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Explanation of New Tax Laws Starting January 1, 2018

This Tax Newsletter provides guidance on the main portions of the new tax laws pertaining to Individuals and Pass-Through Businesses (S-Corporations, LLCs, and Sole-Proprietorships). Taxpayers with a basic understanding how the new laws impact their finances can help their advisors shape excellent tax plans. Our Newsletter has four Parts and several Examples.

Part I - The 20% Business Income Deduction (BID) – An Overview with Examples.

A. The General BID Rule. Typically individuals who own businesses own their interests as members of a limited liability company or they are stockholders in an S-Corporation. The LLC or S-corporation is known as a flow-through entity. The Business Income Deduction ("BID") flows from the business to the owner's personal tax return, Form 1040. The first BID rule is an individual may deduct the lesser of:

(1) 20% of the net income from their flow-through, or

(2) 50% of the W-2 wages with respect to the business.

The Widget, LLC example below illustrates the two prong general BID rule.

Widget, LLC Example	No W-2 Bid Limit	W-2 BID Limit
Business Net Income	$250,000	$250,000
W-2 Wages	180,000	80,000
Calculations:		
20% of Net Income	50,000	50,000
50% of W-2 Wages	90,000	40,000
BID is the lesser of the two	$ 50,000	$ 40,000

B. The Capital BID Rule. Many businesses have relatively low wages, but invest heavily in equipment or buildings, such as real estate rental companies. For these companies, the BID deduction is allowable up to *the greater of* (1) or (2) below:

(1) First, the general BID rule - the lesser of: (a) 20% of net income or (b) 50% of W-2 wages,

(2) Second, or 25% of W-2 wages, *plus* 2.5% of generally the cost of qualified property.

The example below for Building, LLC illustrates the capital BID rule.

Building , LLC Example	Capital BID Rule
Business Net Income (from Rents)	$250,000
W-2 Wages	5,000
Cost of Building	1,800,000
General BID allows only 50% of Wages of $2,500	
But, the Capital BID Rule Allows More:	
First, 25% of W-2 Wages	1,250
Plus 2.5% of Building Cost	45,000
Equals:	$ 46,250

Thus, Capital BID allows a $46,250 deduction instead of $2,500.

Tax Observation: Capital intensive companies can maximize their BID by maintaining accurate tax depreciation records for their assets, including old fully depreciated assets.

C. <u>BID Only Applies to Business Income.</u> Business income from a non-corporate taxpayer, including a trust or estate, a partnership, S corporation, or sole proprietorship is eligible for BID. Generally, income from the aforementioned sources will qualify for BID, unless excluded.[1] Some notable inclusions are: (i) income allocable to passive partners and shareholders, (ii), rental income, and (iii) oil and gas working interests, but not mineral royalties.

Tax Tip! Business owners of qualifying businesses may want to consider structuring the business allowing key employees to own part of the company instead of paying W-2 bonuses or higher salaries. LLCs are typically better than S-Corporations to achieve these objectives.

D. <u>BID and Service Income.</u> The BID does not apply to Certain Specified Service Income. With the *exception of engineering and architects*, many service businesses are not eligible for the BID including: physicians, nurses, dentist, lawyers, accountants, investment management services, actuarial sciences, performing arts (but not services provided to the performing arts), consultants, athletics, and businesses where the principal asset of such is the reputation or skill of one or more of its employees[2], or employees performing services of an employee.

Does the BID exclusion apply to a cosmetologist or handy man services because of their reputation or skill? Perhaps, but a limited Middle Class Service Income exception allows many individuals with otherwise excluded Service Income to take advantage of the BID.

E. <u>Middle Class Service Income Exception.</u> Taxpayers with Service Income that does not otherwise qualify for BID are allowed the deduction if their income is below certain thresholds:

(1) Married taxpayers filing joint and all other individual taxpayers can take full advantage of BID if their *taxable income* is less than \$315,000 and \$157,000 respectively; and

(2) The BID starts phasing out afterwards, and the deduction is fully disallowed after taxable income exceeds \$415,000 and \$207,000 respectively.

Tax Tip! Middle class taxpayers with W-2 Wages from their Service C Corporations can likely generate qualifying BID income from their profits by converting to an S-Corporation or LLC.

