Certified Public Accountants
Strategic Business Consultants

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Greetings:

2017 was a landmark year for changes in the tax laws with the passage of the new Tax Cuts and Jobs Act as well as the promulgation of rulings from the IRS that got less attention in the press but will have significant impact. This letter will provide an overview of those changes, with a special emphasis on the areas most likely to be of interest to our clients.

Most of these law changes are temporary, meaning the rules "sunset" after several years (seven to ten years, in most cases). We have not included the sunset dates in this letter, as almost all tax rules can be viewed as transitory nowadays. A change in control of Congress or the White House will likely cause a change in many of these rules long before the sunset dates arrive. We will alert you to those changes as they occur with future updates.

This letter was prepared by Brian Gourlay, one of our tax partners. In return for taking on this task we agreed to let him insert the occasional editorial comment. All opinions stated are solely his and do not necessarily reflect the opinions of the other partners or our staff.

Words of Caution

This is merely a summary of select portions of the tax law changes. "The devil is in the details" is a phrase that could have been written specifically with the tax law in mind. Our goal here is to bring these changes to your attention, to alert you to potential opportunities – and risks. Please speak with us before attempting to take advantage of any of these changes, and don't hesitate to contact us with any questions.

California does not conform to most of these changes. In some cases that will not come as a surprise. But in others that may be unexpected, such as the expansion of the use of funds from a Section 529 plan.

Tax Rates and Thresholds - Individuals

The **top tax rate for individuals and trusts** will decrease to 37% (from 39.6%) in 2018. The income levels at which the higher rates are reached are going up. While any decrease in the tax rate is welcome, this one is 2.6% and not going to generate any excitement. We've provided the 2018 tax tables before and after the law change at the end of this letter so you can see the specific effect.

The **Social Security tax** applies to earned income up to $128,400 in 2018 ($127,200 in 2017).

California's state disability insurance (SDI) rate has increased to 1.0% (from 0.9% in 2017) on wages up to $114,967 (was $110,902 in 2017).

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The **Standard Deduction** – what you use if you don't itemize your deductions such as home mortgage interest, taxes and charitable contributions – almost doubles in 2018. Single taxpayers get $12,000 (up from $6,350), married filing jointly $24,000 (up from $12,700) and head of household $18,000 (up from $9,350).

Personal Exemptions – that deduction you got for yourself, your spouse and each dependent – would have been $4,150 per person in 2018. This was eliminated in the new tax bill.

Comment: Prior to this change the personal exemption deduction was phased out for higher income taxpayers, so you may not see an effect from the repeal of this deduction.

"Kiddie" Tax – the unearned income of most children under the age of 19 (24 if a full-time student) was previously taxed at their parents' tax rates. Starting in 2018 the unearned income of such children will now be taxed at the rates applicable to trusts.

Observation: Trusts are taxed at the same <u>rates</u> as individuals, but reach the higher rates much sooner. For example, in 2018 married individuals reach the top (37%) rate when their taxable income is $600,000. A trust reaches the 37% rate at $12,500.

Capital Gains – there was much concern regarding a possible increase in the tax rate on capital gain income. The maximum rate remains at 20% in 2018 for individuals and trusts. The net investment income tax continues to apply as well to taxpayers above certain income thresholds, which adds an additional tax of 3.8%, for a potential combined tax rate on capital gain income of 23.8%.

Observation: Qualified dividends continue to be taxed at 23.8% as well, even though the tax rate on corporations decreases substantially in 2018.

Carried Interest – this is generally a profits interest in a partnership received for services. They have been considered somewhat controversial because the carried interest holder receives capital gain treatment when he or she sells their interest in the partnership, as long as they've held that interest for more than one year.

For sales occurring after December 31, 2017 carried interest holders will only be eligible for capital gain treatment if they have held their interest for more than three years.

Comment: carried interests have been under attack by members of Congress in both parties and President Trump since their eligibility for capital gain treatment was noted in a front page article in the Wall Street Journal over ten years ago. (The subject of that article was certain executives of the Blackrock investment fund, but carried interests are also common in the real estate industry.) That this is the only change in the rules related to carried interests is a huge win for those eligible for the benefit.

