Tax Update for 2018 and 2019

The following is a summary of some of the most important tax developments that have occurred that may affect you, your family, your investments, and your livelihood. Remember, these are only highlights, and because everyone's situation is different, this letter is not a substitute for professional advice regarding your particular situation. Please call us for more information about any of these issues and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

TAX REFORM

The Tax Cuts and Jobs Act of 2017, or TCJA, was signed into law by President Donald Trump on December 22, 2017. Most of the changes introduced by the act went into effect on January 1, 2018. Many of the individual tax provisions are temporary and only apply for tax years beginning after December 31, 2017, and before January 1, 2026 whereas most of the business provisions are permanent.

Individual Tax Changes

- **Tax rates:** The new law lowers tax rates for individuals and adjusts the bracket amount. For 2018 through 2025, the tax rates are 10%, 12%, 22%, 24%, 32%, 35% and 37%.
- **Capital gains and qualified dividends:** The system for taxing capital gains and qualified dividends did not change, except that the income levels at which the 15% and 20% rates apply were altered.
- **Standard deductions:** The standard deduction is effectively doubled to $12,000 for single filers, $18,000 for head of household, and $24,000 for joint filers, while the additional standard deductions for the elderly and blind are retained.
- **Personal exemptions:** The act eliminates personal exemptions.
- **Alternative minimum tax:** The alternative minimum tax system is retained, but the exemption amounts are increased to $109,400 for joint returns and $70,300 for single taxpayers.
- **Child tax credit:** The child tax credit is doubled from $1,000 per qualified child to $2,000, subject to a phase-out for high-income taxpayers. The phase out begins at $200,000 for single filers and $400,000 for joint filers. Up to $1,400 of this credit is refundable. In

addition, the new law creates a $500 nonrefundable credit for dependents other than qualifying children.

- **State and local taxes:** The deduction for state and local income tax, sales, and property taxes will be capped at $10,000.
- **Mortgage interest:** Although deduction for prior debt is grandfathered, the new law limits the mortgage interest deduction to interest paid on the first $750,000 of acquisition debt. The limit was previously $1,000,000. It also eliminates deductions for interest paid on home equity loans and lines of credit, unless they are used to buy, build or substantially improve the taxpayer's home that secures the loan.
- **Medical expenses:** For 2018, the threshold for deducting medical expenses is 7.5% of adjusted gross income. For 2019 and later years, the threshold will increase to 10%.
- **Health Insurance:** The act repeals the individual mandate of the Affordable Care Act starting in 2019. However, the 3.8% net investment income tax and the 0.9% additional Medicare tax are not repealed.
- **Charitable contribution deduction limitation increased:** The 50% limitation for cash contributions to public charities is increased to 60%. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years, subject to the later year's ceiling. Gifts of stock to public charities remains at 30% of net income.
- **Charitable gifts with RMD's:** Taxpayers with traditional or ROTH IRA's and who are 70 ½ or older may request the plan administrator or trustee make a distribution from their IRA to a qualified charity. When done correctly, the income from the IRA is not added to taxable income; however, no deduction for the donation is allowed either. However, with the increase in the standard deduction, this may be a smart move for those who will no longer itemize.
- **Deductions for net disaster losses:** The personal casualty and theft loss deduction is suspended, except for personal casualty losses incurred in a Federally-declared disaster area. The standard deduction is increased by the net disaster loss. The AMT adjustment for the standard deduction doesn't apply to the increase in the standard deduction that is attributable to the net disaster loss.
- **Education deductions and credits:** No changes are made to major education deductions and credits. The list of qualified expense for Section 529 plans is expanded to include tuition at an elementary or secondary public, private or religious school up to $10,000.
- **Roth IRAs:** The act repeals the ability to recharacterize Roth conversions.
- **Estate tax:** The federal estate, gift and generation skipping tax exemption for 2018 is $11,180,000 per individual. It is double that amount, or $22,360,000 for a married couple. This amount will be indexed for inflation in future years. Caution - This is one of the changes that is set to sunset after 2025.

- **Miscellaneous itemized deductions:** The act eliminates the deduction for miscellaneous itemized deductions that are subject to the 2% floor. This includes employee business expenses, such as unreimbursed travel.
- **Kiddie tax:** The taxable income of a child attributable to earned income is taxed under the rates for single individuals, and taxable income of a child attributable to net unearned income is taxed according to the bracket applicable to trusts and estates.
- **New deduction for pass-through income:** The act creates up to a 20% deduction of qualified business income (QBI), with some limits, for sole proprietors and owners in partnerships, S corporations, and beneficiaries of trusts. The 20% deduction is not allowed in computing adjusted gross income, but rather is allowed as a deduction reducing taxable income.

