TaxTips

Dedicated to making your life less taxing

Winter 2024-2025

Compliments of Davis Tax & Financial
105 Dayton Street ● Danvers, MA 01923
O: (978) 777-4645 ● C: (617) 962-1563
taxpro@davistaxandfinancial.com
www.davistaxandfinancial.com/

Three Possible Ways to Deduct Your Dog or Cat

Dogs, cats, and other household pets are expensive. Owners spend an average of $1,270 to $2,800 a year to own a dog. Can you ever deduct these costs from your taxes?

The expenses for a family pet that provides you only with love and companionship are never deductible. They are purely personal expenses.

But it is possible to deduct the expenses for a dog, a cat, or another animal if it qualifies as a

1. medical expense
2. business expense, or
3. charitable deduction.

The costs of buying, training, and maintaining a dog or another animal qualify as deductible medical expenses if you

1. use the animal primarily for medical care, and
2. would not have paid the expenses but for the disease or illness involved.

Medical deductions are allowed for service animals trained to aid their owners with a disability. Examples include guide dogs for people who are blind or have low vision, or dogs trained to carry items for people with physical disabilities.

You can also deduct emotional support animals, such as dogs, cats, or other animals that help people suffering from mental or emotional disabilities as a medical expense. Emotional support animals are more challenging to deduct than service animals because they can seem little different from regular pets. The animal should be prescribed (or at least recommended) by a licensed healthcare provider as part of a mental health treatment plan.

You can deduct dogs and other animals as a business expense if they serve a legitimate business purpose. For example, you can deduct a guard dog used for security at your business location. The guard dog should be trained and should be an appropriate breed for guarding purposes, such as a Rottweiler, German shepherd, or Doberman pinscher. Don't try to deduct a small dog like a Chihuahua as a guard dog!

Cats have achieved business-deductible status when used for pest control at a business location.

If you foster dogs, cats, or other animals in your home, you may be able to take a charitable deduction for the reasonable expenses you pay out of your own pocket, such as pet food expenses and veterinary bills. You may not deduct the value of the time you spend fostering animals or the value of donating space in your home for this purpose.

To qualify for this charitable deduction, you cannot foster animals on your own. You must do so on behalf of a Section 501(c)(3) charitable organization. You must also obtain a written acknowledgment from the charity if your expenses exceed $250.

Tax Guide to Deducting Long-Term Care Insurance Premiums

Long-term care costs can be substantial, and neither Medicare nor Medicaid provide comprehensive coverage for most people. Long-term care insurance (LTC) can help protect your finances, and there may be ways to deduct the premiums, depending on your business structure.
Here are four key points to consider:

1. C corporations can provide long-term care insurance as a fully deductible, tax-free benefit to owners.
2. Sole proprietors or single-member LLCs with a spouse as the only employee may be able to deduct 100 percent of the premiums through a Section 105-HRA plan.

3. S corporation owners, partners, and other sole proprietors may be able to deduct premiums subject to age-based limits and include in self-employed health insurance.
4. If you don't qualify for business-related deductions, you might deduct premiums as itemized deductions subject to age-based limits and the 7.5 percent floor.

Smart Solutions That Decrease Social Security and Medicare Taxes

Here are some important updates and strategies regarding Social Security and Medicare taxes that may significantly impact your business.

For 2024, the Social Security tax ceiling increased to $168,600, resulting in a maximum Social Security tax of $20,906 for high earners. The Social Security Administration projects this ceiling to rise annually, reaching $242,700 or more by 2033. Additionally, the government adds a 2.9 percent Medicare tax to all wages and self-employment income, with an extra 0.9% for high-income earners.

If you're self-employed, these taxes can be particularly burdensome. Here are three strategies that can potentially reduce your tax liability:

1. **Operate as an S corporation.** This structure allows the corporation to pay you a reasonable salary and distribute the remaining profits to you, exempt from self-employment taxes.
2. **Leverage community property rules.** Married filers living in community property states can use IRS rules to eliminate or create a spouse partnership in order to reduce self-employment taxes.
3. **Avoid the husband-wife partnership classification.** With close attention to partnership attributes, you can avoid the husband-wife partnership classification and reduce overall self-employment taxes.

