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Newsletter September 2024

Dear clients:

The extended deadlines for pass-through entities and individuals are approaching quickly.

If the returns for your partnership or S-corporation are in process and we are waiting on additional information from you, we kindly ask that you forward us those outstanding items as soon as possible, otherwise the returns may not be filed by the September 15th deadline.

For our clients filing an extended individual return, please take care to forward our office your complete information no later than September 15th. If we receive your information after that date, we cannot guarantee the returns will be filed by the October 15th deadline. If you have questions, please feel free to contact our office and we would be glad to help.

Sincerely,

Aaron Bagby
Kramer, Jensen & Bagby, LLC

Should Tips Be Tax-Free? How Recent Proposals Could Change the Way You Tip

In recent years, tipping culture has seen significant changes, particularly with the rise of digital payment kiosks and self-checkout lanes. A **CBS News** article recently questioned, “Are tip requests getting out of hand?,” pointing out the shift from traditional tipping practices to new scenarios like tipping on to-go coffees and takeout orders.

While the pandemic initially led to an increase in tipping to support service workers, many Americans now face financial constraints due to ongoing inflation. According to a recent **PYMNTS and LendingClub report**, nearly two-thirds of Americans are living paycheck to paycheck.

This raises an important question: How much should you tip, and what are the tax implications

Understanding Tipping Standards

Dr. Jaime Peters, assistant dean and professor of finance at Maryville University, suggests, “It helps to understand how people are paid.” For example, waitstaff at restaurants often receive lower base wages, with tips expected to bring their earnings to or above the minimum wage. This contrasts with other roles, like grocery store cashiers, where tipping is less common and hourly wages are higher.

As tipping expectations expand to include new scenarios, such as at digital kiosks, the question of whether or not to tip—and how much—becomes more complex. **Vincent Birardi**, CFP and wealth advisor at Halbert Hargrove, advises, “One situation in which you should not be compelled to tip relates back to the automated kiosk. There shouldn't be this pressure on customers."

He recommends that if you receive exceptional service, a modest tip of $1 or $2 is appropriate, rather than the standard 20%.

Who Deserves a Gratuity?

Traditional tipped roles include waitstaff, taxi drivers, and salon workers. Dr. Peters told **CNBC**. "Tipped employees may also include front-of-house restaurant staff, bellhops, parking attendants, airport service workers, and food delivery workers," she said. These workers often rely on tips as a significant part of their income, and tipping remains customary in these contexts.

For services where tipping is optional, such as routine car maintenance or handyman visits, Birardi recommends a 10% to 20% tip if the service is exceptional. Alternatively, providing a meal or snack for service workers can be a budget-friendly way to show appreciation for services rendered.

The Tax Implications of Tipping

Recent proposals from former President Donald Trump – the Republican Presidential nominee – and Vice President Kamala Harris – who received the Democratic nod after President Joe Biden bowed out of the race – suggest making tip income tax-exempt. The Senate bill, "No Tax on Tips Act," introduced by Sen. Ted Cruz, proposes a 100% above-the-line deduction for cash tips, while other bills, like the "Tax-Free Tips Act of 2024," aim to exempt tips from both income and payroll taxes.

These proposals reflect ongoing debates about how best to support tipped workers while managing tax policy. Trump and Harris's proposals are part of a broader conversation about tax relief and economic support. However, these proposals have potential drawbacks.

The **Tax Foundation** notes:

By making one type of income (tips) exempt from income tax, while other types of income (most importantly, wages) remain taxable, the proposal would make more employees and businesses interested in moving from full wages to a tip-based payment approach. That would mean more service industries adopting the restaurant industry approach of a list price up front and an expected voluntary tip at the end of the transaction.

Political Implications and the Debate

As election season approaches, discussions about tax policy often bring tipping practices into the spotlight. Both Donald Trump and Kamala Harris have proposed changes that could significantly impact how tips are taxed. These proposals aim to alleviate the tax burden on service workers and potentially simplify the tax code. However, they also raise questions about fairness and effectiveness.

- **Trump's Proposal**: Former President Trump's tax reform proposal includes provisions to make tips tax-free. This move aims to provide immediate financial relief to service workers but could lead to unintended consequences, such as increased tax evasion and wage manipulation by employers.

- **Harris's Proposal**: Vice President Kamala Harris supports a similar approach, arguing that exempting tips from taxes would provide much-needed support to workers in the service industry. However, critics argue that this could disproportionately benefit higher earners and complicate the tax system further.

A concern not addressed by either candidate are the potential issues of Social Security and Medicare. Will their proposals also include tips being exempt from Social Security and Medicare taxes? If so, this could impact workers' retirement and Medicare benefits when they retire. Seems some of the bills introduced in Congress have considered that issue and do not exempt tips from payroll taxes while others do. We will have to wait and see.

Is There a Better Approach?

Raising the standard deduction could potentially be a more effective way to provide tax relief to low- and middle-income earners. For instance, increasing the standard deduction by $6,000 would benefit both wage earners and tipped workers, unlike the no-tax-on-tips proposal, which might disproportionately benefit higher earners and complicate the tax system.

As Dr. Peters concluded her remarks, “You can always decide to tip a little more or less based on your financial situation and your appreciation for the service provided. The thought still counts the most.”

When It’s Okay Not to Tip

While tipping is generally expected, there are specific situations where it may be acceptable to forego a tip. Here are four scenarios:

- **Poor Service**: If the service doesn’t meet expectations, it might be reasonable to withhold a tip. From a tax perspective, this doesn’t affect the overall tax treatment of the service.
- **Prepaid Services**: For services that are prepaid, such as at an all-inclusive resort, additional tipping is typically not expected.
- **Gratuity Included**: Some establishments include a gratuity in the bill, especially for large parties. In such cases, additional tipping is generally not required.
- **Administrative Fees**: Services that include an administrative fee in their charges, like online booking platforms, often replace the need for a tip. These fees are considered taxable income by the IRS.