  In August 2018, the IRS released proposed regulations that help to address the operation and calculation of the section 199A deduction. The proposed regulations include guidance on the definition of a trade or business; some limitations related to specified service trades or businesses; methods of calculating W-2 wages for purposes of the wage basis limitation; and clarify the rules with respect to Sec. 1231 gains and the calculation of QBI. The rules for the new deduction are very complicated with numerous limitations, including specific limits for specified service businesses.
- **Net operating loss deduction:** Net operating losses are limited to 80% of taxable income. Net operating loss carrybacks are eliminated except for farming losses. Unused net operating losses can be carried forward indefinitely.
- **Like-kind exchanges**: Like-kind exchanges under Section 1031 will be limited to exchanges of real property that is not primarily held for sale.
- **Deduction for business losses**: The deduction for net business losses on individual returns is capped. The amount of net trade or business losses that exceed a $500,000 threshold for couples and $250,000 for other filers is nondeductible, but any excess can be carried forward. This limitation applies after application of the current passive activity loss rules.

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Depreciation Changes

- **Section 179 expensing:** The act increases the amount a taxpayer may expense under Section 179 to $1,000,000 and increases the phase out threshold to $2,500,000. The definition of qualified real property is expanded to include all qualified improvement property and certain improvements including roofs, heating, ventilation, and airconditioning property, fire protection and alarm systems and security systems made to nonresidential real property.

- **Bonus depreciation:** The act increases first-year bonus depreciation to 100%. It is effective for any qualified property placed in service after September 27, 2017 and before January 1, 2023. After that, first-year bonus depreciation decreases 20% per year through 2026. Beginning in 2018, you can use bonus depreciation for purchases of new or used property. [Used property has certain restrictions, primarily with reference to acquisitions from related parties.] Any asset that is required to be depreciated using the ADS is not eligible for bonus depreciation.
- **Luxury automobile depreciation limits:** For passenger automobiles placed in service after 2017 and for which bonus depreciation is not claimed, the maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years. Vehicles with a gross vehicle weight over 6,000 pounds are not subject to the luxury auto limits.
- **Farming equipment and machinery:** For property placed in service after December 31, 2017, the cost recovery period is shortened from seven to five years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business, the original use of which commences with the taxpayer. In addition, the required use of the 150% declining balance depreciation method for property used in a farming business is repealed. The 150% declining balance method continues to apply to any 15-year or 20-year property. Land improvements other than buildings are 15-year property, and fences and grain bins have a 7-year recovery period, and single-purpose agricultural or horticultural structures have a 10-year recovery period.
- **Real property:** The cost recovery periods for residential and nonresidential real property remained unchanged at 27.5 years and 39 years, respectively. Under the alternative depreciation system (ADS), the cost recovery period for residential rental property is shortened from 40 years to 30 years.

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Business Tax Changes

- **Corporate tax rate:** The corporate tax rate is reduced to a flat 21% for tax years beginning after December 31, 2017. The act does not require a special rate for personal service corporations.
- **Corporate alternative minimum tax:** Corporate AMT is repealed for tax years beginning after December 31, 2017.

- **Dividend received deduction:** The act reduces the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%.
- **Cash method of accounting:** Taxpayers with average gross receipts of less than $25 million (indexed for inflation) for the prior three taxable years are permitted to use the cash method of accounting, regardless of entity structure or industry. Application of this provision is a change in method of accounting under Section 481.
  The IRS issued Rev. Proc. 2018-40 to give guidance on procedures for automatic consent to change to the cash method of accounting.
- **Uniform capitalization rules:** Taxpayers that meet the cash method $25 million gross receipts test are exempt from the uniform capitalization rules.
- **Interest deduction limitation:** The deduction for business interest is limited to the sum of (1) business interest income;(2) 30% of the business' adjusted taxable income for the tax year; and (3) the taxpayer's floor plan financing interest for the tax year. Any disallowed business interest deduction can be carried forward indefinitely (with certain restrictions for partnerships). Any taxpayer (other than a tax shelter) that meets the $25 million gross receipts test for the preceding 3 years, is exempt from the interest deduction limitation. Real property businesses that use the ADS and farming businesses can elect not to be subject to the business interest deduction limitation. Electing farming businesses must use the ADS to depreciate property with a recovery period of 10 years or more. For partnerships, the business interest limitation is determined at the partnership level.
- **Deductions for income attributable to domestic production activities:** The deduction is repealed for all taxpayers for tax years beginning after December 31, 2017.
- **Entertainment expenses:** The act disallows a deduction for (1) an activity generally considered to be entertainment, amusement, or recreation; (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes; or (3) a facility or portion thereof used in connection with any of the above items.
- **Employee transportation fringe benefits:** The deductions for employee parking and mass transit are eliminated, but the exclusion from income for such benefits received by an employee is retained.
- **Employer credit for paid family or medical leave:** The act allows eligible employers (employers that allow all qualifying full-time employees at least two weeks annual paid family and medical leave and allow part-time employees a commensurate amount of leave on a pro rata basis) to claim a credit equal to 12.5% of the amount of wages paid to a qualifying employee during any period in which the employee is on family and medical leave. If the payment rate under the program is 50% of the wages normally paid to an employee, the credit is increased by 0.25 percentage points (but not above 25%) for each