Each of these strategies has specific requirements and potential trade-offs.

No Business Income, No Home-Office Deduction?

You may have heard you cannot claim a home-office deduction without business income. That's not accurate, as I explain below.

Points to Consider

1. **Claim business deductions with no business income.** Even if your business did not generate income this year, you should claim all business deductions. Such deductions might create a net operating loss, which would carry forward to offset future taxable income.
2. **Claim the home office with no business income.** Claim the home-office deduction even with no business income. The home-office expenses not allowed this year carry over to future years in the separate home-office deduction bucket. And this gets even more important when you consider business miles.
3. **Loss of business miles.** Trips from your home to many business locations are personal miles if you do not deduct your home office as your principal place of business. Establishing that "principal place of business" is easier than it sounds.
4. **File a tax return.** Without business income, you may be exempt from filing a tax return. Forget that. File a return. You need a filed return to claim the benefits above.

Action Steps

1. **Document your home office.** Insure you have appropriate documentation that proves your home office is your principal place of business.
2. **Claim all possible deductions.** Even in a loss year, claiming all possible deductions is essential.

Conclusion

Your home office can provide significant tax advantages, even when your business income is low or non-existent. Make sure you position yourself to take full advantage of these benefits now and in the future.

Reduce Taxes by Using the Best Cryptocurrency Accounting Method

Consider this happy scenario: You purchased one Bitcoin for $15,000 14 months ago and another six months later for $40,000. Today, you sell one Bitcoin for $60,000. You're a genius! But is your taxable gain $45,000 or $20,000?

It all depends on your crypto accounting method.

Many crypto owners are enjoying substantial gains at a time of surging cryptocurrency prices. When you sell multiple crypto units in the same year, you reduce your taxable gains using a crypto accounting method that provides the highest possible tax basis for each unit sold, resulting in the lowest taxable profit.

As you might expect, the default method approved by the IRS doesn't always provide the highest basis, resulting in higher taxes. The IRS made FIFO (first in, first out) the default method. It requires you to calculate your basis in chronological order for each crypto unit sold. With FIFO, your basis in the above example is $15,000, and your taxable profit is $45,000.

You can use a method other than FIFO. The other methods are called "specific identification methods" and include HIFO (highest in, first out) and LIFO (last in, first out). With HIFO, you are deemed to sell the crypto units with the highest cost basis first; your basis in the above example would be $40,000, and your taxable profit only $20,000.

Because HIFO sells your crypto with the highest cost basis first, it ordinarily results in the lowest capital gains and the largest capital losses. But using HIFO can cause loss of long-term capital gains treatment if you have not held the crypto for more than one year.

Using HIFO or LIFO is more complicated than using FIFO. You must keep records showing

1. the date and time you acquired each crypto unit,
2. your basis and the fair market value of each unit at the time it was acquired,
3. the date and time each unit was sold or disposed of, and
4. the fair market value of each unit when sold or disposed of.

If you lack adequate records, the IRS will default to the FIFO method during an audit, which could result in more taxable profit.

It's next to impossible to manually create the needed crypto records, particularly if you have many trades. Most crypto owners use specialized crypto tax software that automates the basis and gain/loss calculations and can even fill out the required tax forms.

You can change your crypto accounting method from year to year without obtaining IRS permission—for example, you can change from FIFO to a specific identification method such as HIFO. You don't have to disclose which method you use on your tax return.

Tax Planning to Winter in Florida and Summer in Massachusetts

You can plan your tax-deductible business life to avoid cold winters and hot summers.

Spend a moment examining the following four short paragraphs containing the *Andrews* case's basic facts.

For six months of the year, from May through October, Edward Andrews lived in Lynnfield, Massachusetts, where he owned and operated Andrews Gunite Co., Inc., a successful pool construction business.