<u>Deduction for Qualified Business Income</u>
In general, the new tax act allows individuals to deduct 20% of their qualified business income. In other words, if your business income is $100 you get to deduct $20 and are taxed on $80. This deduction cannot exceed your taxable income.

Qualified business income is income you receive from a trade or business that is not a C corporation. Rental real estate qualifies as a business for this purpose. Business income passing through from a partnership or S corporation qualifies. Sole proprietors (Schedule C) qualify for this deduction. It does not matter if you are active or passive in the business.

Comment: most of the media coverage on this new deduction has implied it only applies to "pass-through" entities such as partnerships and S corporations. The deduction is available to sole proprietors (Schedule C) and single member limited liability companies owned by individuals as well.

Income from a business does *not* include payments you receive that are:

- W-2 wages
- Guaranteed payments from a partnership
- Independent contractor/1099-MISC payments from a partnership in which you are a partner
- Capital gains (short or long term)
- Interest
- Dividends

If your taxable income exceeds $207,500 ($415,000 if married filing jointly) then the following limitations apply:

- Income from a service business does not qualify for the deduction. (There are exceptions, such as engineering and architectural businesses.)
- The deduction is limited to the *lesser* of:
    (1) 20% of qualified business income, or
    (2) The greater of:
        a. 50% of W-2 wages, or
        b. 25% of W-2 wages plus 2.5% of the unadjusted basis of depreciable property.

If your taxable income (before this deduction) is between $157,500 and $207,500 ($315,000 and $415,000 for married taxpayers filing jointly) then the limitations discussed above are phased in. These phase in rules are very complex and beyond the scope of this letter.

Observation: the term "unadjusted basis" refers to the basis of the property immediately after it was acquired – i.e., before depreciation. This will increase the importance of maintaining accurate and detailed records of any fixed assets acquired.

The **Section 199 Domestic Production Activities Deduction** has been repealed, effective December 31, 2017.

Changes Affecting Itemized Deductions

Medical Expenses – beginning in 2017 the threshold for deducting medical expenses will decrease from 10% to 7.5% of adjusted gross income. Note: prior to 2017 the threshold was 7.5% for taxpayers age 65 and older, so this change will only affect younger taxpayers.

Comment: this is one of the few law changes that is retroactive, taking effect on January 1, 2017. It is only effective for 2017 and 2018. In 2019 the threshold returns to 10%.

State and Local Taxes (SALT) – beginning in 2018 the deduction for state and local taxes, i.e., income tax, real estate tax and sales tax are limited to $10,000 ($5,000 if married filing separately). Note: this limitation does not apply to property used in a trade or business, including rental real estate.

Comment: the state and local tax deduction was the primary preference item (non-deductible expense in the AMT) for many California residents. For that reason some of our clients may see little or no tax effect from this change, as they were not receiving a tax benefit from this expense.

Home Mortgage Interest – beginning in 2018 interest on home mortgages is only deductible on the first $750,000 of debt. Interest on home equity indebtedness is no longer deductible.

Exception: home mortgage debt that was in existence prior to December 15, 2017 is still subject to the prior limit of $1 million in 2018 and beyond.

Observations: this limitation is on the mortgage debt of all homes combined. The earlier proposal to disallow the deduction of interest on second homes did not become law. Interest on home equity indebtedness is no longer deductible, even if in existence at December 15, 2017.

The **Charitable Deduction Limitation** has been increased from 50% to 60% of adjusted gross income for contributions to public charities and certain private foundations beginning in 2018.

Casualty and Theft Losses – incurred after December 31, 2017 are no longer deductible unless incurred in a Federally-declared disaster.

Miscellaneous Deductions such as brokers fees, investment expenses, unreimbursed business expenses and tax preparation fees (sorry) are no longer deductible beginning in 2018.

Phase Out of Itemized Deductions – prior to 2018 most itemized deductions were reduced by up to 80% if your adjusted gross income exceeded a specified level. This phase out has been removed by the new tax act.

