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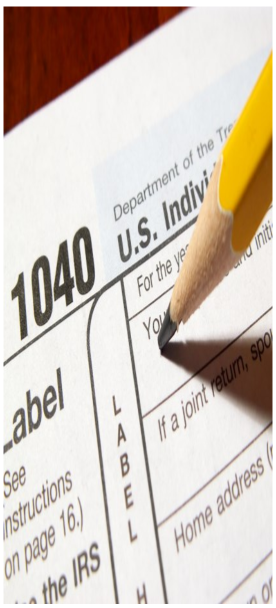
Strand Boyce O'Shaughnessy, CPAs, Inc.

Tax Reform

The new tax bill: the good, the not so good, the bad, and the ugly.



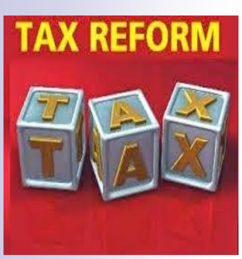
To say that December was an interesting month in the tax world is a bit of an understatement! The Tax Cuts and Jobs Act (also known as the "accountants full employment act"), was signed into law on December 22. This is tax reform on a major scale, and we have one thing to say: There "ought to be a law" that no law of this magnitude can be passed in the final weeks of the year. Decisions had to be made by December 31, and some businesses and individuals may require a change in entity type or need to make hiring decisions in order to benefit from some of the provisions in the bill. Simply put, there is a lot to consider going forward.

No one should assume that they will be better off or worse off under the new tax law. Some high income tax payers will be pleasantly surprised by the reduction in their federal income tax; others will find they will pay more Some lower income taxpayers will also pay more tax, while others will pay less. It all depends on what tax brackets apply to you, how much your itemized deductions are and which ones you lose, whether you were subject to the alternative minimum tax in the past, how the loss of the deduction for personal exemptions affects you and how the new business provisions affect you.

Some provisions are very easy to understand, others will require IRS guidance and regulations to clear up inconsistencies and ambiguity. Unless otherwise noted, these changes are effective for tax years starting in 2018. Many of the changes are only effective until 2025, and several phase out earlier. Of course the law changes have many "ifs, ands, buts, and except fors", so please, check with us *before* you make any decisions. Planning ahead to take advantage of the new rules will be important for some of you. For others, we can only say "it is what it is".

Keep in mind: these are federal tax law changes only. We don't know what changes, if any, California (or any other state) will conform to. The fun has only just begun!

Inside this issue:



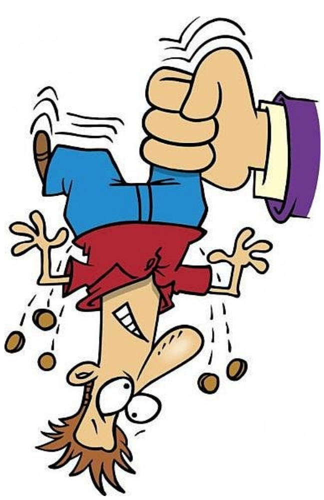
Here are some of the main federal tax law changes that may affect you. (There are more, but we realize there is a limit to your willingness to read our newsletters through to the end!)

Individuals:

- **The tax brackets have changed.** The lowest bracket is now 12% (was 15%) and the top rate is now 37% (was 39.6%).
- **Personal exemptions have been eliminated.** High income taxpayers are not losing much because the exemptions phased-out at a certain point and the alternative minimum tax didn't allow this deduction. Lower income taxpayers may feel some pain.
- **The child tax credit** for dependent children under age 17 has been increased to $2,000 and a new credit of $500 for other non-child dependents was added. These credits are phased out for higher income taxpayers.

Individuals (continued)

A maximum of $10,000 combined state and local income tax and property tax is allowed.



- **Higher standard deduction.** Taxpayers have always been allowed to claim whichever deduction is higher: the standard deduction or total itemized deductions. The standard deduction in 2018 is $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers and $12,000 for everyone else. If you're 65 or older you get an extra $1,300 if you're married, $1,600 if you're not. Some of you who are used to itemizing will no longer do so, others will see much less benefit from itemizing. Consider "bunching" deductions like charitable contributions, property taxes and even mortgage interest so that you are able to itemize in certain years. Planning ahead is key.

