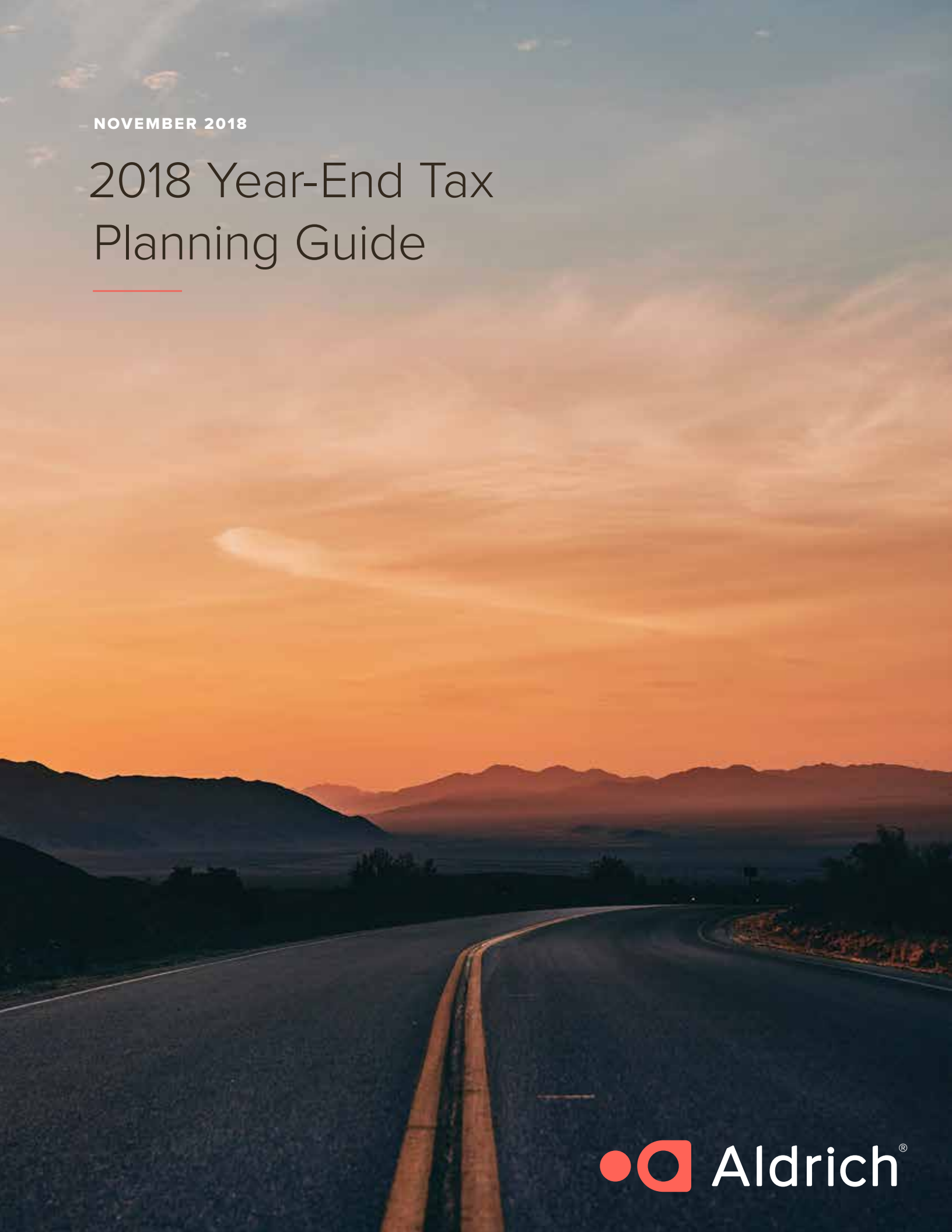
NOVEMBER 2018

# 2018 Year-End Tax Planning Guide



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# What to Expect from the Most Sweeping Tax Changes in Decades

The past year was an eventful one from a tax-planning perspective. A major piece of tax reform legislation, the Tax Cuts and Jobs Act (TCJA), was signed into law at the end of 2017, initiating the biggest overhaul to the U.S. tax code in almost three decades. This legislation has had a major impact on tax planning for businesses and individuals. In general, many of the changes related to businesses are permanent, while the changes for individuals often only apply from 2018 to 2025.

