HUTSON CPAs GOBBLE LLC

Key Provisions of the New Tax Law and 2018 Year-End Strategies

The Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017 by the president and is the most comprehensive tax law change in thirty years. This new legislation will impact nearly every individual and business taxpayer. Although the new law has lowered current income tax rates for both individuals and businesses, the act also limits or eliminates many existing tax deductions, and many of its tax relief provisions are set to expire after 2025.

The politicians had touted the TCJA as tax simplification, but for many taxpayers the new law will bring considerable complexity. In this article we will highlight several key areas potentially impacting individuals, businesses, and estates. The new tax laws are complex and there is no replacement for tax planning tailor made for your own situation. Please do not hesitate to contact our office to discuss these items, or any others, and how they may affect your taxes.

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Individual Planning

Personal Income Tax Rates

What changes were made to individual income tax rates?

The new law changed the individual tax rate structure by reducing the current ordinary income tax rates and expanding the tax brackets for upper income taxpayers. The new tax brackets are indexed by inflation and are effective for 2018 but expire after 2025. Here is a comparison of the tax rates under the old law and the new rates effective for 2018:

Single Filer

Old Law		**New Law**	
Taxable Income	Tax Rate	Taxable Income	Tax Rate
Up to $9,325	10%	Up to $9,525	10%
$9,326 to $37,950	15%	$9,526 to $38,700	12%
$37,951 to $91,900	25%	$38,701 to $82,500	22%
$91,901 to $191,650	28%	$82,501 to $157,500	24%
$191,651 to $416,700	33%	$157,501 to $200,000	32%
$416,701 to $418,400	35%	$200,001 to $500,000	35%
Over $418,400	39.6%	Over $500,000	37%

Married Filing Jointly

Old Law		**New Law**	
Taxable Income	Tax Rate	Taxable Income	Tax Rate
Up to $18,650	10%	Up to $19,050	10%
$18,651 to $75,900	15%	$19,051 to $77,400	12%
$75,901 to $153,100	25%	$77,401 to $165,000	22%
$153,101 to $233,350	28%	$165,001 to $315,000	24%
$233,351 to $416,700	33%	$315,001 to $400,000	32%
$416,701 to $470,700	35%	$400,001 to $600,000	35%
Over $470,700	39.6%	Over $600,000	37%

Note: The Head of Household filing status is retained, with a separate bracket schedule.

What about capital gains and qualified dividend tax rates?

The favorable long-term capital gain tax rates and qualified dividend tax rates of 0%, 15%, and 20% are unchanged under the new law. The 15% rate kicks in at $77,200 of taxable income for married filing joint taxpayers and the 20% rate applies for taxable income of $479,000 or more. For single taxpayers, these thresholds are $38,600 and $425,800.

Was the Obamacare Medicare surtax repealed?

Both the 3.8% Medicare surtax imposed on net investment income and the 0.9% surtax and on earned income were retained under the new law. Net investment income is defined as gross income from interest, dividends, capital gains, annuities, royalties, rental income, and passive activities. Earned income includes wages, salaries, and self-employed income. The surtax applies to those taxpayers with modified adjusted gross income (MAGI) greater than $250,000 for joint filers and $200,000 for singles filers.

Was the dreaded Alternative Minimum Tax (AMT) repealed?

The new law retains the AMT for individuals but with some favorable modifications. It temporarily increases through the year 2025 the alternative minimum tax exemption to $109,400 for married filers and $70,300 for single filers. It also increased the phase-out threshold to $1 million. Given these higher exemptions and threshold, we anticipate that fewer of our clients will be subject to the AMT in 2018 and future years.

Standard Deductions and Personal Exemptions

What changes were made to the standard deduction and personal exemptions?

The new law nearly doubled the standard deduction to $12,000 for single taxpayers, $18,000 for head of households, and $24,000 for married filing joint returns. Taxpayers age 65 or older get an additional standard deduction of $2,600 for married taxpayers and $1,600 for single filers. As a result of the new higher standard deduction, many taxpayers will no longer need to itemize if their standard deduction exceeds their qualifying itemized deductions.

