THE TAX INSTITUTE AT H&R BLOCK

TAX in the News

Tax Information for Tax Practitioners

October 10, 2018

Bonus depreciation opt-out reminder for 2017. TCJA's 100% bonus depreciation provision applies retroactively. Calendar year taxpayers who placed qualifying property in service during 2017 and do not wish to apply bonus depreciation on 2017 returns have until October 15, 2018, to opt out of 100% bonus depreciation (for property placed in service after September 27, 2017), and/or to opt out of 50% bonus depreciation (for property placed in service before September 28, 2017). See IRS news release IR-2018-196 and fact sheet FS-2018-9.

TAX NEWS

Expanded Guidance on New Family Leave Business Credit—A new general business credit is available for employers who provide paid family and medical leave to qualifying employees during 2018 and 2019. Notice 2018-71 expands earlier guidance on the credit. The credit is up to 25% for up to 12 weeks of leave paid pursuant to the employer's written policy. Employers who set up a program or amend an existing program by December 31, 2018, may claim the credit for qualifying leave already paid during 2018. Page 2

Disaster Relief: Northern Mariana Islands (Typhoon Mangkhut)—Parts of the Northern Mariana Islands have been declared a major disaster area because of Typhoon Mangkhut beginning September 10, 2018. Federal deadlines for affected taxpayers are generally postponed until January 31, 2019, including the October 15 filing deadline for individuals and other taxpayers with valid extensions. Disaster-related casualty losses may be claimed on 2017 or 2018 tax returns. Page 2

Per Diem Update for 2018-2019—Notice 2018-77 provides updated special per diem rate information for the new fiscal year. For taxpayers using the high-low substantiation method, the meal and incidental expense (M&IE) rate is $70 for high cost localities and $60 for other localities. The special M&IE rate within the continental U.S. for the transportation industry is $66. Under the TCJA, employees may no longer claim itemized deductions for unreimbursed business expenses. Thus, per diem rate information applies only to self-employed taxpayers and to employers' plans. Page 3

Qualified Business Income Deduction – Part 5: Reductions for SSTBs— In our last QBI deduction article we went through the calculations for business that are not specified service trades or businesses (non-SSTBs). This time we'll cover the calculation for taxpayers with income from SSTBs. Please refer to Part 3 of the series (TAX in the News September 19, 2018) for definitions of terms used in the calculations. Page 4

QUESTION OF THE WEEK

Clients have been asking about the newest Apple watch, which has built in heart-monitoring functions, as well as other new functions that are not related to heart or health issues. If a client has or is at risk for developing a heart condition and has a doctor's prescription for the watch, could the client pay for it with HSA funds? Page 5

EXPANDED GUIDANCE ON NEW FAMILY LEAVE BUSINESS CREDIT

The TCJA introduced a new general business credit for employers who provide paid family and medical leave to qualifying employees during 2018 and 2019. The §45S credit is available to employers who have a written policy in place providing leave for special circumstances, such as the birth of a child. See TAX in the News May 9, 2018 for background on this credit.

Earlier this year, the IRS released FAQs explaining the basics of the credit. News release IR-2018-191 and Notice 2018-71 expand on this guidance. Here are some highlights:

- The written policy must cover all employees who were employed at least a year and not paid over a specified amount in the previous year (2017 wages of $72,000 for the 2018 credit).
- The policy must provide at least two weeks of paid leave (pro-rations are allowed for part-time employees) and pay at least 50% of the qualifying employee's salary.
- Leave must be specifically dedicated for one or more Family and Medical Leave Act (FMLA) purposes. These include the birth or adoption of a child, caring for immediate family members, and certain medical emergencies.
- The base credit is 12.5% of qualifying leave, increased by 0.25% for each percentage point by which the rate of payment exceeds 50%. The maximum credit percentage is 25% and the maximum annual leave that may be taken into account is 12 weeks.

See the notice for details on the written policy requirements, eligible employers and employees, qualifying leave, and credit calculations. Guidance in the notice is effective September 24, 2018, for wages paid in tax years beginning after December 31, 2017 and before January 1, 2020. Employers who set up a qualifying program by December 31, 2018 or amend an existing program before the end of the year may claim the credit retroactive to January 1, 2018, for qualifying leave already paid this year.

DISASTER RELIEF—Northern Mariana Islands (Typhoon Mangkhut)

Parts of the Northern Mariana Islands have been declared a major disaster area eligible for federal disaster aid to individuals and businesses.

Affected taxpayers have the option of waiting to claim 2018 disaster-related casualty losses on their 2018 tax return filed next year during the 2019 tax season or on an original or amended tax return for 2017 filed during 2018. In addition, the IRS has postponed deadlines for affected taxpayers to file returns, pay taxes, and perform other time-sensitive acts.

Affected taxpayers are those who:

- Live in the covered disaster area
- Have a main place of business located in the covered disaster area
- Have books and records needed to complete the return located in the disaster area
- Assist governments or qualified non-profit organizations in relief efforts
- Were injured or killed while visiting the area

Note: Generally, the IRS identifies affected taxpayers located in the disaster area and automatically applies filing and payment relief. Affected taxpayers outside the disaster area should call the IRS at 1-866-562-5227 to request tax relief.