The rise of tipping at digital payment kiosks and the proposed tax changes reflect ongoing shifts in how we view and manage tipping. While 20% remains the general rule of thumb for tipped services, it’s important to tip according to your financial situation and the service received.

And, while the debate over tax-exempt tips continues, focusing on straightforward ways to support service workers and manage your finances effectively remains priority number one.

Limited Deductions: How Landlords Can Navigate Beyond the $25,000 Loss Limitation

Article Highlights:

- $25,000 Rental Passive Loss Limitation
- Unlimited Losses When Qualifying as a Real Estate Professional
- What is Material Participation?
- Navigating the Rules
- Examples

The intricacies of tax law, particularly around rental real estate, can be both a boon and a bane for investors. Among these complexities, the $25,000 rental passive loss limitation stands out as a critical rule for taxpayers who own rental properties. This provision, coupled with the concept of unlimited losses when qualified as a real estate professional, forms a cornerstone of tax planning for real estate investors. This article delves into these topics, offering insights into how investors can navigate these rules to optimize their tax outcomes.

The $25,000 Rental Passive Loss Limitation

At its core, the $25,000 rental passive loss limitation is a tax provision that allows real estate investors to deduct up to $25,000 of losses from passive rental activities against their nonpassive income. Generally, passive losses are only allowed to offset passive gains. This rule is relevant for individuals who own rental properties and actively participate in the activity. “Active participation” is a less stringent standard than material participation (discussed below). For example, you may be treated as actively participating if you make management decisions, such as approving new tenants, deciding on rental terms, approving expenditures and similar decisions, in a significant and bona fide sense. Passive activities are defined as business activities in which the taxpayer does not materially participate.

You aren’t treated as actively participating in a rental real estate activity unless your interest in the activity (including your spouse's interest) was at least 10% (by value) of all interests in the activity throughout the year.

For single individuals and married couples filing jointly, the maximum special allowance is $25,000. This allowance is halved for a married individual filing separately, provided they lived apart from their spouse throughout the tax year. A married taxpayer filing separately who lived with their spouse at any time during the year is not eligible for any amount of the special allowance. The allowance is also available to qualifying estates, albeit with certain adjustments.

However, this beneficial allowance comes with limitations. The full $25,000 deduction is only available to taxpayers whose modified adjusted gross income (MAGI) is $100,000 or less. For those with MAGI between $100,000 and $150,000, the allowance is gradually phased out, reducing by 50% of the amount by which the taxpayer's MAGI exceeds the $100,000 threshold. Taxpayers with a MAGI of $150,000 or more are ineligible for this allowance.

Unlimited Losses When Qualifying as a Real Estate Professional

Generally, rental activities are passive activities even if you materially participated in them. However, for any tax year in which you qualify as a real estate professional, the rule treating all rental activities as passive activities doesn't apply to your rental real estate activity. Instead, that activity is not a passive activity if you materially participated. For this purpose, the default rule is that each interest you have in a rental real estate activity is a separate activity. But you can choose to treat all interests in rental real estate activities as one activity.

You are considered a real estate professional (qualifying taxpayer) for a particular tax year if BOTH qualifications below are met:

- More than half of the personal services you perform during that year are performed in real property trades or businesses in which you materially participate, **and**
- You perform more than 750 hours of services during that year in real property trades or businesses in which you materially participate (1).

If you own at least one interest in rental real estate and meet the above tests the IRS considers you a real estate professional.

(1) The IRS outlines several tests to determine material participation, including working on the activity for more than 500 hours during the tax year, providing substantially all the participation, or spending more than 100 hours and nobody else spends more time. Material participation offers a significant advantage for qualified real estate professionals who are also real estate investors who materially participate in the management their properties. By meeting the material participation criteria, these real estate professionals can offset their nonpassive income without the $25,000 limitation, potentially leading to substantial tax savings.

Navigating the Rules
Understanding and navigating these rules require a strategic approach. For passive investors, actively participating in rental property management can be a game-changer. This level of involvement can qualify investors for the $25,000 passive loss allowance (within the MAGI limitations noted above), providing a valuable tax deduction.

For those real estate professionals aiming to deduct unlimited losses, achieving the required hours of involvement and material participation is key. This may involve restructuring activities to meet the IRS criteria for material participation or increasing involvement in the property's management. Eligible real estate professionals can benefit from this approach, as their entire rental losses can be deductible against their other income.

Examples

Consider the case of Mike, a single taxpayer with a salary of $42,300, dividends of $300, interest of $1,400, and a rental loss of $4,000 from a property he actively managed. Despite the rental activity being passive, Mike's active participation allows him to use the entire $4,000 loss to offset his other income, thanks to the special allowance.

In another scenario, Stacey, a single taxpayer with a MAGI under $100,000, actively participates in her rental real estate activities that result in a loss of $27,000. Her involvement allows her to utilize the special $25,000 allowance to offset up to $25,000 of her nonpassive income, demonstrating the tax-saving potential of active participation. The $2,000 that she can't deduct will carry over to the next year.

If Stacey was a qualified real estate professional, she would be able to deduct the entire $27,000 loss against her non-passive income in the year the loss occurred.

Please contact this office if you have questions or would like to see if you can benefit from meeting the active participation criteria or qualify as a real estate professional.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

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