The new law also repealed the personal exemption of $4,050 each for individual taxpayers, their spouses and any dependents. The dependency exemption has been replaced with an enhanced

child tax credit of $2,000 per qualifying child under age 17. This credit begins to be phased out for taxpayers with adjusted gross income greater than $400,000 for married filing joint and $200,000 for all other filers. Dependents that do not qualify for the child tax credit may qualify for a $500 tax credit under the new law.

Itemized Deductions

Is mortgage interest still tax deductible?

Yes, but there have been changes to the rules. Prior to 2018 you could deduct the mortgage interest on up to two personal use homes with combined mortgage debt of up to $1 million. Under the new law, the limit is reduced to $750,000 for mortgages incurred after December 15, 2017 for the purchase of or improvements to a primary residence or second home. Mortgages of up to $1 million of home acquisition or home improvement debt that were incurred prior to the December 15, 2017 date are grandfathered and the interest on these loans is still deductible.

The new law also eliminated the deduction for interest on home equity mortgages. This applies to interest paid after December 31, 2017 on both existing and newly incurred home equity loans if the proceeds were not used to buy, build, or improve the property.

What about the deductions for state income taxes and real estate taxes?

The new law made a significant change to the itemized deductions allowed for state and local income or sales taxes, real estate taxes and personal property taxes. Beginning in 2018, individual taxpayers will only be able to deduct up to $10,000 total for their state and local income, sales, real estate and personal property taxes combined.

Are there any other changes to itemized deductions?

Miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) threshold are no longer deductible under the new tax law. These include write-offs for unreimbursed employee business expenses, union dues, investment management fees, and tax preparer fees.

Medical expenses are still deductible under the new law. If you itemize, the amount of your out-of-pocket medical expenses that exceed 7.5% of your adjusted gross income are deductible in 2018. This adjusted gross income (AGI) threshold increases to 10% in 2019 and later years.
The 3% phase-out limitation on itemized deductions for certain taxpayers with higher income has been eliminated under the new law.

What about the deduction for charitable donations?

The new law made no significant changes to the charitable contribution deduction rules, but with the increase in the available standard deduction and the limitation or elimination of other itemized deductions noted above, many taxpayers will lose the tax benefits from their charitable contributions because they will claim the higher standard deduction amount instead.

There are two strategies that taxpayers might consider to get the most tax benefit from their charitable giving. One strategy is to ‘bunch’ their charitable giving in one tax year so that their

itemized deductions exceed their available standard deduction. A donor advised fund might be used to implement this strategy.

The second strategy applies to taxpayers over age 70 ½ who must take required minimum distributions from their individual retirement accounts. These individuals can contribute directly from their IRA to a charitable organization up to $100,000 annually. The distribution to the charity is excluded from taxable income resulting in a tax benefit equivalent to an itemized deduction for a charitable contribution.

Other Changes Effecting Personal Taxes

What are some of the other changes affecting personal taxes?

Alimony payments under the old law were generally tax deductible by the payer and included in taxable income for the recipient. The new law repeals both the deduction and income inclusion for alimony payments. The repeal does not apply to existing divorce or separation agreements or to agreements executed on or before December 31, 2018.

Moving expenses are no longer tax deductible under the new law and employer paid moving expenses are no longer excludable from the taxable income of the employee. This provision does not apply to members of the military.

Section 529 college savings plan distributions of up to $10,000 annually can now be withdrawn tax free if used to pay for elementary or high school tuition. Under the prior law, only distributions for college tuition were non-taxable.

Roth IRA conversions are still allowed under the new law, but the ability to 'undo' the conversion has been eliminated. Careful tax planning for Roth IRA conversions will be crucial going forward since Roth IRA re-characterizations are no longer permitted.

Business Planning

Meals and Entertainment

Are business meals and entertainment expenses still tax deductible?

Meals may still be deductible, but entertainment is not. The new rules are complex and we are still waiting on the IRS to finalize additional guidance. Here is a summary of the new rules:

- The IRS defines 'entertainment' as any activity that constitutes entertainment, amusement or recreation. This includes entertaining clients or prospects at night clubs, bars, theaters, golf and athletic clubs, sporting events, and hunting or fishing trips. These expenses are no longer deductible. Meals and beverages if purchased separately at the entertainment event are 50% deductible.
- Meals taken while on mandatory business travel will remain 50% deductible for owners and employees.