The Supreme Court also handed down a decision in the Wayfair case, which also drastically changed the landscape in which businesses need to collect sales tax from their customers.

We have identified a few areas to pay especially close attention to in the coming weeks when starting year-end tax planning for 2018 and beyond.

# Tax Planning for Businesses and Business Owners

## Section 199A - Qualified Business Income Deduction

One of the biggest changes that came out of tax reform is the new 20% deduction for business income, also called the QBI deduction. Generally, if an individual reports taxable income on their personal return from some sort of business, they can exclude 20% of that income from being taxed. There are some limitations of when this can be utilized. One of the biggest limiters is the line of business that generates the income. Many owners of service businesses (SSTBs) will miss out on this deduction, unless their overall income is below certain thresholds. For other owners, the deduction can also be limited by the amount of wages paid and/or the amount of depreciable assets the business owns.

## Potential Benefits of Converting from S Corp to C Corp Status

For many businesses, the centerpiece of the TCJA was a permanent reduction of the corporate tax rate to a flat 21%. However, this rate only applies to C corporations, not to businesses organized as pass-through entities like S corporations, partnerships, sole proprietorships and limited liability companies (LLCs).

In these other businesses, income "passes through" the business directly to owners/shareholders, where it's taxed at their individual rate. The top rate for pass-through entities is now 37%, or possibly 29.6% for businesses that qualify for the new qualified business income (QBI) deduction.

While the lower flat corporate tax rate of 21% makes converting an entity to a C corporation something a business might want to consider, this is far from a black-and-white issue. Many of the historic factors for being a C corp versus not still exist.

*Factors to Consider*

These changes have some pass-through business owners thinking about reorganizing as C corporations. Whether or not this makes sense depends on a number of different factors, starting with how much income a business earns. The graduated personal income tax rates that currently apply to owners of pass-through entities allow the business to earn significant income before reaching the flat 21% tax rate.

For example, if an S corp owner is filing a joint tax return with a spouse and takes the standard deduction, the Federal tax rate wouldn't hit the flat 21% until the their adjusted gross income (AGI) reached $402,500. If the company income qualifies for the QBI deduction, the income allowed before reaching 21% is even greater. This owner would not benefit from a C corp conversion unless the business's AGI is greater than this amount if only the Federal tax rate is considered. When state taxes are factored in, the current tax benefit of switching is reached at lower income levels.

Another factor is the actual cost of making the C corp conversion, including the total legal and other fees that should be considered in financial calculations. These costs will generally be a one-time hit, but could be substantial if the company isn't already in a corporate form.

One of the biggest drawbacks of being a C corp is that income is potentially taxed twice — at the corporate level and again at the individual level when profits are distributed to owners/shareholders. If the plan is to keep profits in the business and not pay dividends, this could make converting to a C corp more attractive. Any future plans to sell the company would push the scale back to not being a C corp.

All in all, any change in entity structure is not straight forward and should be fully evaluated.

## Pros and Cons of C Corps and S Corps

Aside from the factors above, there are inherent advantages and disadvantages of the different forms of business organization.

| S Corps | C Corps |
|---|---|
| Ownership: up to 100 shareholders. | Unlimited number of shareholders. |
| Shareholders must be U.S. residents or citizens. | Owners can live wherever. |
| There can only be one class of stock. | Can issue both common and preferred shares of stock. |
| Shares must be held by individuals, estates or certain trusts — they can't be held by other businesses. | No restriction on ownership. |
| Owners can write off business losses on their personal tax returns. | Owner/employees are allowed to take a greater advantage of tax-free employee benefits. |

## Deductions for Business Meals and Entertainment

The deduction for business meals and entertainment has historically been a valuable tax break for many businesses — especially those that entertain clients and prospects on a regular basis. The TCJA made some important changes to this deduction.