- **Limited state and local income tax and property tax deduction.** A maximum of $10,000 combined state and local income tax and property tax is allowed. This includes your auto registration fee and property tax paid on your boat or plane, the SDI tax withheld from your paycheck, your real estate tax, and state income tax or sales tax paid. This is not good, but not as bad as it appears for some: If you were paying alternative minimum tax you were already losing the deduction for this tax.

- **Miscellaneous itemized deductions.** No deduction is allowed for investment management fees, unreimbursed employee business expenses, professional fees paid for personal tax or estate planning, legal costs incurred related to income producing assets and most employment matters, and personal tax preparation charges. (Tax planning/preparation charges related to your business, farm, or rental properties are still deductible as a business expense.) This is not good, but not as bad as it appears for some: If your income was high and/or you were paying alternative minimum tax you were already losing some or all of the deduction for these expenses.

- **Mortgage interest limitation.** Qualified mortgage interest paid on up to $1 million of loans existing at 12/14/17 for first and second homes is still deductible. For loans incurred *after* 12/14/17, the deduction for mortgage interest is limited to underlying indebtedness of $750,000 and only applies to purchases of first and second homes and amounts spent for home improvement. If you refinance a pre-12/15/17 mortgage, there are limitations on how much of the refinanced amount is deductible, taking into account the new $750K limit and the old loan amount. *Starting in 2018 no interest on home equity loans is allowed unless the borrowed amount is used in your business, to make an investment or purchase a rental property.* If the amount on the home equity loan was used for personal purposes, or for your home improvements, that interest is no longer deductible, regardless of which year the borrowing occurred. Many elements of this new tax provision are ambiguous. We hope IRS provides additional guidance soon!

- **Kiddie tax.** A major change to the tax rates on the unearned income of your dependent children: The parents' maximum tax rate no longer applies. The child's tax will be calculated using the income tax rates and brackets which apply to trusts and estates. Bad!

- **Alimony** payments will not be deductible and alimony received will not be taxable for divorce or separation agreements executed *after* 2018 (or executed before 2019 but modified after 2018 if the modification expressly provides that the new amendments apply).

Individuals (continued)

- **"Pass-through" entity deduction:** Individuals will be allowed a deduction of up to 20% of qualified business income from a partnership, S-corporation or sole proprietorship, as well as from some other specific types of investments. Qualified business income includes net income from rental properties that meet the definition of a trade or business. *No deduction will be allowed for net rental income which is received from a property rented under a triple net lease.* The deduction is limited and phased out by various factors, including the type of business activity, wages paid by the business, and your personal taxable income. For some this will result in significant tax savings; for others not. Tax planning is required to determine how to maximize the deduction. Many elements of this new tax provision are ambiguous. We are hoping IRS provides guidance soon!

- **Net business losses.** If you incur business losses of more than $500K ($250K if married filing separately) in a tax year, you will not be allowed to claim all of the losses against your other income in that tax year. You will be required to carry the excess loss forward. Business losses include losses from self-employed businesses, rentals, partnerships, S-corporations and farms.

- **Moving expenses.** You can no longer claim a deduction for employment related moving expenses, and any reimbursement for such expenses that you receive from your employer will be taxable. (There is a limited exception for members of the Armed Forces on active duty.)

- **Alternative minimum tax (AMT).** The exemption amounts were increased significantly. As a result, we expect many taxpayers will no longer be required to pay the alternative minimum tax. For many of you, elimination of the alternative minimum tax will offset the loss of deductions for miscellaneous itemized expenses, your state income and property tax, and personal exemptions.

- **Roth conversions.** If you convert a regular IRA to a Roth-IRA you will no longer be able to change your mind after the fact and unwind the conversion. It will require better planning up front to assure that you don't convert too much.

- **The estate and gift tax** exemption amount is much higher and will eliminate the need for many taxpayers to file estate tax returns. The exemption amount is now about $11.2 million per person.

- **W4 allowances.** Don't assume that your current W4 withholding allowances will result in the correct amount of federal income tax withholding. According to IRS your current W4 allowances should get you close if you claim the standard deduction and have no dependents. For everyone else, you should revise your Form W4. A new IRS withholding calculator is expected to be released before the end February. We encourage you to go to the IRS website and use the calculator to determine the amount of allowances to claim, and submit a new W4 form to your employer. This calculator should only be used for federal income tax purposes.

Employment related moving expenses will no longer be deductible.