Other Changes Affecting Individuals

Alimony will not be deductible (by the payer) or taxable (to the recipient) for divorce or separation agreements executed after December 31, 2018. Alimony paid or received under agreements executed prior to that date remain subject to the old rules.

Use of **Section 529 Plans** has been expanded. Prior to 2018 only qualified expenses related to college level education were eligible. Effective for distributions made after December 31, 2017 qualified expenses for elementary and secondary are now eligible, as are expenses associated with home schooling.

The **Child Tax Credit** has been doubled, from $1,000 to $2,000 per child beginning in 2018.

Comment: The Child Tax Credit is phased out for higher income taxpayers. That phase out threshold has been substantially increased, to $400,000 (from $110,000) for married taxpayers filing jointly and $200,000 for all others (from $75,000 for single and $55,000 for married taxpayers filing separately).

Alternative Minimum Tax – the AMT for individuals was not repealed by the new law, but the exemption amounts were increased (almost doubled).

Observation: this, combined with the limitation on the deduction of state and local income taxes, should substantially reduce the number of taxpayers subject to the AMT.

<u>Estate and Gift Taxes</u>
The annual **Gift Tax Exclusion** increases to $15,000 per gift (from $14,000) in 2018. This change was due to a cost of living adjustment, not the new law.

The **Lifetime Exemption** has been doubled, beginning in 2018. For decedents dying and gifts made after December 31, 2017 the total amount that can be transferred to your beneficiaries without incurring an estate or gift tax increases to approximately $11,200,000 per individual. Married couples that combine their estate plans can transfer up to $22,400,000 without incurring an estate tax. We are still waiting for the exact amount of the new exemption figure for 2018, but it should be close to $11,200,000.

Valuation Discounts – in August of 2016 the IRS issued a set of complex proposed regulations which would have expanded the Service's ability to challenge the valuation discounts commonly taken in the estate and gift area.

On April 21, 2017 President Trump issued Executive Order 13789, which suspended the implementation of several recently enacted regulations, including the proposed limitation on valuation discounts. On October 2, 2017 the IRS formally withdrew the proposed regulations.

Comment: although the IRS denied it, many tax professionals viewed these proposed regulations as an attempt to eliminate the discounts on family owned business interests. The withdrawal of these proposed regulations is a welcome relief for the estate planning community.

<u>Changes Affecting All Taxpayers</u>
The **Net Operating Loss carryover rules** have changed. Prior to 2018 a net operating loss could be carried back two years, and carried forward 20 years. Effective for losses incurred after December 31, 2017 there is no carryback option and losses can be carried forward indefinitely.

However, the deduction of NOLs incurred after 12/31/17 will be limited to 80% of taxable income (determined without regard to the NOL deduction).

Comment: this will have a significant impact on those incurring net operating losses in 2018 and beyond. By limiting the use of NOLs to 80% of taxable income Congress has ensured that taxpayers will no longer be able to bring their tax liability to zero through the use of loss carryforwards, no matter how large that loss may be.

Like Kind (Section 1031) Exchanges are now limited to real property.

Changes Affecting All Businesses

The changes discussed in this section apply to all types of businesses. In addition there have been changes specific to certain types of businesses, such as C corporations and partnerships. Those changes are discussed later in this letter.

The limitation on **Section 179** expensing increases in 2018 to $1 million (from $500,000). The phase out level for total asset purchases has been increased to $2.5 million (from $2,030,000). The list of property eligible for Section 179 has been expanded. Additional property used in nonresidential real estate is now eligible, such as roofs, HVAC systems, fire protection and security/alarm systems.

Bonus Depreciation has greatly expanded, and the changes have an unusual effective date: assets placed in service after September 27, 2017:

- First year deduction is now 100% of adjusted basis (was 50%)
- Used property is now eligible (previously only first use property could be expensed)
- You can elect to expense 50%, rather than 100% of the basis

Observation: many assets are eligible for both Section 179 and bonus depreciation. Please contact us regarding which option is best for you, as these rules have subtle but important differences.

The **Depreciable Lives of Certain Real Property Assets** have been shortened. Normally nonresidential real property is depreciated over 39 years. Prior to 2018 only certain qualified leasehold improvements to nonresidential property were eligible to be depreciated over a 15 year life.

