TaxTips

Keeping You Informed • Summer 2018

Your Trusted Advisor

Covenant CPA LLC | *Taxpro@Covenant-cpa.com* | www. Covenant-CPA.com

Our mission is to partner with businesses and families to achieve financial success through Biblical principles in order to further God's kingdom.

Tax Cuts and Jobs Act 2017 (TCJA)

Exciting and significant changes to the Internal Revenue Code are happening! The law reduces tax rates for individuals and corporations and repeals many deductions, thus simplifying filing for many taxpayers.

Most of the individual changes will expire the end of 2025, meaning the old tax code rates and deductions will return in 2026 unless Congress passes another law before then. Our newsletter is highlighting some of the notable changes taking effect in 2018.

Covenant CPA LLC 2733 Willow Street Pike N, Willow Street, PA 17584 Phone: 717-464-2951
www.Covenant-CPA.com 226 South Reading Road, Ephrata, PA 17522 Phone: 717-733-2218

TCJA Provides New 20% Deduction! Domestic Production deduction is repealed.

Business and Rental Owners will very likely benefit from this new deduction.

The now repealed Section 199 Domestic Production Activity Deduction provided a 9% deduction to certain industries. The new 2018 Section 199A tax deduction that you can claim on your IRS Form 1040 is a big deal. There are many rules (all new, of course), but your odds as a business owner of benefiting from this new deduction are excellent.

Rejoice if you operate your business as a sole proprietorship, partnership, or S corporation, because your 2018 income from these businesses can qualify for some or all of the new 20 percent deduction.

We are still waiting for some clarification from the IRS, but it appears you also can qualify for the new 20 percent 2018 tax deduction on the income you receive from your real estate investments, publicly traded partnerships, real estate investment trusts (REITs), and qualified cooperatives.

When can you as a business owner qualify for this new 20 percent tax deduction with almost no complications?

To qualify for the 20 percent with almost no complications, you need two things. First, you need qualified business income from one of the sources above to which you can apply the 20 percent. Second, to avoid complications, you need "defined taxable income" of:

- $315,000 or less if married filing a joint return, or
- $157,500 or less if filing as a single taxpayer.

Example. You are single and operate your business as a proprietorship. It produces $150,000 of qualified business income. Your other income and deductions result in defined taxable income of $153,000. You qualify for a deduction of $30,000 ($150,000 x 20 percent).

If you operate your business as a partnership or S corporation and you have the qualified business income and defined taxable income numbers above, you qualify for the same $30,000 deduction. The same is true if your income comes from a rental property, real estate investment trust, or limited partnership.

Some unfriendly rules apply to what Section 199A calls a specified service trade or business, such as operating as a law or accounting firm. But if the doctor, lawyer, actor, or accountant has defined taxable income less than the thresholds above, he or she qualifies for the full 20 percent deduction on his or her qualified business income.

In other words, if you are a lawyer with the same facts as in the example above, you would qualify for the $30,000 deduction.

Once you are above the thresholds and phase outs ($50,000 single, $100,000 married filing jointly), you can qualify for the Section 199A deduction only when

- you are not in the out-of-favor group (accountant, doctor, lawyer, etc.), and
- your qualified business pays W-2 wages and/or has property.

Child Tax Credit *Increasing!*

The child tax credit will increase to $2,000 per qualifying child and will be refundable up to $1,400, subject to phase-outs. To receive the refundable portion of the child tax credit, a taxpayer must include a social security number for each qualifying child claimed on the tax return.

Also included is a temporary $500 nonrefundable credit for other qualifying dependents who are not qualifying children.

Phase-outs, which are not indexed for inflation, will begin with adjusted gross income of more than $400,000 for married taxpayers filing jointly and more than $200,000 for all other taxpayers.

Standard Deduction / Personal Exemptions

Standard Deduction:

Filing Status	2018	2017 (for comparison)
Married Filing Joint	$24,000	$12,700
Head of Household	$18,000	$9,350
Single	$12,000	$6,350
Married Filing Separate	$12,000	$6,350
Additional Amount if over age 65, blind, or disabled	$1,600 (unmarried) $1,300 (each spouse meeting criteria)	$1,550 (unmarried) $1,250 (each spouse meeting criteria)

Personal Exemptions - Repealed, **no exemptions for 2018.** (For 2017 it was $4,050 per individual claimed on a return.)

2018 Tax Bracket and Tax Rates

For brackets and rates for all filing statuses go to our Website [(www.Covenant-cpa.com)](http://www.Covenant-cpa.com) -Client Resources, Helpful Links Page. The 2018 Tax Guide has a lot of helpful information.