F. <u>Other Aspects, Observations, and BID Example Comparison.</u>

(1) The BID W-2 Wage limitations (50%/25%) do not apply to *any* types of business income, including sole proprietorship income, if an individual's taxable income is less than the (D) thresholds.

(2) BID does not reduce Self-Employment income to reduce the 15.6% Self-employment Tax.

(3) BID is not an itemized deduction, or a deduction reducing adjusted gross income, but rather a deduction reducing taxable income. The distinction *probably* means the BID will not reduce Oklahoma taxable income.

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[1] Income from interest, dividends, capital gains and other portfolio income do not qualify for the BID.

[2] Service businesses will seek opportunities to "break out" their income streams to qualifying BID income.

(4) BID disfavors W-2 Wages compared to independent contractors or sole proprietorships.

(5) The following example illustrates how Business Income is more favorable than W-2 income. Column #1 is the tax for a software engineer making $125,000 as a W-2 wage earner. Column #2 is the tax for a free-lance software engineer making $125,000 operating as an S-corporation. Individual #2's taxes are $3,000 less because of the BID.

Example-BID Laws & 2018 Tax Rates	#1 Wage Earner	#2 S-Corp. Free-Lance
Software Engineer W-2 Wages	$125,000	$62,500
S-Corporation Flow-Through Income	None	62,500
Less: BID (20% of Flow-Through)	None	(12,500)
Less: Standard Deduction	(12,000)	(12,000)
Equals: Taxable Income	113,000	100,500
2018 Tax Difference – $3,000	$ 21,410	$ 18,410

Both of their taxes for 2018 would probably be less than 2017's because of the new reduced tax rates and brackets. Part II are charts comparing tax rates and brackets.

Part II – New Tax Rates & Brackets

A. Individual Tax Rates & Brackets Comparison Charts.

Single Taxpayers

2017 Tax Rates

Taxable income over	But not over	Is taxed at
$0	$9,325	10%
$9,325	$37,950	15%
$37,950	$91,900	25%
$91,900	$191,650	28%
$191,650	$41,700	33%
$416,700	$418,400	35%
$418,400	And up.	39.6%

2018 Tax Rates

Taxable income over	But not over	Is taxed at
$0	$9,525	10%
$9,525	$38,700	12%
$38,700	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$500,000	35%
$500,000	And up.	37%

Married Filing Jointly & Surviving Spouses

2017 Tax Rates

Taxable income over	But not over	Is taxed at
$0	$18,650	10%
$18,650	$75,900	15%
$75,900	$153,100	25%
$153,100	$233,350	28%
$233,350	$416,700	33%
$416,700	$470,700	35%
$470,700	And up.	39.6%

2018 Tax Rates

Taxable income over	But not over	Is taxed at
$0	$19,050	10%
$19,050	$77,400	12%
$77,400	$165,000	22%
$165,000	$315,000	24%
$315,000	$400,000	32%
$400,000	$600,000	35%
$600,000	And up.	37%

2017 Tax Rates / **2018 Tax Rates**

Married Filing Separate

2017 Tax Rates:

Taxable income over	But not over	Is taxed at
$0	$9,325	10%
$9,325	$37,950	15%
$37,950	$76,550	25%
$76,550	$116,650	28%
$116,650	$208,350	33%
$208,350	$235,350	35%
$235,350	And up.	39.6%

2018 Tax Rates:

Taxable income over	But not over	Is taxed at
$0	$9,525	10%
$9,525	$38,700	12%
$38,700	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$300,000	35%
$300,000	And up.	37%

Head of Household

2017 Tax Rates:

Taxable income over	But not over	Is taxed at
$0	$9,325	10%
$9,325	$37,950	15%
$37,950	$76,550	25%
$76,550	$116,650	28%
$116,650	$208,350	33%
$208,350	$235,350	35%
$235,350	And up	39.6%

2018 Tax Rates:

Taxable income over	But not over	Is taxed at
$0	$13,600	10%
$13,600	$51,800	12%
$51,800	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$500,000	35%
$300,000	And up.	37%

B. <u>2018 Long-Term Capital Gain & Qualified Dividend Tax Rates.</u> The chart below outlines the three Capital Gain Rates (0%, 15%, and 20%), and the income level and filing status required to obtain the preferential tax treatment.