Effective for assets placed in service after December 31, 2017 the definition of "qualified improvement property" will include any interior improvement to a nonresidential building that is not attributable to the enlargement of the building, an elevator or escalator or internal structural framework of the building.

Qualified improvement property is depreciated on a straight-line basis over 15 years. Such property is eligible for bonus depreciation, discussed earlier.

Note: Congressional intent, as detailed in the Committee Reports, was to assign a 15 year life to qualified improvement property. However, due to a drafting error, this is not how the final law actually reads. A technical correction will be required to make this happen.

Cash Method of Accounting – for tax years beginning after December 31, 2017 taxpayers with average gross receipts under $25 million will now be eligible to use the cash method of accounting. A taxpayer must aggregate their commonly controlled businesses in applying this gross receipts test. Previously the threshold was $10 million ($5 million under certain circumstances).

Disallowance of Entertainment Expenses – beginning in 2018 entertainment expenses will no longer be deductible. This includes the cost of golf, sporting events, theater tickets, etc. 50% of the cost of business meals is still deductible. In light of this change we suggest you expand your chart of accounts to create separate expense categories for "meals" and "entertainment".

Limitation on Deduction of Business Losses – beginning in 2018 non-corporate taxpayers can only deduct the first $250,000 of their business losses against non-business income ($500,000 in the case of married taxpayers filing a joint tax return). Any excess losses become NOLs, the use of which are subject to new limitations, discussed above.

Example: in 2018 Fred, a single taxpayer, has a net loss of $325,000 from all his business activities. Fred also has investment income (interest, dividends and gains from stock sales) of $350,000. None of Fred's business losses are passive.

Prior to this law change, Fred would have taxable income of $25,000 (the investment income of $350,000 less the business losses of $325,000). Due to this new limitation Fred can only deduct his first $250,000 in business losses, so his taxable income will be $100,000 (the investment income of $350,000 less the *allowed* business losses of $250,000). The excess loss of $75,000 ($325,000 - $250,000) becomes a net operating loss, which carries forward to future years.

Limitation on Deduction of Business Interest Expense – beginning in 2018 a business whose average gross receipts are greater than $25 million can only deduct business interest expense up to 30% of its adjusted taxable income plus any business interest income. Any deductions disallowed by this provision carry forward indefinitely. Businesses commonly controlled by the taxpayer must be aggregated for purposes of determining whether the $25 million threshold has been reached.

Note: there are special rules regarding how this limitation will apply to rental real estate.

<u>Changes Affecting C Corporations</u>

The **Tax Rate** for C corporations will be a flat 21% for tax years beginning after December 31, 2017. This includes personal service corporations. Prior to this change C corporations were taxed at graduated rates ranging from 15% to 35%, depending on their level of taxable income. Personal service corporations were taxed at a flat rate of 35%.

Comment: while certainly a welcome change for our C corporation clients, this remains the least tax-efficient form of business entity. Net income of a C corporation will still be taxed twice: once on the corporate level, at a 21% rate and again at the shareholder level, at a 23.8% rate for individuals receiving dividends. That's a total federal tax of 44.8%, versus the maximum 37% rate for owners of flow-through entities such as partnerships and S corporations. And that's before the new 20% deduction of business income is applied.

The **Alternative Minimum Tax** for C corporations has been repealed for tax years beginning after December 31, 2017.

<u>Changes Affecting Partnerships</u>

The **Technical Termination Rule** for partnerships has been repealed, effective for partnership years beginning after December 31, 2017. Previously any partnership that had a 50% or more change in ownership in a 12 month period was deemed to have terminated.

Partnership Audit Rules – In 2015 Congress passed the Bipartisan Budget Act, which radically changed the rules governing the audit of partnerships (including limited liability companies). These new rules are effective for partnership tax years beginning on or after January 1, 2018. While there are still a number issues that require clarification by the IRS, we want to bring this to your attention now because you should amend your partnership agreements as soon as possible to adjust for these new rules.