*Entertainment Expenses No Longer Deductible*

Businesses have traditionally been able to deduct 50% of the cost of meals and entertainment if the expenses are considered by the IRS to be "ordinary and necessary" for the purpose of running the business. These expenses may be incurred while travelling or in a home city. For example, when taking a local client or prospect out to dinner and discussing business, 50% of the cost of the meal can be deducted. When attending an industry trade show in another state, 50% of the cost of meals on the trip can also be deducted. This part of the tax law has not changed.

However, the 50% deduction for business entertainment expenses has been eliminated effective for 2018 and forward. Entertainment would include things like taking clients and prospects to concerts or sporting events.

*Cut in Deduction for Employee Meals*

The meals provided to employees at a place of business or in a cafeteria located on business premises used to be 100% deductible. Starting this year, they are only 50% deductible. And starting in 2026, the deduction for these kinds of meals will be eliminated.

However, changes were not made to the deduction for expenses and meals associated with social and recreational activities that are primarily for the benefit of employees, like a picnic or a holiday party. These remain 100% deductible.

*Substantiation of Business Meals*

As always, it's critical to properly substantiate the business purpose of meals if deducting 50% of the cost. If the expenses were incurred while travelling, one must retain documentation that proves travel was for business purposes. Specifically, at least 50% of time on the trip must be devoted to business purposes.

If the expenses were incurred locally, it's important to save the meal receipt and write down the business purpose of the meal along with those who were in attendance. For example:

> 10/15/18: Dinner with client ABC Manufacturing to discuss their upcoming inventory needs. In attendance were myself, President Bob Barnes and Controller Rich Gray.

The IRS has up to three years from the date of filing to audit a tax return. Receipts and substantiation need to be saved for at least this long in case audited by the IRS.

## No Significant Retirement Plan Changes

While early drafts of tax reform legislation suggested that the limits on employee tax deferrals to employer-sponsored retirement plans might be reduced, the TCJA didn't make any significant changes to qualified retirement plans offered by businesses to their employees. Contribution, benefit and compensation limits for 401(k), 403(b) and 457 plans remain the same.

Contributions to retirement plans have become that much more of a tax planning strategy as it relates to the QBI deduction. The QBI deduction is limited or eliminated for the owners of some types of businesses once their AGI exceeds certain thresholds. The phase-out begins once AGI reaches $315,000 if married and filing a joint income tax return, or $157,500 if single. It is eliminated once AGI reaches $415,000 if married and filing jointly or $207,500 if single.

If AGI exceeds these thresholds, contributing to one or more retirement plans could bring the AGI low enough to qualify for the QBI deduction. For example, an owner with $500,000 in AGI could contribute $160,000 to a cash balance plan, $24,500 to a 401(k) plan and $16,500 to a profit-sharing plan. This would bring the AGI down to $299,000 and enable the owner to qualify for the deduction. Thus, their true out-of-pocket expense would be much lower than the $201,000 contributed.

### Retirement Plan Limits for 2018

| | |
|---|---|
| Elective deferral limit for 401(k), 403(b) and 457(b) plans | $18,500 |
| SEP IRA contribution limit | $55,000 |
| Defined contribution limit for 401(k), profit sharing and money purchase pension plans | $55,000 |
| Annual compensation limit for 401(k), profit sharing and money purchase pension plans | $275,000 |
| Catch-up contribution limit for 401(k), 403(b) and 457(b) plans (age 50 and over): | $6,000 |

## More States Sales Taxes to be Collected with the Wayfair Decision

In June, the U.S. Supreme Court made a ruling that will affect how businesses collect sales taxes on items sold online and via mail or the telephone.