Long-term capital gains tax rate	Single	Married, filing jointly	Head of Household	Married, filing separately
0%	$0 to $38,600	$0 to $77,200	$0 to $51,700	$0 to $38,600
15%	$38,601 to $425,800	$77,201 to $479,000	$51,701 to $452,400	$38,601 to $239,500
20%	$425,801 or more	$479,001 or more	$452,401 or more	$239,501 or more

C. <u>Tax Observations of the New Rates and Brackets.</u>

(1) There are essentially three categories or tiers of income for tax purposes:

(a) High ordinary rates per Part II (A) for W-2 wages, pension income, interest income, some dividend income, short-term capital gains, taxable social security, most mineral royalties, alimony, raw land rents, and any other income that is not in (b) or (c) below.

(b) More favorable Business Income tax rates that are 20% less than the ordinary rates. The marginal rates for business income are 8%, 9.6%, 17.6%, 19.2%, 25.6%, 28%, and 29.6%.

(c) Capital rates as low as 0% and a maximum of 20% for investments held over a year; most corporate dividends (but not S-Corporation dividends) will enjoy similar low rates.

(2) The new tax laws do not repeal the 3.8% Investment Income Tax.

(3) The new tax rates eliminate the marriage penalty, except for the 37% bracket taxpayers.

(4) Contributions to traditional IRAs and 401(k)'s yield high <u>initial</u> tax savings.

(5) Overall, the tax rates have dropped about 3% for most people. However, particularly those who previously itemized their deductions or do not have young children, many taxpayers will "give back" about 1% to 2% of the rate decreases because of Individual Tax changes.

Part III – The Main Individual Tax Changes

A. State and Local Taxes (SALT) Limited.

(1) Prior to 2018 individual taxpayers could deduct from their taxable income as an itemized deduction several types of taxes paid at the state and local level, including real and personal property taxes, income taxes, and/or sales taxes.

(2) Starting in 2018 the SALT limit is $10,000. Capping the deduction for state and local income and property taxes is seen as punitive to high-tax states such as NY, NJ, and CA.

B. Home Mortgage Interest Limited.

(1) Prior to 2018 individual taxpayers could deduct as an itemized deduction qualified residence interest, which included interest paid on a mortgage secured by a principal residence or a second residence. The underlying mortgage loans could be acquisition indebtedness of up to $1 million ($500,000 in the case of a married individual filing a separate return), plus home equity indebtedness of up to $100,000.

(2) Starting in 2018 the deduction for interest on home equity indebtedness is suspended, and the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 ($375,000 for married taxpayers filing separately). But, the old limits apply to any acquisition indebtedness incurred before *December 15, 2017*; and a taxpayer can still re-finance their pre December, 15, 2017 mortgage under the old limits as long as they don't pull cash out of the refinancing. What does this mean? Interest on home equity lines of credits (ELOCs) are no longer deducible and interest deductions on new larger mortgages will be reduced.

C. <u>The Standard Deduction Increases.</u> Taxpayers are allowed to deduct the standard deduction or the sum of itemized deductions to determine their taxable income.

(1) Prior to 2018 the standard deductions were going to be $6,500 for single individuals and married individuals filing separately; $9,550 for heads of household, and $13,000 for married individuals filing jointly (including surviving spouses).

(2) Starting in 2018 the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers.

D. **The Personal Exemption.** The $4,150 personal exemption has been cut to zero which can negate the benefit of the increased standard deduction.

Tax Observation: Although the standard deduction has nearly doubled, the actual benefit can be fairly modest after the repeal of personal exemptions, unless a taxpayer did not otherwise itemize their deductions and/or can take advantage of the Child Tax Credits.

E. **The $2,000 Child Tax Credit.** Starting in 2018 the Child Tax Credit (CTC) has doubled to $2,000 for dependents less than 17, and the AGI levels at which the CTC phases out has increased significantly. The new phase-out thresholds start at $400,000 (for married taxpayers filing a joint return) and $200,000 (for all other taxpayers).

F. **The $500 Child Tax Credit.** If a child is over 16, he or she does not qualify for the $2,000 credit, but a $500 *partial* CTC is available for 17 or 18 year old dependents, or a full-time student under age 24, or a disabled child of any age.

G. **Itemized Deduction Phase-Out Suspended.** Prior tax law required higher-income taxpayers to reduce their itemized deduction based by a 3% AGI formula and an 80% overall formula. This was known as the "Pease" limitation. The Pease limitation is suspended.