Previously any increase in partnership income, which caused an increase in the partner's taxes, had to be assessed and collected at the <u>partner</u> level. This was a significant burden for the IRS, especially in the case of large partnerships, as they had to pursue each partner individually. Under these new rules the IRS can assess and collect tax at the <u>entity</u> (partnership) level. Therefore, in the new system, the <u>partnership</u> (rather than the partners) pays any tax, interest and penalties resulting from an IRS audit adjustment.

So what happens if there has been a change in the partners? For example, John and Marsha are partners in a partnership that incurs a loss of $100,000 in 2018. In 2019 Ted acquires John's interest in the partnership. In 2020, the IRS audits the partnership's 2018 tax return and determines the loss should have been only $50,000. Under the old rules, the IRS would have gone after John and Marsha (the 2018 partners) for the tax due on the $50,000 increase in income.

Under the new rules the IRS will assess the tax for that $50,000 adjustment on the partnership – whose partners are now Ted and Marsha. So Ted will now share in the burden of that additional tax, even though John was the partner that received the benefit of that (erroneous) deduction. For that reason the new rules allow the partnership to elect to "push out" any audit related liabilities to the old partners – i.e., the partners that were in the partnership in the year under audit.

In order to avoid any future misunderstandings, and surprises, partnership agreements should be amended now to address these push out rules and indicate how audit adjustments will be handled. If the partnership will be making the push-out election the agreement should note that the partnership will be providing the IRS with the former partner's identity and location. Because the push-out election can only be made if the IRS can be provided with that data, the former partners should be required to inform the partnership of their whereabouts while the statute of limitations is open for any year in which they were a partner.

The new audit rules also introduce the concept of a "partnership representative", which replaces the old Tax Matters Partner. The Partnership Representative does not need to be a partner, and has broad powers to bind the partnership and its partners. The operating agreement should stipulate the process for selecting the Partnership Representative and, if possible, designate one. The identity of the Partnership Representative must be disclosed beginning with 2018 partnership tax returns.

Virtual Currencies (Bitcoin, Litecoin, Ethereum, etc.)
Trading in and using virtual currencies (also known as cryptocurrencies) has gone from a fad to a serious investment endeavor. We wanted to point out a couple of important tax issues regarding these currencies. Unlike conventional foreign money (think: Euro, Pound, Peso) virtual currencies are treated as a capital asset – i.e., in the same manner as a stock, or precious metal. That has advantages and disadvantages.

The advantage is, the gains you realize from your investment in virtual currencies are capital gains, subject to lower tax rates.

The disadvantage is, using your appreciated Bitcoin to purchase an asset – say that new Tesla Model 3 – triggers gain recognition on that appreciation. So, if you purchased a Bitcoin for $3,000 then used that Bitcoin when it was worth $18,000 to purchase the Tesla, you'll have taxable income of $15,000. Taxable income is also triggered if you simply convert your Bitcoin (or other virtual currency) into U.S. dollars.

Comment: for those of you thinking the IRS will never find out – it is called a cryptocurrency, after all – please note that Coinbase (the largest virtual currency broker in the U.S.) is already complying with IRS subpoenas. Not completely, Coinbase is still fighting this in court, but there are similarities to how the breach of Swiss banking secrecy got started.

Note: there is also concern that owning a virtual currency may need to be reported under the FATCA rules in the same manner as other foreign assets. The IRS has not gone down this path (yet), but virtual currencies are a sore spot and the government has been very vocal about their success in using the FATCA and FBAR rules to find and seize hidden wealth.

Paying Taxes Via The Internet
Both the IRS and California's Franchise Tax Board (FTB) now offer the ability to pay your taxes via their web sites without a fee. This applies to balances due for a tax return, for an extension and for estimated tax payments. To pay your taxes on line please go to:

IRS: https://directpay.irs.gov/directpay/

FTB: https://webapp.ftb.ca.gov/WebPay/

When making a payment via these web sites please review the options very carefully. The user interface for these sites can be confusing, and we frequently see payments misapplied (for example, an extension payment for 2017 accidently designated as an estimated tax payment for 2018 – both of which are due on April 15).

After you complete the process you will see a screen showing a summary of the transaction and a transaction number. Please print this screen, on paper or to an Adobe pdf file, as proof of your payment.

