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Tax & Business Alert

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EXECUTIVE COMPENSATION REQUIRES INFORMED DECISION-MAKING

Business owners want to compensate themselves and their top executives fairly and competitively for their work, results and commitment. So, how do you achieve that goal without attracting undue IRS scrutiny and claims of inappropriate compensation? By making informed, astute decisions.

START WITH THE BASICS

Compensation is affected by the amount of cash in your company's bank account. Just because your financial statements report a profit doesn't necessarily mean you'll have cash available to pay owners a salary or make annual distributions. Net income and cash on hand aren't synonymous.

Other business objectives — for example, buying new equipment, repaying debt, and sprucing up your offices or facilities — will demand dollars as well. So, it's a balancing act between owners' compensation and dividends or distributions on the one hand, and capital expenditures, expansion plans and financing goals on the other.

C CORPORATION CHALLENGES

If you operate as a C corporation, your business is generally taxed twice. First, its income is taxed at the corporate level, and then it's taxed again at the personal level as the owners draw dividends. This is a long-running challenge to those who own C corporations.

In light of the situation, many owners have been tempted to classify all the money they take out as salaries or bonuses to avoid being double-taxed on dividends. But the IRS is wise to this strategy: It's on the lookout for excessive compensation to owners and will reclassify above-market compensation as dividends, potentially resulting in additional income tax as well as interest and penalties.

The IRS also monitors a C corporation's accumulated earnings. Much like retained earnings on your balance sheet, accumulated earnings measure the buildup of undistributed earnings. If these earnings get too high and can't be justified as needed for things such as a planned expansion, the IRS will assess a tax on them.

KNOW YOUR FLOW-THROUGH

Perhaps your business is structured as an S corporation, limited liability company or partnership. These are all examples of "flow-through" entities that aren't taxed at the entity level. Instead, income *flows through* to the owners' personal tax returns, where it's taxed at the individual level.

Dividends (typically called "distributions" for flow-through entities) are tax-free to the extent that an owner has tax basis in the business. Simply put, basis is a function of capital contributions, net income and owners' distributions.

So, the IRS has the opposite concern with flow-through entities: Agents are watchful of dealer-owners who *under*pay themselves to avoid payroll taxes on owners' compensation. If the IRS finds you're downplaying compensation in favor of payroll-tax-free distributions, it'll reclassify some of your distributions as salaries. In turn, while your income taxes won't change, you'll owe more in payroll taxes than planned — plus, potentially, interest and penalties.

BEWARE OF EYEBROW-RAISERS

Above- or below-market compensation raises a red flag with the IRS, and that's always undesirable. Not only will the agency evaluate your compensation expense — possibly imposing extra taxes, penalties and interest — but a zealous IRS agent might turn up other challenges in your records, such as nonsalary compensation or benefits.

What's more, it might cause a domino effect, drawing attention in the states where you do business. Many state and local governments face budget shortages and are hot on the trail of the owners' compensation issue; they'll follow federal audits to assess additional taxes when possible.

FOLLOW THE REGULATIONS

When setting executive compensation, you want to be aware of all current IRS regulations and other applicable requirements. We can explain in detail how federal and state laws will affect your compensation decisions. ■

REVIEWING BUSINESS MEAL EXPENSES UNDER TODAY'S TAX RULES

In the due course of business, you probably spend time and money "wining and dining" current or potential customers, vendors and employees. And, as you may recall, what you can deduct on your tax return for these expenses changed under the Tax Cuts and Jobs Act (TCJA). Let's review the rules.

3 BASIC RULES

Among the biggest changes is that you can no longer deduct most business-related entertainment expenses. The TCJA disallows deductions for entertainment expenses, including those for sports events, theater productions, golf outings and fishing trips.

You can still deduct 50% of the cost of food and beverages for most meals conducted with business associates. However, you need to follow three basic rules in order to prove that your meal expenses are business related:

1. The expenses must be "ordinary and necessary." This means your food and beverage costs are customary and appropriate. They shouldn't be lavish or extravagant.

2. The expenses must be directly related or associated with your business. This means that you expect to receive a concrete business benefit from them. The principal purpose for the meal must be business. You can't go out with a group of friends for the evening, discuss business with one of them for a few minutes, and then write off the check.

3. You must be able to substantiate the expenses. There are requirements for proving that meal and beverage expenses qualify for a deduction. You must be able to establish the amount spent, the date and place where the meals took place, the business purpose and the business relationship of the people involved.

Set up detailed recordkeeping procedures to keep track of business meal costs. That way, you can prove them and the business connection in the event of an IRS audit.

OTHER CONSIDERATIONS

What if you spend money on food and beverages at an entertainment event? The IRS clarified in guidance (Notice 2018-76) that taxpayers can still deduct 50% of food and drink expenses incurred at entertainment events, but only if business was conducted during the event or shortly before or after. The food-and-drink expenses should also be "stated separately from the cost of the entertainment on one or more bills, invoices or receipts," according to the guidance.

Another related tax law change involves meals provided to employees on the business premises. Before the TCJA, these meals provided to an employee for the convenience of the employer were 100% deductible by the employer. Beginning in 2018, meals provided for the convenience of an employer in an on-premises cafeteria or elsewhere on the business property are only 50% deductible. After 2025, these meals won't be deductible at all.