The Supreme Court ruled in *South Dakota v. Wayfair, Inc.* that states can now require businesses to collect sales tax on goods that are sold in a state even if there is no physical presence of the business in the state. This overturned a ruling from 1992 when the Court ruled in *Quill Corp. v. North Dakota* that a business had to have at least some physical location in a state to be required to collect sales tax for the state.

The retail marketplace was very different a quarter-century ago when the Quill ruling was delivered. Today, "the Internet's prevalence and power have changed the dynamics of the national economy," the Court stated in its ruling. For example, total U.S. mail-order sales in 1992 were $180 billion (e-commerce didn't exist yet) while online retail sales alone were more than $453 billion in the U.S. last year.

Meanwhile, many states are facing revenue shortfalls due to their inability to collect sales and use taxes associated with online sales. These prohibitions cost states more than $13 billion last year alone, according to the Government Accountability Office.

*Physical Presence and Sales Tax Nexus*

With its Wayfair decision, the Supreme Court has removed the physical presence requirement for sales tax nexus. States that couldn't require out-of-state businesses to collect sales taxes on online, mail and telephone order (or MOTO) sales are now free to pass legislation requiring sellers to collect and remit these taxes. Technically, online shoppers are supposed to pay applicable sales taxes on their purchases when they file their state tax returns, but few actually do this. It is expected that all states will make these changes in the coming year to compensate for these online shoppers.

Some experts believe that the biggest impact of the Wayfair ruling will be on mid-sized online retailers whose online sales volume exceeds state de minimis rules. In South Dakota, for example, businesses with less than $100,000 in sales or fewer than 200 transactions in a state still don't have to collect sales tax in the state. Most states are expected to pass similar de minimis rules.

If so, most small businesses that sell merchandise online via sites like eBay or Etsy won't be affected by the ruling. And most big online retailers like Wal-Mart and Amazon meet the physical presence requirement for sales tax nexus so they're already collecting and remitting sales tax for online purchases.

*Start Preparing Now*

If a business sells goods online or via MOTO, it may eventually have to register in every state where it has sales. Software programs are available that can help ensure compliance with each state's sales tax requirements. Not collecting sales tax from customers when required can create large liabilities for a company that can and should be avoided.

## New Regulations Clarify Sec. 199A Business Income Deduction

The new QBI deduction is an entirely new concept, which creates the need for a whole new set of rules and regulations. The IRS has recently provided some guidance in the form of proposed regulations.

We must look to these proposed regulations for guidance as to how to apply Section 199A to a variety of issues, including what items of income and deductions from a pass-through business are QBI.

In general, QBI means items of gross income, gain, deduction and loss to the extent such items are connected with the conduct of a trade or business within the United States. The following items are not taken into account as QBI:

- Capital gains or losses, including section 1231 gains treated as capital gains
- Interest income, unless allocable to a trade or business (but not from investments of working capital)
- Reasonable compensation received by a shareholder from an S corporation (however, the S corporation's deduction for such reasonable compensation will reduce QBI)
- Guaranteed payments received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an entity. However, the partnership's deduction for such guaranteed payment will reduce QBI.

*Determining if a business is a specified service trade or business (SSTB) and thus having a severely limited QBI deduction*

Generally an SSTB is any trade or business involving the performance of services in one or more of the following fields: health, law, accounting, actuarial, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading, dealing in securities or commodities, and any trade of business where the principal asset is the reputation or skill of one or more of its employees or owners.

However, the regulations exclude certain types of business activities from each of the above-mentioned general SSTB categories. For example, the performance of services in the field of health means only the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, etc. providing medical services directly to a patient. It does not include health/medical-based businesses not providing services to patients.

