JHS CPAs LLP

Thomas N. Henle, CPA
Michael R. Huhn, CPA
James F. Kepke, CPA
Craig A. Cleveland, CPA

November 2018

Dear Client:

Year-end planning for 2018 takes place against the backdrop of a new tax law—the Tax Cuts and Jobs Act (TCJA)—that makes major changes in the tax rules for individuals and businesses. For individuals, there are new, lower income tax rates, a substantially increased standard deduction, severely limited itemized deductions and no personal exemptions, an increased child tax credit, and a watered-down alternative minimum tax (AMT), among many other changes. And there's a new deduction for non-corporate taxpayers with qualified business income from pass-through entities. For businesses, the corporate tax rate is cut to 21%, the corporate AMT is gone, there are new limits on business interest deductions, and significantly liberalized expensing and depreciation rules. Highlighted below are some of the major changes and planning ideas brought forth by the TCJA. Note that California will not follow most of these new provisions.

Individuals

Lower tax brackets: Almost all taxpayers will pay tax at a lower rate starting in 2018. Only the lowest earners, generally those making less than $20,000, will see no change.

Larger standard deduction and credits for dependents: The personal exemption deduction is completely repealed in 2018. To offset the loss of the personal exemption deduction, the standard deduction is nearly doubled for all taxpayers. For 2018, the amounts are $12,000 for singles and those who use married filing separate status, $24,000 for married joint filing couples, and $18,000 for heads of household. The TCJA retains the additional standard deduction for the elderly and blind. Additionally, those with children under 17 years can claim up to a $2,000 credit per child and a $500 credit for other dependents. The credit is reduced when a married couple's income reaches $400,000 ($200,000 for a single parent).

If your total annual itemizable deductions for 2018 will be close to your standard deduction amount, consider making additional expenditures before year-end to exceed your standard deduction. For example, consider making bigger charitable donations this year and smaller contributions next year to compensate. That will lower this year's tax bill. Next year, you can claim the standard deduction, which will be increased a bit to account for inflation.

Limited state and local tax deductions: An individual taxpayer's SALT (state and local tax) deductions are limited to a maximum of $10,000 under the new law with no carryover for taxes paid in excess of that amount. The SALT deduction limit does not apply to property taxes paid by a trade or business or for a rental.

Other lost deductions: The following deductions have been either repealed or limited under the new law: personal casualty and theft losses, moving expenses, unreimbursed business expenses (business miles, home office, union dues, meals and entertainment, etc.), and investment advisor fees, among others. Deductions pertaining to rental properties or businesses remain deductible.

Mortgage interest: Mortgage interest is now limited to only the first $750,000 of mortgage debt, but only for loans used to purchase, construct, or make improvements to your home and one secondary residence. Loans that were in place on or before December 15, 2017, may still use the old rules, even if they are refinanced, but only for the first $1 million of debt. Interest is no longer deductible for any home equity debt unless the proceeds were used for a rental, business, home purchase or improvements.

JHS CPAs, LLP

135 TOWN & COUNTRY DRIVE P.O. BOX 9500 DANVILLE, CALIFORNIA 94526
ph (925) 820-1821 fx (925) 820-8266 www.jhs.com

2300 E. KATELLA AVENUE, SUITE 370 ANAHEIM, CALIFORNIA 92806
ph (714) 978-1800 fx (714) 978-6722 www.jhs.com

Capital gains and investments: The TCJA retained the 0%, 15%, and 20% rates on long-term capital gains and qualified dividends recognized by individual taxpayers. However, for tax years 2018 through 2025, these rates have their own brackets that are not tied to the ordinary income brackets.

While your income may be too high to benefit from the 0% rate, you may have children, grandchildren, or other loved ones who will be in the 0% bracket. If so, consider giving them appreciated stock or mutual fund shares that they can sell and pay 0% tax on the resulting long-term gains. Gains will be long-term as long as your ownership period plus the gift recipient's ownership period before the sale equals at least a year and a day.

If you give securities to someone who is under age 24, the Kiddie Tax rules could potentially cause the resulting capital gains and dividends to be taxed at the higher rates that apply to trusts and estates. That would defeat the purpose. Please contact us if you have questions about the Kiddie Tax.