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Businesses

- **All C-corporations will now pay a flat 21% tax rate.** This sounds good but remember that any income left in a C-corporation will ultimately be subject to double tax, at both the state and federal level. Therefore, it is still unlikely that being taxed as a C-corporation is a good strategy. For those C-corporations that always end up paying tax (for example, due to high non-deductible expenses) 21% is mostly good news. However, if your corporation was paying at the 15% tax rate, you're not going to be happy. The 15% rate is gone - you will be paying the flat tax rate of 21%.

All C-corporations will now pay a flat 21% tax rate.

- **Section 179 (First year expensing election).** You can now expense tangible personal property acquired for residential rental properties (good!). Also, you can now expense, for nonresidential real property, roofs, HVAC systems, fire/alarm/security systems (all good!!). The annual allowable deduction is now $1 million (phases out at $2.5 million of property placed in service).

- **Bonus depreciation has been enhanced (another type of first year expensing):** You can now claim a deduction of 100% (previously 50%) of the cost of new and used property. The big news on this is that if you purchase a car weighing more than 6,000 pounds that you use in your business, you now get a much larger deduction in the first year. Even better news: this particular provision applies to property acquired and placed in service after 9/27/17! This was a surprise retroactive tax provision and should make those of you who bought heavy vehicles at the end of 2017 very happy.

- **A much shorter (15-year, straight line) depreciation method** applies to qualified improvements made to real property used in a business and to rental property.

- **Net operating losses.** These can no longer be carried back two years, only carried forward. This means you will no longer be able use the loss to offset prior years' income and get a refund of income taxes paid in those years. The loss can only reduce future years' taxable income (and that is limited to 80% in any one year). Ugly!

- **Auto depreciation.** The annual expense amount increased significantly! You can now claim $10,000 in year one, $16,000 in year two, $9,600 in year three and $5,760 thereafter. You get twice as much write-off in just the first two years compared to old law. The existing $8,000 of bonus depreciation is retained for autos that are not SUVs/heavy autos. Keep in mind that these amounts are adjusted by the personal use percentage for self-employed taxpayers.

- **Like-kind exchange treatment** is now only allowed for real property, which is rental or investment property or property used in a trade or business. The like kind exchange rules no longer apply to other assets. This is actually good news for those of you trading in business autos for new autos, because usually the trade-in value produced a tax loss that you were not allowed to claim under the exchange rules. You'll now be able to claim the loss on the trade-in. However, if you have a gain on the trade-in (which, given the new and improved bonus and depreciation expense, you might), you won't be able to defer the gain.

Businesses (continued)

- **The Section 199 deduction** for manufacturing and other production activities is repealed. Apparently Congress thought this was no longer needed now that a lower 21% corporate tax rate and 20% qualified business income deduction is effective. Some will see little benefit from the QBI deduction, but “it is what it is”.

- **Entertainment expenses (for marketing and business promotion):** You no longer need to keep records regarding the business purpose, dates, and names of people that you entertained. The reason you no longer have to document the business purpose is because the government doesn’t care whether there is a business purpose – no entertainment expenses are deductible. Zero, none! Ugly!

- **Employee benefits.** An employer can still deduct the expense of an office party, annual picnics or summer outings provided it is only for the benefit of the employees and does not discriminate in favor of owners, officers, or highly compensated employees. In order to be 100% deductible it appears that the function must not be on the employer’s premises.

- **Transportation benefits** paid by the employer are no longer a deductible expense. The benefits are still tax free to the employee if paid from a flexible spending account, except for bicycle commuting reimbursements – those are now taxable to the employee. We really do wonder why Congress is discriminating against employees who bicycle to work!

- **Meals.** The current 50% limit on the deductibility of business meals is expanded to those provided on the employer’s premises, including meals provided to employees for the convenience of the employer (e.g. working meals).

Your company holiday party is still deductible.

No business entertainment expenses are deductible. Zero. None. Ugly!

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Summary

There is a lot of change! Please don't expect us to be able to do the math in our heads when you ask us if you are going to be better off or worse off in 2018. For very simple situations, we have a nice excel worksheet we developed that we can use to figure out, generally, how your federal taxes will be affected. For anything beyond very simple, we have very good (and expensive) tax planning software that will be updated as new guidance is issued (we pity the software programmers who have been working even more hours than we have to understand the new law). We will be checking in with you as we work on your tax returns to discuss what planning opportunities you have for 2018. It is going to be an interesting and challenging year!