Regarding the catch-all category of any trade of business where the principal asset is the reputation or skill of one or more of its employees or owners, the SSTB income is limited to income and expenses related to fees, compensation, or other income: for endorsing products or services; for the use of an individual's image, name, signature, voice, etc.; or for appearing at an event or on radio, television or another media format.

The regulations suggest that services that support or are ancillary to the named professional or other services probably fall outside the scope of specified services. However, an SSTB includes any trade or business that provides 80% or more of its property or services to an SSTB if there is 50% or more common ownership of the trades or businesses.

> Example: A law firm provides legal services to clients, owns its own office building and employs its own administrative staff. The law firm divides into three partnerships: legal, building rental and administrative. All three of the partnerships are owned by the same people. Because there is 50% or more common ownership, all three partnerships will be treated as one SSTB.

*Aggregating separate lines of business for purposes of calculating the QBI deduction and the wage and fixed asset limitation*

An individual or pass-through entity may be engaged in more than one trade or business. Unless certain conditions are met and the taxpayers elect to aggregate the separate lines of business, each trade or business is a separate trade or business for purposes of applying the limitations under Section 199A.

Trades or businesses may be aggregated only if:

- The same person or group of persons, directly or indirectly, owns 50% or more of each trade or business;
- The 50% ownership exists for a majority of the year;
- All of the items to be aggregated are reported on returns with the same taxable year;
- None of the trades or businesses to be aggregated is an SSTB; and
- The trades or businesses satisfy at least two of the following factors:

  (a) They provide products and services that are the same or customarily offered together.

  (b) They share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology resources.

  (c) They are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

*Owner not required to provide substantial services to qualify for the QBI deduction*

A direct or indirect owner of a trade or business engaged in the performance of a specified service is engaged in the performance of the specified service for purposes of Section 199A, regardless of whether the owner is passive or participated in the specified service activity.

## Revised Partnership Audit Rules

Effective January 1, 2018, the new IRS Audit Rules for partnerships will affect all partnerships, large and small. We are recommending that business owners look into their partnership operating agreements and have them reviewed by a professional to determine whether amending them is necessary to address these changes.

Under the new audit rules, the partnership itself will be responsible for an assessment of tax. Previously, the individual partners would be subject to and pay the assessed underpayment. The tax assessed from the partnership audit would be at the highest individual tax rate (currently 37 %). There are certain exceptions to being taxed at the highest available rate that can be considered during the audit. The IRS also has given an option to entirely opt-out of the new rules via an annual election for certain partnerships. This would make the partners individually liable for the tax rather than the partnership.

## Qualified Opportunity Zones Investment Tax Benefits

The Qualified Opportunity Zone (QOZ) is part of the new tax reform legislation which incentivizes investment in a struggling economic area through preferential income tax treatments. The Opportunity Zones program offers three tax benefits for investing in low-income communities through a Qualified Opportunity Fund:

- A temporary deferral of capital gains reinvested in an Opportunity Fund. The deferred gain would be recognized on the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026.
- A step-up in basis for capital gains reinvested in an Opportunity Fund. The basis is increased by 10% if the investment in the Opportunity Fund is held by the taxpayer for at least 5 years and by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation.
- A permanent exclusion of capital gains from the sale of an investment in an Opportunity Fund if held for at least 10 years. This exclusion only applies to gains accrued after an investment in an Opportunity Fund.
- Anyone can invest in a QOZ and receive these preferential tax treatments as long as they have capital gains to invest.

To learn more about pursuing a Qualified Opportunity Zone investment, please reach out to Aldrich to begin the discussion.

## Depreciation Changes

The rules for depreciation seem to change every year. The TCJA expanded bonus depreciation to include a 100% deduction for many fixed assets in the near term, except for actual building purchases. Section 179 limits were also increased. Businesses should always only buy additional assets if actually needed.