During the other six months, Mr. Andrews lived in Lighthouse Point, Florida, where he owned and operated a sole proprietorship engaged in successful horse racing and breeding operations. In addition, he, his brother, and his son owned a successful Florida-based pool construction corporation from which Mr. Andrews took no salary but where he did assist in its operations.

Instead of renting hotel rooms in Florida, Mr. Andrews purchased a home, claimed 100 percent business use of the Florida home, and depreciated the house and furniture as business expenses on his Schedule C for his horse racing and breeding business.

Mr. Andrews then allocated his other travel expenses and the costs of owning and operating this house in Florida on his individual income tax return as

1. personal deductions on his Schedule A for a portion of the mortgage interest and taxes,
2. business deductions on his Schedule C for the horse racing and breeding business, and
3. employee business expenses on IRS Form 2106 for the pool construction business.

(Tax reform under the Tax Cuts and Jobs Act *eliminates* employee business expense deductions for tax years 2018 through 2025—so Mr. Andrews would change his strategy to obtain expense reimbursements from the pool business.)

As Mr. Andrews did, you can tax-plan your life to spend your winters in one state and your summers in another.

In this scenario, your tax-deductible home takes the place of hotels. The other home is likely your principal residence located near your tax home.

Your travel expenses between the homes are deductible because you do business in both places. You also deduct your meals and other living costs while at the deductible travel destination.

You can have separate businesses in each state or a branch business in the second state.

The Department of Labor Makes It Harder to Hire Independent Contractors

Does your business classify workers as independent contractors instead of employees? You should know that the U.S. Department of Labor is trying to make it harder for all businesses to use independent contractors
.
The Department of Labor enforces the Fair Labor Standards Act (FLSA), the federal law that requires most employers to pay employees a minimum wage and non-exempt employees time-and-a-half for overtime.

The key word here is "employee." FLSA does not apply to independent contractors. They need not be paid time-and-a-half for overtime or even the minimum wage.

The question is, who is an independent contractor?

Initially, it's up to each business to decide how to classify workers. However, your decision could be reviewed by the Department of Labor, other government agencies such as the IRS, and your state unemployment and workers' compensation agencies.

Bad things can happen if the government decides you've misclassified an employee as an independent contractor. The Department of Labor can make you pay back overtime pay for two years (three years if the misclassification is intentional). Your workers can also bring lawsuits for violations.

For FLSA purposes, workers are employees if, *as a matter of economic reality*, they are *economically dependent* on the hiring firm. The Department of Labor's new test contains six factors hiring firms must consider:

1. Opportunity for profit or loss
2. Investment in facilities and equipment
3. Permanency of the relationship
4. Degree of control by the hiring firm
5. Integration into the employer's business
6. Skill and initiative required

This test is complex and hard to apply. No one factor is determinative. Rather, you must examine all the circumstances of the relationship.
To make worker classification even more challenging, the Department of Labor test is only one of many. The IRS, for example, uses a more business-friendly right-of-control test. Many states use an even stricter ABC test for workers' compensation, unemployment, and state wage and hour law purposes.

Limited Partners and Self-Employment Taxes

Self-employment taxes are substantial, and most people want to minimize them. Self-employed taxpayers often avoid self-employment taxes by operating as an S corporation.

The distributions from the S corporation are not subject to self-employment tax. But Social Security and Medicare tax must be paid on the shareholders' employee compensation (which must be reasonable based on the services they provide). S corporations are also subject to various legal restrictions that can be inconvenient.

How about using the partnership form to avoid self-employment tax? This doesn't work for general partnerships because general partners always have to pay self-employment taxes on their distributive share of the ordinary income earned from the partnership's business.

But what about limited partnerships? These are partnerships that contain two classes of partners:

1. General partners who are personally liable for partnership debts and manage the business
2. Limited partners whose personal liability for partnership debts is limited to the amount of money or other property they contribute

The tax law provides that limited partners "as such" don't have to pay self-employment tax on their distributive share of partnership income.

Moreover, in about half the states, limited partnership laws have been revised to permit limited partners to work for the partnership without losing their limited liability.