(Continued on page 3)

(Continued from page 2)

Northern Mariana Islands disaster: Typhoon Mangkhut beginning September 10, 2018

FEMA disaster declaration announcement DR-4396 dated September 29, 2018

IRS release: NMI 2018-01, dated October 2, 2018

Covered disaster area: the islands of Rota, Saipan, and Tinian

Postponement periods:

Tax returns and other time-sensitive acts due on or after September 10, 2018, and before January 31, 2019 are postponed until **January 31, 2019.**

This includes the following 2018 deadlines: the September 17, 2018 and January 15, 2019 estimated tax deadlines, quarterly excise and payroll tax returns due October 31, 2018, the September 17, 2018 filing deadline for businesses with valid extensions, and the October 15, 2018 filing date for individuals and other taxpayers with valid extensions.

Employment and other excise tax deposits due on or after September 10, 2018, and before September 25, 2018, must have been deposited by September 25, 2018.

PER DIEM UPDATE FOR 2018-2019

The IRS has issued Notice 2018-77, an annual notice providing updated *special* per diem rate information for the federal fiscal year starting October 1, 2018. Because employees may no longer claim itemized deductions for unreimbursed business expenses, including travel expenses, per diem rate information applies only to self-employed taxpayers and to employers' accountable plans and other travel guidelines.

1. *Transportation industry rates*. The special meal and incidental expense (M&IE) rates for the transportation industry increases from $63 to $66 for the continental United States (CONUS) and from $68 to $71 outside the continental United States (OCONUS).
2. *Incidental expense rate*. The rate for the incidental expense only deduction remains at $5 for CONUS and OCONUS.
3. *High-low substantiation method rates*. The per diem rates increase from $284 to $287 for travel to high-cost localities and from $191 to $195 for travel to other localities. The meals and incidental expense (M&IE) portion of the high-low rates increases from $68 to $71 for high cost localities and from $57 to $60 for other localities. The notice includes a list of high-cost localities for purposes of this method.

Incidental expenses: Rev. Proc. 2011-47 states that for tax purposes the term *incidental expense* has the same meaning as that used in the Federal Travel Regulations issued by the General Services Administration (GSA). These regulations provide that incidental expenses include only "fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships." Other types of miscellaneous expenses may be deductible but require substantiation of the actual expense.

Reminder: There is no standard lodging allowance. Employers use the lodging rates to determine the maximum travel allowance that may be provided tax-free to employees under an accountable plan. Self-employed taxpayers must use *actual* lodging expenses to calculate their lodging deduction.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 5: REDUCTIONS FOR SSTBs

In the last article in our QBI deduction series we went through the reduction calculation for businesses that are *not* specified service trades or businesses. This time we'll explain the calculation for businesses that *are* SSTBs.

Please refer to Part 3 of the QBI series (TAX in the News September 19, 2018) for definitions of the terms used in these calculations.

Taxable income does not exceed lower threshold

Reductions for SSTBs apply only when the taxpayer's taxable income exceeds the lower threshold of $157,500 ($315,000 MFJ). Otherwise, no special calculation for the QBI deduction is needed. This is so if the business is an SSTB or non-SSTB. Either way, the deduction is 20% of qualified business income or, if smaller, 20% of the taxpayer's taxable income net of any capital gain. When reductions apply for higher income taxpayers, for our discussion of the reduction formula, we'll simply refer to this leg of the calculation as "20% of QBI."

Taxable income exceeds upper threshold

For SSTBs, once the taxpayer's taxable income exceeds $207,500 ($415,000 MFJ), the QBI deduction is not allowed or, stated another way, it is fully phased out.

Taxable income is between the two thresholds

If a taxpayer's taxable income is between the lower and upper thresholds, the QBI deduction is subject to a wage/property limitation, but the calculation has more steps than the non-SSTB calculation. Here are the steps:

Step 1. Find the phase-in ratio and applicable percent:

a. Subtract the lower threshold amount ($157,500 or $315,000 MFJ) from the taxpayer's taxable income.
b. **Phase-in ratio**. Divide the result in Step1a by $50,000 ($100,000 MFJ).
c. **Applicable %**. Subtract the phase-in ratio from 1.

Step 2. Find the adjusted amounts to use for the 20% of QBI and wage/property calculations by multiplying each unreduced amount by the applicable %:

a. **Adjusted QBI**. Multiply QBI by the applicable %.
b. **Adjusted wages**. Multiply wages by the applicable %.
c. **Adjusted UBIA**. Multiply UBIA by the applicable %.

Step 3. Calculate 20% of QBI and the two wage/property limitations but using the adjusted amounts:

a. **20% of QBI**. Adjusted QBI by 20%.
b. **Wage/property Method 1**. Adjusted wages × 50%.
c. **Wage/property Method 2**. Adjusted wages × 25% + adjusted UBIA × 2.5%.
d. Use the higher of Method 1 or Method 2 for the wage/property limitation.