# Tax Planning for Individuals

## Major Impacts to Itemized Deductions

One of the most significant changes to individual taxes was the doubling of the standard deduction. This is a temporary change impacting 2018-2025. More than half of the individuals who itemized in 2017 are projected to use the standard deduction largely due to the increase in the standard deduction. The cap on the tax deduction of a max of $10,000 ($5,000 for MFS) is another significant factor. This cap applies to the total of income, sales tax and property taxes.

The changes to the home interest deduction and removal of the deduction for home equity line interest are also expected to have an impact. For those acquiring a mortgage or increasing the principal on their current mortgage through refinancing, the deductible interest is capped on principal of $750,000 (down from $1 million). For loans from homes originating before December 15, 2017, the mortgage is grandfathered under the prior $1 million limit. Home equity line debt interest is no longer deductible if not used to acquire or substantially improve the property.

Generally, miscellaneous itemized deductions are not deductible. This list includes investment fees, unreimbursed employee expenses, and most nonbusiness casualty or theft loss deductions.

After discussing the many deductions that have been reduced or removed from 2018-2025, there is a silver lining for this period. There is no Pease limitation. This limitation applied for those with high adjusted gross income and would reduce itemized deductions. If the total of the itemized deductions didn't match the deduction at the bottom of Schedule A, it's likely because of the Pease limitation.

## Reduced Tax Rates

The top individual rate dropped from 39.6% to 37%, but even at the lower tax brackets taxpayers will see some benefits due to lower, expanded brackets.

## Benefits to Making Retirement Contributions

Contributing to a qualified retirement plan is a great way to help ensure a financially comfortable retirement. But there are other benefits as well, including a lower current tax bill.

Elective deferrals made to a traditional 401(k) account will reduce taxable income, which will lower taxes. Contributions made to a SEP-IRA can be deducted from gross income. In addition, retirement plan contributions made on a pre-tax basis will grow tax-deferred, which could result in a larger retirement nest egg later.

## Changing Limits and Tax Benefits for Charitable Contributions

Under the new law, for contributions made in tax years after 2017 and before 2026, the 50% limitation for cash contributions to public charities and certain private foundations 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.

Although the charitable contribution deduction limitation increased from 50% to 60% of adjusted gross income, it may be much harder to claim a Federal tax deduction for charitable contributions for the 2018 tax year. Since the standard deduction threshold amounts nearly doubled, some taxpayers may no longer itemize for Federal purposes and as such receive no Federal tax benefit for their donations.

Another change impacting charitable contribution deductions under the new law is that no charitable deduction will be allowed for any amounts paid for college athletic seating rights. This changes the special rules that existed as it applied to certain payment to institutions of higher education in exchange for which the donor received the right to purchase tickets or seating at an athletic event, where a donor could treat 80% of a payment as a charitable deduction if certain conditions were met.

The recordkeeping and substantiation rules on donors for charitable contributions remains unchanged. No charitable deduction is allowed for contributions of $250 or more unless the donor substantiates the contribution by a contemporaneous written acknowledgment from the receiving qualified organization. Contributions made through payroll deduction of $250 or more from a single paycheck can be substantiated with a pay stub or other documents provided by the employer.

There are some tax planning strategies for donors who are on the cusp of not itemizing in a given year to receive a tax benefit for donations. Strategies include "bunching" contributions, where larger gifts are made in some years and no gifts in other years or contributions are made to a self-directed donor-advised fund to hold charitable funds for later distributions to charities.

For state income tax purposes, a charitable contribution may still provide the same tax benefit it did in previous years as many states have much lower standard deductions than provided in Federal tax law. Therefore, a taxpayer may still be able to itemize for state income tax purposes and deduct charitable contributions in a given year even though the taxpayer did not itemize on the Federal return.