Does this mean limited partners in many states can work for the partnership and avoid paying self-employment tax on their share of the partnership income? High-earning limited partners—hedge fund managers, for example—could save substantial tax if this were the case.

Unfortunately, in *Soroban*, a recent precedential decision involving a highly successful hedge fund and well-paid limited partners, the U.S. Tax Court held that the answer to this question is "no."

The court held that the limited partner exception to self-employment taxes applies only to limited partners who are passive investors, not to those actively involved in the partnership business.

Soroban is the latest in a series of cases involving self-employment taxes for partnership-like entities that the IRS has won. The other cases involved active participants in a state limited liability partnership, a limited liability company taxed as a partnership, and a professional limited liability company. Only passive investors in these entities can avoid self-employment tax.

Encouraged by these victories, the IRS is writing regulations requiring a functional analysis to determine whether a person is a limited partner. The IRS is also likely to conduct more self-employment audits of limited partnerships.

Shutting Down Your S Corporation

As you consider the process of shutting down your S corporation, it is crucial to understand the federal income tax implications that come with it. Here, I outline the tax basics for the corporation and its shareholders under two common scenarios: stock sale and asset sale with liquidation.

Scenario 1: Stock Sale

One way to shut down an S corporation is to sell all your company stock. The gain from selling S corporation stock generates a capital gain. Long-term capital gains tax rates apply if you held the shares for more than a year. The maximum federal rate for long-term capital gains is 20 percent, but this rate affects only high-income individuals.

If you are a passive investor, you may also owe the 3.8 percent Net Investment Income Tax (NIIT) on the gain. But if you actively participate in the business, you are exempt from the NIIT. Additionally, state income tax may apply to the gain from selling your shares.

Scenario 2: Asset Sale and Liquidation

A more common way to shut down an S corporation involves selling all its assets, paying off liabilities, and distributing the remaining cash to shareholders. Here's how the tax implications unfold.

Taxable gains and losses. The S corporation recognizes taxable gains and losses from selling its assets. These gains and losses are passed to shareholders and reported on their personal tax returns. You will receive a Schedule K-1 showing your share of the gains and losses to report on your Form 1040.

Long-term gains and ordinary income. Gains from assets held for more than a year are typically taxed as Section 1231 gains at long-term capital gains rates. But gains attributable to certain depreciation deductions are taxed at higher

ordinary income rates, up to 37 percent. Real estate depreciation gains attributable to straight-line depreciation can be taxed up to 25 percent.

NIIT considerations. Passive investors may owe the 3.8 percent NIIT on passed-through gains, while active participants are exempt.

Liquidating distributions. The cash distributed in liquidation that exceeds the tax basis of your shares results in a capital gain, taxed as a long-term capital gain if held for more than a year. If the cash is less than the basis, it results in a capital loss.

Tax-Saving Strategy for Asset Sales

Your number one strategy for tax savings is to allocate more of the sale price to assets generating lower-taxed gains (e.g., land, buildings) and less to those generating higher-taxed ordinary income (e.g., receivables, heavily depreciated assets).

Compliance and Reporting

Report asset sales and allocations on IRS Form 8594 (Asset Acquisition Statement Under Section 1060).

File the final federal income tax return using Form 1120-S, including final shareholder Schedule K-1s.

Know the Exceptions to the 10 Percent Penalty on Early IRA Withdrawals

Early withdrawals from a traditional IRA before age 59 1/2 generally incur a 10 percent penalty tax on the taxable portion of the withdrawal. There are several exceptions to this rule that can help you avoid the penalty under specific circumstances. Below, we have outlined the key exceptions that may apply to your situation.

Substantially equal periodic payments. You can arrange for a series of substantially equal periodic payments. This method requires careful calculation and adherence to strict rules but allows penalty-free withdrawals.

Medical expenses. Withdrawals for medical expenses exceeding 7.5 percent of your adjusted gross income, or AGI, are exempt from the penalty.