- Meals provided for the convenience of the employer (i.e. feeding an employee working through lunch or dinner) are now only 50% deductible.
- Office holiday parties and company picnics are still 100% deductible.
- Meals provided to the general public are still 100% deductible (i.e. food & beverages provided at a company 'open house' event).
- Travel for business reasons and the related costs continue to be 100% deductible.

Equipment Purchases

Is bonus depreciation still available for 2018?

Yes. For business use property placed in service after September 28, 2017 and before January 1, 2023, first year bonus depreciation is increased to 100% for both new and used property (increased from 50%). This effectively allows businesses to deduct the entire cost of personal property in the year of purchase rather than deducting it gradually over its useful life.

What about the section 179 expense election?

Under section 179, taxpayers can elect to deduct the cost of qualified property in the year of purchase. For 2018, the section 179 expense election is increased from $510,000 to $1 million and the phase-out threshold for new equipment purchases is increased from $2 million to $2.5 million. The 2018 amounts will be adjusted for inflation in future years.

The new law also expands the definition of section 179 property to include the following improvements made to nonresidential real property used in a trade or business:

- Roofs, HVAC, fire protection, security, and alarm systems
- Qualified improvement property which is defined as any improvement to a building's interior, except for improvements for:
  - the enlargement of the building,
  - any elevator or escalator or
  - the internal structural framework of the building.

Pass-through Deduction for Qualified Business Income

Is there tax relief for pass-through businesses and self-employed taxpayers?

Beginning in tax year 2018 and through 2025, there is a new 20% deduction for qualified business income (QBI) available to owners with pass-through income from an S-corporation, partnership, or sole proprietorship. QBI does not include investment income, partner guaranteed payments, and W-2 compensation paid to the owner. QBI does include income from real estate businesses, including management and rental income, but excludes gain from the sale of real property.

This 20% QBI deduction may be limited for individuals with taxable income over $315,000 for married filing joint or $157,500 for single filers. The limitation is based on the wages paid by the business and/or the cost of property used in the business. The QBI deduction amount for the business is equal to the *lesser* of 20% of the qualified business income or the *greater* of

a) 50% of the amount of the annual W-2 wages paid to employees of the business, or
b) 25% of W-2 wages plus 2.5% of the cost of qualified property used in the business.

The 20% deduction is not available to the following types of service businesses for individuals with taxable income over the same $315,000 and $157,500 thresholds:

Accounting, law, health, consulting, financial services, investment management, trading or dealing in securities, actuary science, athletics, performing arts or any business whose principal asset is the reputation or skill of one or more of its owners. This limitation, however, specifically excludes engineers and architects.

Rental income may qualify for the 20% deduction for some taxpayers. If a rental activity rents or licenses tangible or intangible property to the taxpayer's commonly controlled business, then the rental activity qualifies for the QBI deduction. Other rental activities may also qualify for the QBI deduction if the level of rental activity and participation constitutes a trade or business versus an investment activity. This is a case by case determination based on individual facts and circumstances. There is still much uncertainty in this area of the new law and we are hoping that the IRS provides additional guidance when it issues its final regulations.

C-Corporation Tax Changes

What changes have been made to corporate income taxes?

The graduated tax rate schedule has been eliminated for corporations for tax years ending after December 31, 2017 and replaced with a 21% flat rate. Prior to the new law, the graduated corporate tax rate started at 10% with a maximum rate of 35%. The alternative minimum tax (AMT) for corporations has been eliminated under the new law.

With the new lower corporate tax rate should I convert my pass-through business to a C-corporation?

There are other considerations besides the income tax rate. C corporations are still subject to double taxation, with the income taxed once at the entity level and then taxed again when it is distributed to the shareholders as dividends. Wages paid to the owners are taxed at the individual's tax rate which is likely higher than the 21% corporate rate. It may make more sense to continue operating the business as a pass-through entity especially with the new 20% QBI deduction available. If you plan to sell the business in the near future, the gain on the sale of the business would also be subject to double taxation in the C corporation.