Many states are currently enacting legislation in response to the SALT (sales and local tax) deduction limit changes under the new law. Some states have passed bills that allow taxpayers to make charitable contributions to a state fund rather than pay state taxes in anticipation that taxpayers can fully deduct those taxes as a charitable contribution. However, in August 2018, the IRS issued proposed regulations providing rules on the availability of charitable contribution deductions when a taxpayer receives or expects to receive a corresponding state or local tax credit. Under these proposed regulations, a taxpayer who makes eligible payments to states to receive tax deductible contributions must reduce his/her charitable deduction on the Federal return by the amount of any state or local tax credit the taxpayer receives or expects to receive.

## Estate Planning for Maximum Income Tax Benefit

Although the lifetime unified credit has doubled ($11.18 million in 2018), there are still many reasons to consider estate planning under the new tax reform. The larger exemption is set to sunset in 2025. There is optimism that the credit would not be reduced, but there is always concern of the potential for claw back or other changes in the estate tax rules.

One of the big new focuses is on income tax planning for the heirs as it relates to an estate. Upon death, the assets of the decedent generally have a step up in their basis to the value at the date of death. Old strategies for some focused on minimizing the estate or gift tax, but now with the higher exemption, maximizing the potential income tax benefit to heirs can have a greater impact.

Trusts have multiple purposes that go beyond simply the transfer of wealth. There are strategies to help protect heirs and to minimize probate. There are various trust options that range from simple to complex that can help with a wide range of issues.

A family limited partnership can be another helpful wealth transfer tool to reduce the value of an estate. This structure allows for potential valuation discounts, and the donor can maintain control as a general partner in the entity. There are some risk protections as well. The implications for these strategies can be quite complex, especially in a state with an estate or inheritance tax.

# Tax Reform 2.0 — Other Potential Changes Coming

Many provisions contained in earlier drafts of tax reform didn't make it into the final legislation. It's possible that some of these provisions could re-emerge in what some are calling Tax Reform 2.0.

## Make Tax Benefits Permanent

Many of the TCJA's taxpayer-friendly changes are only temporary, expiring at the end of 2025. These include the lower federal income tax rates for individuals, the doubled child tax credit, expanded standard deductions, a higher gift and estate tax exemption, more favorable alternative minimum tax (AMT) rules and the 20% QBI deduction for pass-through business entities. Some legislators would like to end these sunsets and make these benefits permanent.

## Modify Section 529 College Savings Plans

The rules regarding withdrawals from 529 plans could be changed to allow tax-free withdrawals to pay for home schooling or apprenticeships or to pay off student loans.

## Introduce a New Universal Savings Account

Contributions to these accounts would be made with after-tax dollars (like with Roth IRAs) and tax-free withdrawals would be allowed at any time for a variety of purposes.

## Change Rules Regarding Withdrawals from Retirement Accounts

These changes would allow penalty-free withdrawals from qualified retirement accounts like IRAs and 401(k)s after the birth or adoption of a child.

## Allow Capital Gains Indexing for Inflation

This would allow investors to increase the tax basis of investments like stocks, bonds and mutual funds shares to account for inflation. The result would be lower taxable gains and taxes when investment assets are sold.

## Enhance Tax Benefits for Startup Businesses

These could include measures like improving the Section 179 deduction and creating a new standard deduction for startup business costs.

## Eliminate the Social Security Earnings Penalty

This penalty reduces Social Security benefits by 50% for seniors who claim benefits before they reach full retirement age. Some legislators would like to see it abolished.

Of course, getting any of these provisions through a divided Congress and onto the President's desk for his signature is far from a sure thing. The House has passed 3 separate bills that make up the current Tax Reform 2.0, but the Senate will most likely not vote on them in the near term since there doesn't seem to be enough votes to pass them.

But there is bipartisan support for some of these provisions, including those that would make it easier to save for retirement, expand the use of funds saved in Section 529 plans and encourage entrepreneurship. The hope that Tax Reform 2.0 gains traction has been greatly diminished by the most recent election results, but changes are always possible.

Please contact us with any questions about year-end tax planning strategies.

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