> *Note*: When 20% of the adjusted QBI is less than the adjusted wage/property limitation, use 20% of adjusted QBI for Step 5 and disregard the reduction calculation in Step 4.

Step 4. Calculate the reduction amount:

a. Subtract the wage/property limitation from 20% of QBI.
b. **Reduction amount.** Multiply the excess by the phase-in ratio.

Step 5. **QBI deduction**. Subtract the reduction amount from 20% of QBI.

(Continued on page 5)

(Continued from page 4)

Illustration. Harry is single. He has taxable income of $180,000 and QBI of $125,000 from his SSTB. Applicable wages and UBIA are $35,000 and $10,000 respectively. Since Harry's taxable income is between the two thresholds we'll need to go through the steps to calculate his QBI deduction.

Step 1. Phase-in ratio and applicable percent.

a. $22,500 ($180,000 taxable income - $157,500 lower threshold).
b. 45% phase-in ratio ($22,500 / $50,000).
c. 55% applicable % (1 – 45%).

Step 2. Adjusted amounts.

a. $68,750 adjusted QBI ($125,000 QBI × 55%)
b. $19,250 adjusted wages ($35,000 wages × 55%)
c. $5,500 adjusted UBIA ($10,000 UBIA × 55%)

Step 3. 20% of QBI and wage/property limitations

a. $13,750 20% of QBI ($68,750 adjusted QBI by 20%)
b. $9,625 wage/property Method 1 ($19,250 adjusted wages × 50%) ✓
c. $4,950 wage/property Method 2 ([$19,250 adjusted wages × 25%] + [adjusted $5,500 UBIA × 2.5%])
d. $9,625 wage/property limitation (the higher of Method 1 or Method 2)

Step 4. Calculate the reduction amount:

a. $4,125 excess ($13,750 20% of QBI - $4,950 wage/property limitation)
b. $1,856 reduction amount ($4,125 excess × 45% phase-in ratio)

Step 5. QBI deduction

$11,894 ($13,750 20% of QBI - $1,856 reduction amount)

In this example, Harry's QBI deduction is $11,894. How does Harry's SSTB stack-up against Mabel's non-SSTB (TAX in the News September 26, 2018)? As we've pointed out many times, as long as their taxable income doesn't exceed the lower threshold, the calculations are the same. That is, they are not subject to wage/property limitations. When taxable income exceeds the upper threshold, Mabel's QBI deduction is subject to the wage/property limitation while Harry is not eligible for the QBI deduction at all.

When taxable income is between the two thresholds, Mabel's wage/property limitation is phased in using the phase-in ratio. Harry's calculation is not quite as dissimilar as it first appears. The important difference is that all the amounts needed to perform the calculations must first be reduced by the applicable percent. It is the adjusted amounts that must then be used to make the 20% of QBI and wage/property test comparisons, to calculate the reduction amount, and the QBI deduction.

QUESTION OF THE WEEK

Q. Clients have been asking us about the newest Apple Watch. They say it includes a built-in electrocardiograph and can detect heart-related conditions and that these new features have been FDA-approved. If a doctor prescribes the watch for monitoring and detecting heart conditions for people at high risk of developing them, could the watch be a qualified medical expense for their HSAs? Of course, the watch has many other functions that are not related to heart or other health issues.

(Continued on page 6)

(Continued from page 5)

A. The cost of the new Apple watch, by itself, is not a qualified medical expense. The incremental cost of monitoring heart functions may be a qualified medical expense in limited circumstances.

Qualified medical expenses for HSA purposes (§223) generally follow the same guidelines as those for itemized deduction (§213) purposes. This includes the cost of “medical care,” defined in part as costs paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

The cost of medical equipment may meet this definition, whereas the cost of an item ordinarily used for personal, living, or family purposes generally would not unless it can be clearly established that it is used *primarily* to prevent or alleviate a physical disability or illness.

Although it has many new capabilities related to health, the Apple watch is a personal use item and its cost would not qualify as a medical expense. While one of its new functions is a device for detecting atrial fibrillation and taking an electrocardiogram (ECG), the line between personal use item and medical device is not as clear and will depend on each individual’s facts and circumstances.

If a client has a doctor’s prescription and the facts and circumstances support the medical need of the mobile ECG device, then the incremental cost, which may include an additional cost for the app, an upgrade, or a monthly subscription may be a medical expense for HSA or itemized deduction purposes. Note that a client that is simply interested in the various health monitoring functions could not treat the cost as a medical expense. The client must have a diagnosed medical condition and a doctor’s prescription for this particular device, not merely a recommendation for the watch.

Also, it is quite likely that clients with heart and other serious medical conditions requiring regular monitoring already have FDA-approved devices to do so. Such devices may be far less expensive than the watch and may be covered by insurance. Many heart monitoring functions on the new watch may not yet be available or may only have FDA “clearance” rather than approval.