HITT AND COMPANY, LLC

CLIENT TAX NEWSLETTER - Fall 2021

CALENDAR

- NOVEMBER 25, 2021
THANKSGIVING DAY
- DECEMBER 15, 2021
4TH QUARTER ESTIMATED PAYMENTS - BUSINESSES
- DECEMBER 25, 2021
CHRISTMAS DAY
- JANUARY 1, 2022
NEW YEAR'S DAY
- JANUARY 18, 2022
4TH QUARTER ESTIMATED PAYMENTS - INDIVIDUAS

Social Security wage base, COLA set for 2022

The maximum amount of an individual's taxable earnings in 2022 subject to Social Security tax will be $147,000, the Social Security Administration (SSA) announced Wednesday.

An increase from $142,800 for 2021, the wage base limit applies to earnings subject to the tax, known officially as the old age, survivors, and disability insurance (OASDI) tax. Because the OASDI tax rate is 6.2%, an employee with total wages from an employer at or above the maximum in 2022 will pay $9,114 in tax, with the employer paying an equal amount.

The Medicare hospital insurance tax of 1.45% each for employees and employers has no wage limit and is unchanged for 2022.

Individuals with earned income of more than $200,000 ($250,000 for married couples filing jointly and $125,000 for married taxpayers filing separately) pay an additional hospital insurance tax under Sec. 3103(b)(2) of 0.9% of wages with respect to employment (also unchanged).

Self-employed individuals pay self-employment tax equal to the combined OASDI and Medicare taxes for both employees and employers, i.e., 15.3%, up to the OASDI wage base and 2.9% in Medicare taxes on net self-employment income above it, with an offsetting above-the-line income tax deduction of half of the OASDI-equivalent component of self-employment tax.

The SSA also announced on Wednesday a cost-of-living adjustment (COLA) based on an increase in the consumer price index from the third quarter of 2021, applicable to Social Security benefits payable in 2022, of 5.9%, compared with a COLA increase for 2021 of 1.3%.

The annual amount that retirees receiving Social Security benefits can earn in the year they reach full retirement age before their benefits are reduced (by $1 for every $3 in earnings over the limit) will be $51,960 for 2022, up from $50,520 in 2021.

Beneficiaries younger than full retirement age will be able to earn up to $19,560 in 2022 (an increase from $18,960 in 2021) before their benefits are reduced by $1 for every $2 in excess earnings. The maximum Social Security benefit for a worker retiring at full retirement age will increase to $3,345 per month in 2022 from $3,148 per month in 2021.

If you have any questions regarding your social security benefits and how they are taxed, please contact our office.

Supersized 'Dirty Dozen' highlight top tax tricks and abuses

The IRS's annual "Dirty Dozen" (actually, this year, 16) list of tax-related scams and schemes for 2021 spotlighted "pandemic-related scams," "personal information cons," "ruses focusing on unsuspecting victims," and "schemes that persuade taxpayers into unscrupulous actions."

Pandemic-related scams

1. Economic impact payment theft: Most economic impact payments, also known as stimulus payments, are made electronically by direct deposit to taxpayers' bank accounts, but even these can be diverted by thieves, the IRS noted, and those paid by check can be stolen from mailboxes.

2. Unemployment fraud: The IRS reminded taxpayers to be alert to identity theft related to unemployment benefit payments. In many cases, the thieves filed fraudulent unemployment benefit claims using stolen personal information of individuals who did not file claims. The owners of that information in many cases received Form 1099-G, *Certain Government Payments*, reporting unemployment compensation income that they did not in fact receive.

Personal information cons

3. Phishing: The IRS warned individuals to be vigilant for sham emails or websites looking to steal victims' personal data and potentially infect their devices by convincing them to download malicious programs. The Service noted that some phishing scams target tax professionals, such as by seeking to trick practitioners into clicking on innocent-looking attachments in emails purportedly from a new client. Another ploy mimics verification of electronic filing identification numbers (EFIN) and Centralized Authorization File (CAF) numbers.