Higher education expenses. You can use penalty-free withdrawals for qualified higher education expenses for you, your spouse, and your children.

First-time home purchase. You can withdraw up to $10,000 (lifetime limit) for qualified home acquisition costs without penalty.

Birth or adoption. You can withdraw up to $5,000 for expenses related to the birth or adoption of a child.

Emergency expenses. Starting January 1, 2024, you can withdraw up to $1,000 annually for emergency personal expenses without penalty.

QUICK TIPS

1. If by year-end you haven't contributed funds to your IRA, or if you've put in less than the maximum allowed, don't worry. You can contribute to either a traditional or Roth IRA up until the April due date for filing your tax return. Your employer contributions to a Keogh, SEP, or a SIMPLE plan are due by the time you file your tax return unless you have a valid extension then you have until the extended due date to make the contribution.

2. Are you planning on making any substantial gifts? Talk to me first. For 2024, gifts with values exceeding $18,000 must be reported to the IRS.

3. The new standard mileage rates (SMR) for the use of a car, including vans, pickups, or panel trucks are:

	2024	2025
Business SMR	67.0¢	70.0¢
Medical and Moving rate	21.0¢	21.0¢
Charitable rate per mile	14.0¢	14.0¢

4. Have you thought about contributing to a Roth IRA but your income disqualifies you? Give me a call to discuss the backdoor Roth IRA option.

5. As a self-employed taxpayer, you may contribute to a sole-owner 401(k) retirement plan as both an employer and as an employee. As an employer, you may contribute up to 25 percent of your total income to your retirement plan. As an employee, you may also contribute up to an additional $23,000 in 2024 ($30,500 if age 50 or over). Your maximum contribution to an individual 401(k) plan is the lesser of $69,000 ($76,500 if age 50 or over) or the sum of the employer and employee maximums. Unlike other retirement plans such as SEP and SIMPLE IRAs, an individual 401(k) plan allows you to take out loans from plan assets.

6. The Federal Estate Tax exemption for 2024 is $13,610,000 and $13,990,000 for 2025. The rate is 40%. Additionally, heirs get to use stepped-up basis to value assets inherited. The exemption in MA is now $2,000,000.

7. In 2024 the tax rate of 37 percent will affect individuals and Heads of Households whose taxable income exceeds $609,351 ($731,201) for married taxpayers filing a joint return.

8. If you turned age 73 in 2024, you are not required to begin your required minimum distributions (RMD) from your IRA until April 1, 2025. You will also need to take your 2025 distribution by December 31st. Failure to do so results in a 25 percent penalty on the amount you do not take.

9. NEW Beginning in 2025, those between ages 60 and 63 will be eligible to contribute up to an additional $11,250 (50% more than the regular limit) as a super catch-up contribution to their 401(k) plan.

Disaster recovery. Withdrawals for qualified disaster recovery expenses are exempt from the penalty, up to an aggregate limit of $22,000.

Disability. If you are disabled and cannot engage in substantial gainful activity, you can withdraw funds without penalty.

Long-term care. Beginning December 29, 2025, you can take penalty-free withdrawals for qualified long-term care expenses.

Terminal illness. Withdrawals due to terminal illness are exempt from the penalty.

Post-death withdrawals. Amounts withdrawn after the IRA owner’s death are not subject to the penalty.

Military reservists. Active-duty military reservists called to duty for at least 180 days can withdraw funds without penalty.

Health insurance premiums during unemployment. If you receive unemployment compensation for 12 consecutive weeks, you can withdraw funds to pay for health insurance premiums without penalty.

Domestic abuse victims. Starting January 1, 2024, you can take penalty-free withdrawals of up to $10,000 if you are a victim of domestic abuse.

IRS levies. Withdrawals to pay IRS levies on the IRA account are not subject to the penalty.

It’s important to note that SIMPLE IRAs incur a 25 percent penalty for early withdrawals within the first two years of participation. Additionally, Roth IRAs have different rules, allowing penalty-free access to contributions but potentially taxing and penalizing withdrawals of earnings.