New 20% deduction on pass-through business and rental income: The new deduction based on Qualified Business Income (QBI) from pass-through entities and rentals was a key element of the TCJA. For tax years 2018 through 2025, the deduction can be up to 20% of a pass-through entity and rental owner's QBI. Restrictions can apply at higher income levels. In addition, other restrictions are based on the owner's taxable income and for certain service businesses. The QBI deduction also can be claimed for up to 20% of income from qualified REIT dividends and 20% of qualified income from publicly-traded partnerships.

For QBI deduction purposes, pass-through entities are defined as sole proprietorships, single-member LLCs that are treated as sole proprietorships for tax purposes, partnerships, LLCs that are treated as partnerships for tax purposes, and S corporations. The QBI deduction is only available to individuals and trusts.

Because of the various limitations on the QBI deduction, tax planning moves (or non-moves) can have the side effect of increasing or decreasing your allowable QBI deduction. So, individuals who can benefit from the deduction must be careful at year-end tax planning time. We can help you put together strategies that give you the best overall tax results for the year.

Tax withholding and estimates: The changes to the tax rates resulted in changes to withholding tables. Additionally, the major tax law changes have created uncertainty as to resulting 2018 taxes. It is especially important this year to review your withholding and tax payments to avoid underpayment penalties.

AMT: The TCJA significantly reduced the odds that you will owe AMT for 2018 by significantly increasing the AMT exemption amounts and the income levels at which those exemptions are phased out. Even if you still owe AMT, you will probably owe considerably less than under prior law. Nevertheless, it's still critical to evaluate year-end tax planning strategies in light of the AMT rules. Because the AMT rules are complicated, you may want some assistance.

Estate and gifting: The unified federal estate and gift tax exemption for 2018 is a historic $11.18 million, or effectively $22.36 million for married couples. Even though these big exemptions may mean you are not currently exposed to the federal estate tax, your estate plan may need updating to reflect the current tax rules. Also, you may need to make some changes for reasons that have nothing to do with taxes. Note that this exemption amount is scheduled to revert to the prior exemption after 2025, barring subsequent tax law changes, so any planning should take this expiration into account.

Make gifts sheltered by the annual gift tax exclusion before the end of the year and thereby avoid utilizing your lifetime exemption. The exclusion applies to gifts of up to $15,000 made in 2018 to each of an unlimited number of individuals. You can't carry over unused exclusions from one year to the next. Such transfers may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the Kiddie Tax. When making these planning decisions, note that gifted property has a carry-over tax basis, while inherited property has basis valued at date of death.

Section 529 plan distributions: Qualified distributions will now include tuition payments up to $10,000 in connection with K-12 education.

IRA and RMD: Take required minimum distributions (RMDs) from your IRA, 401(k) plan, or other employer-sponsored retirement plan. RMDs from IRAs must begin by April 1 of the year following the year you reach age 70-½. That start date also applies to company plans, but non-5% company owners who continue working may defer RMDs until April 1 following the year they retire.

If you are age 70-½ or older by the end of 2018, have traditional IRAs, and particularly if you can't itemize your deductions, consider making 2018 charitable donations via qualified charitable distributions from your IRAs. Such distributions are made directly to charities from your IRAs, and the amount of the contribution is neither included in your gross income nor deductible on Schedule A, Form 1040. But the amount of the qualified charitable distribution reduces the taxable amount of your required minimum distribution, resulting in tax savings.

Businesses

Low tax rate for C corporations: All C corporations are now subject to a flat tax rate of 21%. Personal service corporations are no longer subject to a special higher rate. This reduced rate means C corporation owners who pay out all their profit as a salary at the end of each year may want to rethink that strategy. The drawback to leaving funds in a C corporation is that later withdrawals are taxed as dividends, resulting in double taxation. Certain businesses might reconsider operating as a C corporation or, in some cases, converting to an S corporation.

Corporate alternative minimum tax: The AMT is repealed for C corporations. If your C corporation has previously unused AMT credits, you will receive a full refund of those credits over the next few years.

Depreciation and Section 179: Thanks to the TCJA, 100% first-year bonus depreciation is available for qualified new and used property that is acquired and placed in service in calendar year 2018 (assets placed in service from September 28, 2017, through 2022). That means your business might be able to write off the entire cost of some or all your 2018 asset additions on this year's return. So, consider making additional acquisitions between now and year-end. If considering large asset purchases or building improvements, please contact our office to discuss tax treatment of these expenditures.