4. Vishing: The IRS said that "vishing," or voice-related phishing, is on the rise, particularly scams related to federal tax liens.

5. Social media scams: Taxpayers also should be aware of tax scams that rely on social media, the IRS said. Some con artists send emails impersonating the victim's family, friends, or coworkers, relying on information extracted from an individual's social media accounts. One way to protect against these schemes is to review privacy settings and limit data that is publicly shared.

6. Ransomware: This form of malicious software (malware) is used to extort ransom payments from victims in exchange for decrypting the information and restoring victims' access to their systems or data. Ransomware attacks continue to rise across various sectors, particularly governmental entities, as well as financial, educational, and health care institutions, the Service noted.

Ruses targeting unsuspecting victims

7. Fake charities: The IRS advised taxpayers to beware of spurious appeals for donations by scammers who set up what may appear to be a charitable organization but in fact is a swindle. The IRS advised individuals not to feel pressured into giving and to research a recipient organization by its exact name using corroborating sources of information.

8. Immigrant/senior fraud: Seniors and groups with limited English proficiency should keep in mind they may be targets of tax-related scams that may include threats, the IRS advised.

9. Offer-in-compromise (OIC) "mills": Some OIC operations imply or promise they can settle debts for "pennies on the dollar" but rarely deliver, often while charging excessive fees. The IRS advised taxpayers owing a tax debt to do their own research on the OIC criteria and procedure.

10. Unscrupulous tax return preparers: The IRS also warned against "ghost" income tax return preparers, meaning those who refuse to digitally or manually sign the returns they prepare.

11. Unemployment insurance fraud: Some individuals have connived with or against employers and financial institutions to obtain state and local assistance to which they are not entitled, the IRS said.

Schemes that persuade taxpayers into unscrupulous actions

12. Syndicated conservation easements: "Promoters take a provision of tax law for conservation easements and twist it through using inflated appraisals of undeveloped land and partnerships," the IRS warned. "These abusive arrangements are designed to game the system and generate inflated and unwarranted tax deductions, often by using inflated appraisals of undeveloped land and partnerships devoid of a legitimate business purpose."

13. Abusive microcaptive arrangements: In these structures, "promoters, accountants, or wealth planners persuade owners of closely held entities to participate in schemes that lack many of the attributes of insurance," often with questionable coverage and inflated premiums, the IRS said.

14. Misuse of the United States—Malta tax treaty: Some taxpayers, invoking the U.S.—Malta income tax treaty, contribute appreciated property to certain Maltese pension plans and claim to have no tax consequences when the plan sells the assets and distributes proceeds to them.

15. Improper claims of business credits: These often involve the research credit, with "failures to participate in, or substantiate, qualified research activities and/or satisfy the requirements related to qualified research expenses," the IRS noted.

16. Improper monetized installment sales: In this promoted scheme, taxpayers defer recognition of gain upon the sale of appreciated property via an installment note that may provide for payments of interest only, with recognition of gain being improperly deferred until the payment of principal at the end of the term.

Proving employee business expense deductions

Prior to the passage of the law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, taxpayers were allowed to deduct unreimbursed employee business expenses as miscellaneous itemized deductions, subject to Sec. 67's 2% floor on miscellaneous itemized deductions and Sec. 68's overall limitation on itemized deductions, on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*. The deduction was disallowed for the years 2018 to 2025 by the enactment in the TCJA of Sec. 67(g), which suspends the allowance of miscellaneous itemized deductions. Nonetheless, because unreimbursed employee business expenses will be deductible again in 2026, and court cases involving disputes between the IRS and taxpayers over their deduction on tax returns for years before 2018 continue to make their way through the courts, knowledge of the details of the unreimbursed employee business expense deduction remains important.

Employee business expense deduction

To get started, what is a deductible unreimbursed employee business expense? Per Sec. 162(a), there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. Performing services as an employee constitutes a trade or business (see, e.g., *Primuth*, 54 T.C. 374 (1970)). Thus, with respect to employee business expenses, a deduction under Sec. 162(a) will be allowed for an unreimbursed expense that is:

- Paid or incurred during an employee's tax year;
- For carrying on his or her trade or business of being an employee; and
- Ordinary and necessary.