Tax Return Due Dates

Last year the IRS made a number of changes to the due dates of tax returns. Even though we've been through one full cycle (year) of these changes, we still frequently receive questions regarding when tax returns are due. Below is a chart of the current due dates. All dates assume a year end of December 31 unless otherwise noted.

	Federal Due Dates		California Due Dates	
Type of Return	Initial	Extended	Initial	Extended
Individuals	April 15	October 15	April 15	October 15
Partnerships/LLCs (multiple members)	March 15	September 15	March 15	October 15
Single member LLCs:				
Member is an individual, LLC, C corporation or partnership	Not applicable – no filing requirement.		April 15	October 15
Member is an S corporation	Not applicable – no filing requirement.		March 15	September 15
S corporations	March 15	September 15	March 15	September 15
C corporations:				
Year ends 12/31	April 15	October 15	April 15	October 15
Year ends 6/30	September 15	April 15	October 15	April 15
All others	See Note 1	See Note 2	See Note 3	See Note 4
Trusts	April 15	September 30	April 15	October 15

Note 1: C corporations with a year end of other than June 30 or December 31 are initially due on the 15th day of the fourth month after the year end of the corporation.

Note 2: The extended due date of a C corporation with a year end of other than June 30 or December 31 is the 15th day of the tenth month after the year end of the corporation.

Note 3: California C corporation returns are initially due on the 15th day of the fourth month after the year end of the corporation.

Note 4: The extended due date of a California C corporation return is the 15th day of the tenth month after the year end of the corporation.

FTB Tax Information Authorization

For years California's Franchise Tax Board (FTB) has given tax professionals the ability to access certain data regarding their clients – primarily estimated tax payments made and copies of any notices sent. We often use this data to confirm the FTB's record of payments made matches that of our clients.

Starting in 2018 the FTB will require tax professionals to have Form 743, Tax Information Authorization on file to provide permission to acquire this data. Please expect to receive a copy of that form from us. When you do we'd appreciate it if you would sign and return the form as soon as possible (via e-mail or fax is fine). We will retain this form in our files, it is only given to the FTB if they request a copy.

New Tax Tables

TAX BRACKETS

The following charts compare the new tax brackets for 2018 and the 2018 tax brackets previously released by the IRS. (TCJA §11001, amending IRC §1) All income levels will be indexed for inflation. (TCJA §11001, amending IRC §1)

2018 Tax Brackets (Tax Cuts and Jobs Act)				
Rate	**MFJ**	**MFS**	**Single**	**HOH**
10%	$0–$19,050	$0–$9,525	$0–$9,525	$0–$13,600
12%	$19,051–$77,400	$9,526–$38,700	$9,526–$38,700	$13,601–$51,800
22%	$77,401–$165,000	$38,701–$82,500	$38,701–$82,500	$51,801–$82,500
24%	$165,001–$315,000	$82,501–$157,500	$82,501–$157,500	$82,501–$157,500
32%	$315,001–$400,000	$157,501–$200,000	$157,501–$200,000	$157,501–$200,000
35%	$400,001–$600,000	$200,001–$300,000	$200,001–$500,000	$200,001–$500,000
37%	$600,001 and over	$300,001 and over	$500,001 and over	$500,001 and over

2018 Tax Brackets (Previous Law; No Longer Applicable)				
Rate	**MFJ**	**MFS**	**Single**	**HOH**
10%	$0–$19,050	$0–$9,525	$0–$9,525	$0–$13,600
15%	$19,051–$77,400	$9,526–$38,700	$9,526–$38,700	$13,601–$51,850
25%	$77,401–$156,150	$38,701–$78,075	$38,701–$93,700	$51,851–$133,850
28%	$156,151–$237,950	$78,076–$118,975	$93,701–$195,450	$133,851–$216,700
33%	$237,951–$424,950	$118,976–$212,475	$195,451–$424,950	$216,701–$424,950
35%	$424,951–$480,050	$212,476–$240,025	$424,951–$426,700	$424,951–$453,350
39.6%	$480,051 and over	$240,026 and over	$426,701 and over	$453,351 and over