MORE COMPLICATED

The treatment of meal and entertainment expenses has become more complicated under the TCJA. We can keep you up to speed on the issues and suggest strategies to save taxes on your business meal bucks. ■

SENIORS: MEDICARE PREMIUMS COULD LOWER YOUR TAX BILL

Americans who are 65 and older qualify for basic Medicare insurance, but they may need to pay additional premiums to get the level of coverage they desire. The premiums can be expensive — especially if you're married and both you and your spouse are paying them. One aspect of paying premiums might be a positive, however: If you're eligible, they may help lower your tax bill.

PREMIUM TAX DEDUCTIONS

Premiums for Medicare health insurance can be combined with other qualifying health care expenses for purposes of possibly claiming an itemized deduction for medical expenses on your individual tax return. This includes amounts for "Medigap" insurance and Medicare Advantage plans.

Some people buy Medigap policies because Medicare Parts A and B don't cover all their health care expenses. Coverage gaps include co-payments, co-insurance, deductibles and other costs. Medigap is private supplemental insurance that's intended to cover some or all gaps.

FEWER ITEMIZERS

Qualifying for a medical expense deduction can be difficult for a couple of reasons. For 2019, you can deduct medical expenses only if you itemize deductions and only to the extent that total qualifying expenses exceeded 7.5% of AGI.

The Tax Cuts and Jobs Act nearly doubled the standard deduction amounts for 2018 through 2025. For the 2019 tax year, the standard deduction amounts are \$12,200 for single filers, \$24,400 for married joint-filing couples and \$18,350 for heads of households. So, fewer individuals are claiming itemized deductions. However, if you have significant medical expenses (including Medicare health insurance premiums), you may be able to itemize and collect some tax savings.

Important note: Self-employed people and shareholder-employees of S corporations can generally claim an above-the-line deduction for their health insurance premiums, including Medicare premiums. That means they don't need to itemize to get the tax savings from their premiums.

OTHER DEDUCTIBLE MEDICAL EXPENSES

In addition to Medicare premiums, you can deduct a variety of medical expenses, including those for ambulance services, dental treatment, dentures, eyeglasses and contacts, hospital services, lab tests, qualified long-term care services, prescription medicines and others.

Keep in mind that many items that Medicare doesn't cover can be written off for tax purposes, if you qualify. You can also deduct transportation expenses to get to medical appointments. If you go by car, you can deduct a flat 20-cents-per-mile rate for 2019.

MORE INFORMATION

Contact us if you have additional questions about Medicare coverage options or claiming medical expense deductions on your personal tax return. We can help you identify an optimal overall tax-planning strategy based on your personal circumstances. ■

TAX CALENDAR

April 15

Along with being the last day to file (or extend) your 2019 personal return and pay any tax that's due, first quarter 2020 estimated tax payments for individuals, trusts and calendar-year corporations are due today. Also due are 2019 returns for trusts and calendar-year estates and C corporations. FinCEN Form 114 ("Report of Foreign Bank and Financial Accounts") is due, though an automatic extension applies to October 15. Plus, any final contribution you plan to make to an IRA or Education Savings Account for 2019 is due on this day. SEP and Keogh contributions are also due if your return isn't being extended.

April 30

Employers must file Form 941 for the first quarter (or May 11 if all taxes are deposited in full and on time). Also, employers must deposit FUTA taxes owed through March if the liability is more than \$500.

May 15

Calendar year exempt organizations must file (or extend) their 2019 Form 990, 990-EZ or 990PF returns.

June 15

Second quarter 2020 estimated tax payments are due for individuals, calendar-year corporations, estates and trusts.

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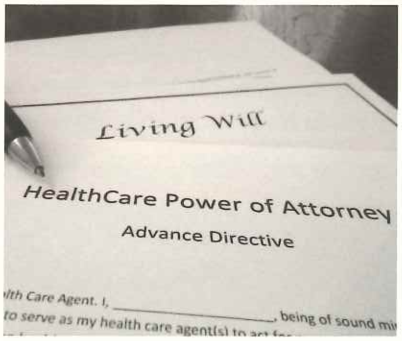
PROTECT YOUR ESTATE WITH THESE TWO ESSENTIAL DOCUMENTS

Estate planning isn't just about what happens to your assets after you die. It's also about protecting yourself and your loved ones. To ensure that your wishes are carried out, and that your family is spared the burden of guessing — or arguing over — what you would decide, put those wishes in writing. Generally, that means executing two documents:

1. A living will. This document expresses your preferences for the use of life-sustaining medical procedures, such as artificial feeding and breathing, surgery, invasive diagnostic tests, and pain medication. It also specifies the situations in which these procedures should be used or withheld.

Living wills often contain a "do not resuscitate" order, often referred to as a "DNR," which instructs medical personnel not to perform CPR in the event of cardiac arrest.

2. A health care power of attorney (HCPA). This document authorizes a surrogate — your spouse, child or another trusted representative — to make medical decisions or consent to medical treatment on your behalf if you're unable to do so. It's broader than a living will, which generally is limited to end-of-life situations, though there may be some overlap.



An HCPA might authorize your surrogate to make medical decisions that don't conflict with your living will, including consenting to medical treatment, placing you in a nursing home or other facility, or even implementing or discontinuing life-prolonging measures.

It's a good idea to have both a living will and an HCPA or, if allowed by state law, a single document that combines the two. Contact us if you have questions regarding either one or about any other aspect of the estate planning process. ■

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