Simplified Accounting Methods for Small Businesses

Are there other tax benefits in the new law for small businesses?

Businesses with annual gross receipts averaging $25 million or less for the past three years may now use the following simplified accounting methods for income tax reporting:

- C Corporations can use the cash basis method of accounting (previously the gross receipts limit was only $5 million).
- Businesses with inventories may use the cash method of accounting.

- Exemption from applying the UNICAP rules for inventory.
- Use of the completed contract method for long term contracts (previously the gross receipts limit was only $10 million).

In general, the use of these accounting methods for tax reporting results in the deferral of taxable income and are favorable to taxpayers.

Business Interest Deduction Limitation

How will the changes to business interest deductions impact my business?

Prior to the TCJA, business interest expense in general was fully deductible. For tax years beginning after December 31, 2017, businesses will only be able to deduct interest expense up to 30% of the sum of its adjusted taxable income and its business interest income. Adjusted taxable income is defined as income before business interest, depreciation and amortization and after 2021, the depreciation and amortization add backs are eliminated. This change may have a negative tax impact on real estate owners who are highly leveraged.

There are exceptions to this new interest deduction rule, including a ‘small taxpayer’ exemption for entities with average annual gross receipts of $25 million or less for the previous three tax years. Related entities with 50% or more common ownership are combined for determining the $25 million gross receipts exemption. Businesses that use floor plan financing loans to fund inventory of motor vehicles for sale or lease are also exempt from these rules.

There is also an exception that applies to real estate and farming entities. These entities can deduct 100% of their interest expense if they make an irrevocable election to use the longer ADS depreciation lives and forego bonus depreciation on their building improvements placed in service beginning in the year the election is made.

This new interest limitation generally applies at the tax filer level to all business debt incurred by the taxpayer. There is no grandfathering of debt existing prior to the enactment. The amount of disallowed business interest carries forward to the following taxable year, and the unused disallowed portion carries forward indefinitely.

Business Loss Deduction Limitations

How has the new law impacted net operating losses?

The new law changes the current rules for net operating losses (NOLs). Generally, NOLs will now be limited to 80% of taxable income for losses generated in tax years beginning after December 31, 2017. This means that even in a year when net operating losses exceed current year income, you would still end up paying tax on 20% of the income. The carryback provisions have also been eliminated for most NOLs, but the carryforward period is now indefinite, subject to the 80% limitation.

Have excess business losses also been changed by the new tax law?

The new law limits the use of business losses for non-corporate taxpayers. Under the prior law, in general, as long as you actively participated and had basis in your trade or business, you could

deduct the loss in full. Under the new law, net business losses that flow through to individuals are limited to $500,000 for married filing joint taxpayers and $250,000 for all other filers. The income or losses from all of your active trades or businesses are combined for this loss limitation. Income from other sources such as wages or investments cannot be off-set by business losses in excess of the threshold. Any excess losses carry forward as a NOL subject to the 80% limitation.

Estate Planning

Estate and Gift Tax Exemptions Increased

What changes were made to the estate and gift tax laws?

The death tax wasn't repealed but the new law doubles the combined estate and gift tax exemption to $10 million for gifts or estates of persons dying after December 31, 2017 and before January 1, 2026. The exemption is indexed annually for inflation and is currently $11.18 million for 2018. This results in a combined estate tax exemption of over $22 million for married couples at least until 2025 when the new law sunsets.

The annual gift tax exclusion amount has also increased from $14,000 to $15,000 per donee for gifts made in 2018. The marginal tax rates for gift, estate, and the generation skipping transfer (GST) tax remains at 40%, unchanged by the new legislation. Also unaffected by the new law are the date of death step-up in tax basis rules for inherited assets (excluding retirement accounts and annuities).

These historically-high exemption amounts, even if temporary, create a rare opportunity to take advantage of strategies for 'locking in' those exemptions and permanently avoiding future transfer taxes, particularly if Congress later changes the estate tax rules yet again. Even with these increased exemption amounts, there are still other non-tax related estate planning issues that should not be ignored, such as asset protection, family business succession planning, guardianship of minor children, and later life planning.

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