percentage point by which the rate payment exceeds 50%. However, this credit is only available in 2018 and 2019.

- **Sales and Use Tax:** Businesses may now find that they must collect and remit sales and use tax based on a revised definition of Nexus. See the separate letter to determine if this will change the states to whom you collect and remit sales tax.

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New IRS' Partnership Audit Rules Beginning in 2018

A revamping of the IRS' partnership audit rules will impact practically every partnership and LLC taxed as a partnership starting in 2018. The new audit rules make the partnership, not the partners, liable for payment of the assessment at the highest individual or corporate tax rate. Further, the audit adjustments are reflected on the return for the year the adjustment is finalized, not the year under review. The new audit rules result in three audit procedures:

- **For 10 or fewer partners**: Audits are at the partner level, much as was the case before the new audit rules.
- **For 11 to 99 partners**: The partnership return is the focus of the audit and any adjustments are binding on the partners who must file amended returns for the year under audit.
- **For 100 or more partners**: The partnership return is the focus of the audit, but any adjustments are taken into account on the partners' current year returns rather than the amended prior year returns.

A partnership with 100 or fewer partners can opt out by making an annual election on its partnership return. Affirmative action is required on each tax return. If the partnership opts out, the audit will proceed against each partner separately. As the law stands now, even a very small partnership might not be able to opt out. To opt out, every partner must be a qualifying partner. A qualifying partner is an individual, a C corporation, an S corporation, or an estate of a deceased partner.

Partnerships must designate a partnership representative. The partnership representative will be the sole person with whom the IRS will communicate audit-related notifications. The partnership representative will have unilateral authority with the IRS to bind the partnership and the partners to decisions affecting them.

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Affordable Care Act (OBAMACARE)

The individual mandate and its associated penalty are applicable to 2018 tax returns. The Internal Revenue Service won't process individual tax returns unless taxpayers indicate whether they have health insurance coverage, had an exemption, or will make a shared responsibility payment.

The repeal of the mandate penalty is effective for months beginning after December 31, 2018.

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IRS Mileage Rates

The standard mileage rates used to calculate the deductible costs of operating a vehicle in 2018 are as follows:

- 54.5 cents per mile for business
- 18 cents per mile for medical or moving
- 14 cents per mile for charitable causes

For 2019, the standard mileage rates are:

- 58 cents per mile for business
- 20 cents per mile for medical or moving
- 14 cents per mile for charitable causes

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Inflation Adjustments

The following inflation adjustments were announced by the IRS:

- Maximum contribution limit for 401(k) and 403(b) retirement plans: $18,500 for 2018, $19,000 for 2019. The "catch-up" contribution for those 50 and older remains at $6,000 for both years.
- Maximum contributions allowed for both traditional and Roth IRAs: $5,500 for 2018, $6,000 for 2019. The additional contribution allowed for those 50 and older is $1,000 for both years.
- Gift tax annual exclusion per donee: $15,000 for both 2018 and 2019.
- Estate, gift and generation skipping tax exemption for 2019 is $11,400,000 per individual. This is increased from $11,180,000 for 2018 as discussed in the section above regarding individual tax changes.
- Taxable wage base (for social security taxes) is $128,400 for 2018, and $132,900 for 2019.
- The threshold amount for cash payments to household employees to be subject to FICA: $2,100 for both 2018 and 2019.
- The annual dollar limit on employee contributions to employer-sponsored healthcare flexible spending arrangements (FSA) is $2,650 in 2018 and $2,700 in 2019. The dollar

limit for both years for dependent care FSAs is $5,000 for married filing joint or head of household filers.

- Health savings account (HSA) limits: for individual coverage, $3,450 for 2018 and $3,500 for 2019. For family coverage: $6,900 for 2018 and $7,000 for 2019. HSA account holders that are 50 or older may contribute an additional $1,000.
- The standard deduction for joint returns in 2019 will be $24,400, $12,200 for single filers, and $18,350 for head of household filers.

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We hope we have provided you with useful information. Please be aware that many of these items are subject to complex rules. Please call us for more information about how these changes affect your situation.

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