An expense is ordinary if it is common and accepted in the taxpayer's trade, business, or profession. An expense is necessary if it is appropriate and helpful to the taxpayer's business; it does not have to be required to be considered necessary.

Employer reimbursements

To prevent a taxpayer from obtaining a double benefit, only unreimbursed business expenses are deductible. Also, business expenses are not "necessary" if reimbursement is possible (*Podems*, 24 T.C. 21 (1955)). Thus, if an employee incurs an expense that he or she has a right to reimbursement for under an expense reimbursement plan of his or her employer, but the employee fails to obtain reimbursement for the expense, the employee cannot take a Sec. 162(a) deduction for the expense.

This is true regardless of why an employee does not seek reimbursement for a business expense incurred on behalf of his or her employer. The Ninth Circuit held in *Orvis*, 788 F.2d 1406 (9th Cir. 1986), that a taxpayer's lack of knowledge that his employer had a policy of reimbursing such expenses was not relevant to whether he could take a deduction for the expenses on his personal return.

The burden of proof

Should the tax return be audited or a notice of deficiency be received, the taxpayer generally has the burden of proof. However, the burden of proof switches to the IRS if an individual taxpayer produces credible evidence in support of an expense, has complied with the substantiation requirements for the expense, has maintained all required records for the expense, and has cooperated with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews regarding the expense.

Credible evidence is evidence that, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). The burden is not shifted if the taxpayer presents incredible or implausible evidence, even if that evidence is not controverted.

Substantiation requirements

An employee must be able to substantiate a deduction for an unreimbursed business expense by keeping (and producing for the IRS, if requested) adequate records. In general, the Code does not require the records to be in a specific form. However, under Sec. 274(d), specific proof is necessary to substantiate deductions for away-from-home travel and business gift expenses, and deductions related to listed property. A taxpayer must substantiate these expenses by adequate records or by sufficient evidence corroborating the taxpayer's own statement showing:

(A) the amount of such expense or other item, (B) the time and place of the travel or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of the person receiving the benefit.

Temp. Regs. Sec. 1.274-5T(c)(2) in general defines "adequate records" as an account book, diary, log, statement of expense, trip sheets, or similar record, and documentary evidence that, in combination, are sufficient to establish each of the required elements of an expense.

Temp. Regs. Sec. 1.274-5T(c)(3) defines "sufficient evidence corroborating the taxpayer's own statement" as the taxpayer's own statement, whether written or oral, containing specific information in detail about the required element of an expense and other corroborative evidence sufficient to establish that element. However, the Tax Court has routinely held that it is not required to accept a taxpayer's self-serving testimony without objective, corroborating evidence.

The taxpayer must substantiate the required elements for every Sec. 274(d) expense. Because Sec. 274(d) overrides the *Cohan* rule (*Cohan*, 39 F.2d 540 (1930)), courts cannot estimate the amount of the taxpayer's expenses.

Temp. Regs. Sec. 1.274-5T(c)(5) offers an exception to the adequate-records rule if the loss of records is due to circumstances beyond the taxpayer's control (e.g., a natural disaster). In this circumstance, the taxpayer has the right to substantiate his or her deductions through reasonable reconstruction of expenses.

Takeaway

If, as scheduled, unreimbursed employee business expenses again become deductible, employees should understand their employer's policy about business expense reimbursements to avoid denial for business expense deductions. If the employer's policy is unclear, the taxpayer should attempt to receive a reimbursement and document the results as evidence. It is important for taxpayers to keep a good record of the business expenses and make sure it is detailed enough to show that the expenses were incurred or paid during the tax year. For deductions for travel expenses, gifts, and deductions related to listed properties, taxpayers must ensure that they can substantiate the deductions under the strict standards in Sec. 274(d).

To discuss these and any other tax issues, please feel free to contact our office.

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