H. **Alternative Minimum Tax (AMT).** AMT exemption and phase-outs levels increase which will help higher income taxpayers. However, with restrictions and limitations on many of the personal deductions, AMT was going to be less burdensome anyway.

I. **Starting in 2018 the Following are also Non-Deductible:**

- College Sports Tickets. No charitable deduction is allowed for a payment to a college or university in exchange for which the contributor receives the right to purchase tickets or seating at an athletic event.

- Moving expenses. The moving expense deduction ceases, except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order and incident to a permanent change of station.

- Miscellaneous Deductions. Most miscellaneous itemized deductions are no longer deductible, including unreimbursed employee business expenses, investment expenses and expenses for the production or collection of income, tax preparation fees, and expenses allowed under the "hobby loss" rules.

- Casualty and Theft Losses. Most personal casualty and theft losses of an individual are no longer deductible unless they're attributable to a federally declared disaster.

J. **Important 2019 Change!- Alimony Non-Deductible and not Includible by Recipient**. The old tax laws stated individuals could deduct alimony or separate maintenance payments; and the payments were includible in the gross income of the recipient spouse. Starting in 2019 for divorce or separation instruments *executed after Dec. 31, 2018*, the deduction for payment of alimony won't apply and the inclusion in gross income for receipt of alimony payments won't apply. ***However, the 2017 rules continue to apply to pre 2019 divorces and separations.***

Tax Observation: My opinion is the 2019 Alimony tax laws will be repealed. Nevertheless (A) through (J) are major Personal Tax Law changes starting in 2018 and the next section has examples illustrating the changes.

K. Three examples illustrating the Personal Tax Law Changes.

(1) Taxes will go down significantly for a married couple making $90,000 with two children under 17 and do not itemize. The decrease is about $250 per month!

	2017	2018
Wages	$90,000	$90,000
Less: Standard Deduction	(12,700)	(24,000)
Less: Exemptions	(16,200)	0
Equals Taxable Income	61,100	66,000
Federal Income Tax	8,236	7,539
Less: Child Credits	(2,000)	(4,000)
Equals: Total Tax	$ 6,236	$ 3,539

(2) Consider a married couple with $150,000 of wages, with one child in college, and itemized deductions of: (a) $13,000 in SALT, (b) $10,000 for Mortgage Interest, and (c) $4,000 for Charity; thus a total of $27,000 in itemized deductions. Their taxes are the same.

	2017	2018
Wages	$150,000	$150,000
Less: Itemized or Standard Deduction	(27,000)	(24,000)
Less: Exemptions	(12,150)	0
Equals Taxable Income	110,850	126,000
Federal Income Tax	19,190	19,599
Less: Child/College Credits	(2,500)	(3,000)
Equals: Total Tax	$ 16,690	$ 16,599

(3) Suppose a married couple, making $400,000 of wages, has two young children, and itemized deductions of: (a) $23,000 SALT, (b) $25,000 Mortgage Interest, and (c) $10,000 Charity for a total of $58,000 in itemized deductions. Their taxes decrease by 18%!

	2017	2018
Wages	$400,000	$400,000
Less: Itemized Deductions	(55,414)*	(45,000)
Less: Exemptions	(4,860)*	0
Equals Taxable Income	339,726	355,000
Federal Income Tax	89,071	76,979
Less: Child Credits	(0)*	(4,000)
Equals: Total Tax	$ 89,071	$ 72,979

* Lower 2017 phase-out thresholds apply to higher income earners.

Tax Observation: Overall, the personal deduction changes tend to lower taxes for taxpayers: (a) with young children, (b) who did not previously itemize, (c) who were paying alternative minimum tax, or (d) with higher incomes.

2018 taxes savings will tend to be diminished for taxpayers with: (a) high SALT, (b) a very large home mortgages, (c) significant employee or investment expenses, or (d) older dependent children.

However, almost all taxpayers with the BID will receive moderate and many times substantial tax savings. In addition, some business deductions are increasing, while several other business deductions have been repealed. Part IV highlights some of these business changes.

Part IV – Some of the Major Business Tax Changes

A. **Code §179 is Expanded.** The maximum a taxpayer may expense under Code §179 is increased to $1 million, and the phase-out threshold is increased to $2.5 million. The definition of Code §179 property expands to include assets such as equipment and furniture used to furnish lodging, and building improvements for non-residential buildings.