For qualifying property placed in service in tax years beginning in 2018, the TCJA increased the maximum Section 179 deduction to $1 million. The Section 179 deduction phase-out threshold amount was increased to $2.5 million.

Meals and entertainment: Entertainment is no longer deductible at all. That includes ballgame tickets, golf outings, etc. Additionally, there are changes to the deductibility of business meals. The rules are very detailed, and we should discuss how to determine which meals are 100%, 50%, or 0% deductible. Your bookkeeping will need to be updated to adequately account for these changes.

New credit for paid family and medical leave: A new credit is available in 2018 and 2019 for businesses that offer paid family and medical leave to their employees. The credit can be as high as 25% of wages paid to your employees while on leave. As with most provisions, there are many requirements that we must discuss before implementing a paid family and medical leave plan.

Like-kind exchanges are limited: Like-kind exchanges (IRC §1031 exchanges) are now limited to real estate only. For real estate investors who have utilized cost segregation studies on their properties, this change may give rise to significant taxable gain if the real estate is relinquished in an exchange. It is important that we discuss, in advance, any moves you intend to make with real estate that has been subject to a cost segregation study.

Business losses: The new law makes significant changes to net operating loss rules, and certain business losses in excess of specified amounts are limited. Please contact us early if you expect business losses this year or next.

De minimis safe harbor: Businesses may be able to take advantage of the de minimis safe harbor election (also known as the book-tax conformity election) to expense the costs of lower-cost assets and materials and supplies, assuming the costs don't otherwise have to be capitalized. To qualify for the election, the cost of a unit of property can't exceed $2,500. This increases to $5,000 if the taxpayer has an applicable financial statement (e.g., a certified audited financial statement along with an independent CPA's report).

Ability to use cash or completed method of accounting: More "small businesses" are able to use the cash or completed contract method of accounting in 2018 and later years than were allowed to do so in earlier years. To qualify as a "small business," a taxpayer must, among other things, satisfy a gross-receipts test. Effective for tax years beginning after December 31, 2017, the gross-receipts test is satisfied if during a three-year testing period average annual gross receipts don't exceed $25 million.

Establish a tax-favored retirement plan: If your business doesn't already have a retirement plan, now might be the time. Current retirement plan rules allow for significant deductible contributions. For example, if you are self-employed and set up a SEP-IRA, you can contribute up to 20% of your self-employment earnings with a maximum contribution of $55,000 for 2018. If you are employed by your own corporation, up to 25% of your salary can be contributed with a maximum contribution of $55,000.

Other small business retirement plan options include the 401(k) plan (which can be set up for just one person), the defined benefit pension plan, and the SIMPLE-IRA. Depending on your circumstances, these other types of plans may allow bigger deductible contributions.

The deadline for setting up a SEP-IRA for a sole proprietorship and making the initial deductible contribution for the 2018 tax year is October 15, 2019, if you extend your 2018 return to that date. Other types of plans generally must be established by December 31, 2018, if you want to make a deductible contribution for the 2018 tax year, but the deadline for the contribution itself is the extended due date of your 2018 return. However, to make a SIMPLE-IRA contribution for 2018, you must have set up the plan by October 1, 2018. So, you might have to wait until next year if the SIMPLE-IRA option is appealing. Be aware that if your business has employees, you may have to cover them too.

Time business income and deductions for tax savings: If you conduct your business using a pass-through entity (sole proprietorship, S corporation, LLC, or partnership), your shares of the business's income and deductions are passed through to you and taxed at your personal rates. Assuming the current tax rules will still apply in 2019, next year's individual federal income tax rate brackets will be the same as this year's (with modest bumps for inflation). In that case, the traditional strategy of deferring income into next year, while accelerating deductible expenditures into this year, makes sense if you expect to be in the same or lower tax bracket next year. Deferring income and accelerating deductions will, at a minimum, postpone part of your tax bill from 2018 until 2019.

On the other hand, if you expect to be in a higher tax bracket in 2019, take the opposite approach—accelerate income into this year (if possible) and postpone deductible expenditures until 2019. That way, more income will be taxed at this year's lower rate instead of next year's higher rate.

Conclusion

This letter only covers some of the year-end tax planning moves that could potentially benefit you and your business. Please contact us if you have questions, want more information, or would like us to help in designing a year-end planning package that delivers the best tax results for your circumstances.

Very truly yours,

JHS CPAs, LLP