated with the active conduct of your business
3. Required you to prove that you had a substantial and bona fide business discussion during, directly preceding, or directly following the meal

The Tax Cuts and Jobs Act repealed all the requirements above, effective January 1, 2018.

The repeal means the rules that allowed the client and business meals when they're directly related to or associated with the active conduct of your business are now gone. Here are some examples of the way we see business meals after the recent tax reform:

- Sam owns a tax practice. He takes Silvia, a prospect, to lunch and pays for the two of them. Now, because of tax reform, this lunch is not deductible.
- Sara and Jim are both dentists in private practice. They go to dinner to discuss a new piece of equipment that could benefit their practices. They

each pay for their own meal. They get no deductions. Because of tax reform, Dutch-treat business meals are no longer deductible.

- Fred takes a client of many years out to dinner to help him with his business plans for this year. They review the plans in detail. The client picks up the tab. Fred's client may not deduct the business meal.

To see the changes in a technical way, let's review what tax reform did to make the business meal not deductible:

1. Removed directly related and associated entertainment from IRC Section 274(a)
2. Removed entertainment from the substantiation expense requirements of IRC Section 274(d)
3. Removed Section 274(n)(1), which applied the 50 percent rule to entertainment, from the tax code

I'm sure we can all agree that the loss of the meal is a sad deal. We hope lawmakers will reconsider and reinstate the client and prospect meal deductions.

Tax Reform Allows Bigger Vehicle Deductions

Finally, lawmakers did the right thing by increasing the luxury auto depreciation limits on business cars. The old luxury limits were unrealistic, punitive, unfair, and discriminatory against any car that cost more than $15,800. The new limits don't create parity in all respects, but they are a big improvement.

If you bought a car in 2017 and paid more than $15,800, you were driving a luxury car that lawmakers punished you for by putting a lid on your depreciation. For example, say in 2017 you bought a $40,000 car and drove it 100 percent for business. Your maximum depreciation deductions for the first five years would total only $15,060. To fully depreciate this car under the old rules would have taken 19 years.

It was ridiculous to take 19 years to depreciate that $40,000 car. And now, finally, lawmakers have fixed a big part of what the tax code calls "luxury automobile limits." Under the new law, this $40,000 vehicle is fully depreciated in six years. Think about that: old law, 19 years. New law, six years. Essentially, the new law sets the so-called luxury automobile limit at $50,000. This means any vehicle that costs $50,000 or less is not penalized by the luxury vehicle limits when you're using MACRS depreciation.

Under the new law, the annual limits are

- Year 1: $10,000
- Year 2: $16,000
- Year 3: $9,600
- Year 4 and each succeeding year: $5,760

What do the new limits mean? Before 2018, many business taxpayers were buying vehicles with gross vehicle weight ratings (GVWRs) greater than 6,000 pounds to escape the draconian luxury limit of roughly $15,000. Even today, SUVs, crossover vehicles, and pickup trucks can avoid the automobile luxury limits and even qualify for immediate write-offs of the full business cost using bonus depreciation or Section 179 expensing. Cars don't qualify for unlimited bonus depreciation or any added benefits from Section 179 expensing.

But the big deal is that because of the higher, more realistic luxury auto limits, there's far less need to buy the bigger, heavier SUV or crossover vehicle. With a car costing $50,000 or less, you realize 71.2 percent of your total vehicle depreciation deductions in the first three years.

Tax Reform Creates Desire for the C Corporation

When you first see that 21 percent tax rate for the C corporation, you have to think that this could be the choice of entity for your business operation. Further, when you find yourself in the out-of-favor group for the 20 percent deduction authorized by new tax code Section 199A, you naturally gravitate to thinking about the C corporation, perhaps as a means of getting even.

The table below gives you a good look at how you would pay taxes on your profits, depending on your Form 1040 tax bracket. In the S corporation column, we listed the tax rates by the brackets that apply to individuals. To see exactly how this table works, let's say that you are in the 34 percent tax bracket and have $100,000 in profits.

If you operate as an S corporation, the profits come to you on a K-1 and you pay your Form 1040 taxes at the 34 percent rate, for a total tax of $34,000 on your S corporation profits.

If you operate as a C corporation, the profits are first taxed at the C corporation level at a rate of 21 percent, for a tax of $21,000. This leaves you with $79,000 of the $100,000 in profits available for distribution as a dividend to you. You are in your "give me the money" mode, so to get the cash, you endure the double taxation, starting with the dividend tax of 15 percent. This creates an $11,850 tax ($79,000 x 15 percent).

Your tax bracket also triggers the net investment income tax (NIIT) that applies because of your dividend income. The NIIT is $3,002 ($79,000 x 3.8 percent).

As a C corporation, your total federal taxes on the $100,000 of income are $35,852, which consists of the following:

1. C corporation taxes of $21,000
2. 1040 dividend taxes of $11,850
3. 1040 NIIT of $3,002

Based on the same $100,000 in profits, operating as an S corporation results in $34,000 to the government compared with the C corporation, where you and the corporation combined pay $35,853. The winner: the S corporation.

You might ask: Why no NIIT on the S corporation profits? Answer: If the shareholder materially participates in the S corporation, the NIIT does not apply to the pass-through income derived from active business operations. In the table below, we treat you as materially participating in your S corporation.

Okay, with this background, you can see how the table below works. You simply compare column 1 (S Corp.) with column 2 (C Corp.) to see the percentage taxes on the profits. And you will note that in all cases, the S corporation pays less in taxes.

S Corp.	C Corp.	C Corp. Rate on 1120	Dividends on 1040	79% of Dividends	79% of 3.8% NIIT
10%	21%	21%	0%		
12%	21%	21%	0%		
22%	32.85%	21%	15%	11.85%	
24%	35.85%	21%	15%	11.85%	3.002%
34%	35.85%	21%	15%	11.85%	3.002%
35%	35.85%	21%	15%	11.85%	3.002%
37%	39.80%	21%	20%	15.5%	3.002%

So, based on the tax rates alone, you have no reason to switch to the C corporation because of the recent tax reform.

Does Tax Reform Dislike Your Reputation or Skill?

Here's a troubling thought. Did lawmakers put you in the out-of-favor tax group that denies you the 20 percent Section 199A deduction because

- your business makes too much money, and
- it does so thanks to the reputation or skill of one or more of the business's owners or employees?

Before going on, remember this: tax reform gives you the new 20 percent deduction on your qualified business income, regardless of whether you're in an in-favor or out-of-favor business, when your 1040 defined taxable income is $157,500 or less (single taxpayer) or $315,000 or less (married filing a joint return).

But when you are in the out-of-favor group, you get a zero Section 199A deduction on your qualified business income when your taxable income is greater than the thresholds above and your business pays no wages or has no qualifying property, or when your taxable income is greater than $207,500 (single) or $415,000 (married filing a joint return).

There are various groups and professions in the out-of-favor group that are easy to identify. But the "reputation or skill" group is not one of those. For example, will the new law treat the following as out-of-favor businesses because the reputation or skill of one or more owners or employees is the principal asset of the business?

- Real estate sales professional paid on a 1099
- Automotive repair shop run by one owner with no employees
- Local property and casualty insurance agent paid on a 1099
- Life insurance agent paid as a statutory employee
- Hairstylist who owns the shop where other stylists rent chairs

We don't know. Will the IRS come to the rescue?

At a District of Columbia Bar Taxation Community event on January 25, 2018, hosted by Jones Day, Treasury tax legislative counsel Thomas West said that we can expect guidance on the Section 199A deduction, including some guidance focused on small business.