Tax Tip! Code §179 can many times be more beneficial than Bonus Depreciation.

B. **Bonus Depreciation.** 100% Bonus Depreciation applies to property placed in service after September 27, 2017 through December 31, 2023; and Bonus applies now to both used and new property. In addition, for 2018, a taxpayer can elect 50% Bonus, which can be helpful when deferring deductions is beneficial.

C. **Net Losses from Businesses.** Bonus depreciation many times creates business losses. Starting in 2018, "excess" business losses are not allowable as a current deduction, but rather the aggregate of business losses are carried forward as a net operating loss. The "excess business loss" limitations start for married taxpayers filing jointly when their other income (such as wages, interest income, and stock gains) is over $500,000 and over $250,000 for all other individuals.

D. **Net Operating Losses (NOL).** Pre 2018 tax laws allowed NOLs to be carried back two years or forward 20 years. Starting in 2018, for most taxpayers, NOLs cannot be carried back, but rather forward indefinitely; and NOL carryforward deductions are limited to 80% of taxable income. For example, suppose a single individual with no itemized deduction incurs a $100,000 NOL in 2018 and then makes $100,000 in 2019, for a two year net income of zero. In 2019 their NOL deduction will be limited and he or she will have $17,600 of taxable income, and a $29,600 NOL carryforward to 2020.

E. **Leasehold Improvements.** Pre 2018 tax laws had burdensome restrictions in order to depreciate leasehold improvements over 15 years instead of 39. Those restrictions have been repealed with respect to leasehold improvements for: (1) non-residential real property, and (2) restaurant and retailers' buildings.

F. **Luxury Automobile Depreciation Increases.** Starting in 2018 the allowable maximum automobile depreciation increases to: $10,000 for the first year, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period if the taxpayer foregoes the $8,000 first year bonus depreciation. Thus, cars can be written off quicker.

G. <u>Domestic Activities Production Deduction.</u> Many manufacturing companies, including engineer and architecture firms, were allowed a 9% manufacture's deduction. The deduction has been repealed. But, those same businesses are eligible for up to the 20% BID.

H. <u>Entertainment Deductions.</u> No deduction is allowed with respect to: (1) an activity generally considered to be entertainment, amusement or recreation; (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes; or (3) a facility or portion thereof used in connection with any of the above items.

I. <u>Employer Credit for Paid Family and Medical Leave.</u> For 2018 and 2019, employers with a written family and medical leave plan can claim a 12.5% to 25% wage credit for compensation paid to an employee when they are on family or medical leave.

J. <u>Cash Method of Accounting.</u> The cash method of accounting may now be used by taxpayers with less than $25 million of gross receipts. The old rule was $10 million and the $25 million amount is indexed for inflation starting in 2019.

In conclusion, our Tax Newsletter covers the major tax changes that will impact all individuals and most small businesses. There are a few other important changes that will be addressed in our summer Tax Newsletter. But, starting in January 2018 we are beginning our 35th tax season. With the support from Theresa Ruth, CPA, who will be with us in her fourth tax season this year, we can assist you and/or your businesses with your 2017 taxes. We can further analyze your taxes to formulate and implement 2018 new tax strategies. Please contact us at: 918.599.7755, or pburgess@barberbartz.com or truth@barberbartz.com. See our website at Paulhburgess.com for the other tax, estate planning, and legal services we provide.

Top 5 Reasons You Should Hire an Attorney-CPA for your Tax & Estate Planning Needs

1. **<u>Unparalleled Perspective:</u>** Dually-licensed Attorney-CPAs have training in accounting and law allowing them to view your matter from more angles than many professionals.

2. **<u>Uniquely Qualified:</u>** Only a small number of professional achieve dual licensing, setting Attorney-CPA's apart from their peers in both professions due to the continuing education demands of a dual license.

3. **<u>First-Class Education:</u>** An Attorney-CPA especially values education, as such Attorney-CPAs tend to be up to speed on the latest developments in their practices.

4. **<u>Best of Both Worlds:</u>** Two professions in one professional who bridges the gap between your legal and financial requirements.

5. **<u>A Practical Solution:</u>** Save time and money by hiring a single dually-licensed Attorney-CPA who is qualified to handle diverse business responsibilities including taxation, accounting, legal, and estate planning.

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