Married Filing Joint (MFJ)

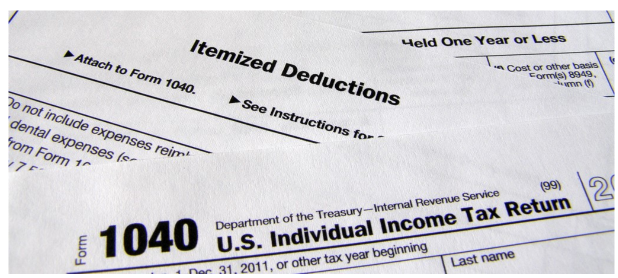
Taxable Income			Base amount of Tax	Marginal Tax Rate	Of the amount over
	<	$19,050	$0.00	10.0%	$ 0
$19,051	to	$77,400	$1905.00	12.0%	$19,050
$77,401	to	$165,000	$8,907.00	22.0%	$77,400
$165,001	to	$315,000	$28,179.00	24.0%	$165,000
$315,001	to	$400,000	$64,179.00	32.0%	$315,000
$400,001	to	$600,000	$91,379.00	35.0%	$400,000
$600,001	>		$161,379.00	37.0%	$600,000

Single

Taxable Income			Base amount of Tax	Marginal Tax Rate	Of the amount over
	<	$9,525	$0.00	10.0%	$ 0
$9,526	to	$38,700	$952.50	12.0%	$9,525
$38,701	to	$82,500	$4,453.50	22.0%	$38,700
$82,501	to	$157,500	$14,089.50	24.0%	$82,500
$157,501	to	$200,000	$32,089.50	32.0%	$157,500
$200,001	to	$500,000	$45,689.50	35.0%	$200,000
$500,001	>		$150,689.50	37.0%	$500,000

Itemized Deductions

With the exception of state/local income taxes, mortgage interest, medical expenses, disaster losses, charitable donations and other deductions not subject to the 2% floor, all other itemized deductions are repealed. The overall limitations on itemized deductions for upper-income individuals is also repealed.



State/Local Taxes– Capped at $10,000 combining income taxes, sales tax, or property taxes.

Mortgage Interest– Capped at $750,000 of debt; home equity loan interest no longer deductible unless used to buy or improve residence.

Medical Expenses– For 2018, deduction is still expenses exceeding 7.5% of income; for 2019, expenses must exceed 10% of AGI.

Disaster Losses– Only losses covered by a specific federal disaster declaration are deductible.

Charitable Donations- Can still itemize contributions; the limitation increased to 60% of income (was 50%).

**Planning Note: If you are over 70 1/2 and your itemized deductions are likely to be less than the new higher standard deduction, you can benefit by making your contributions directly from your IRA. These Qualified Charitable Distributions (QCD's) must go directly from the fund company to the charity. Distributions are not included in income but they do count towards required minimum distributions (RMD's)!*

Moving Expenses- Repealed unless a member of Armed Forces of US on active duty who moves pursuant to order.

Alimony- Beginning with divorces in 2019, alimony payments are no longer deductible and not taxable to recipient

Health Care: Individual Responsibility

The penalty or tax for not having coverage drops to **zero**, but not until **2019**. This is a permanent provision and will not expire in 2025.

For 2018, proof of Minimum Essential Coverage OR an Exemption is required.

2018 Meals & Entertainment Deductions Update

In recent days, we learned that lawmakers did not intend to eliminate business meals with clients and prospects. We are not exactly sure how lawmakers can undo what they have done to the tax code in this area, but experience says that if there is a will, there is a way. We think it may take a technical correction to the tax code, but some speculate that you could get this done with a Joint Committee on Taxation Bluebook explanation.

Regardless, at the moment this appears to be really good news. Obviously, we would like to see some already-in-place technical action on which we could hang our hat, but that is not going to happen for some time, perhaps many months. Meanwhile, here is what you need to do:

1) Track and document your client and prospect business meals as you have done (or should have done) in the past.
2) Keep the pressure on your lawmakers, asking them to codify or otherwise clarify that client and prospect business meals are indeed deductible.
3) Hope that client and prospect meals are indeed deductible for all of 2018.

<u>Chart of Meals and Entertainment after Tax Reform</u>

Tax reform has had a significant impact on the tax deductions you can now claim for business entertainment and meals. The chart below shows you how the Tax Cuts and Jobs Act treats 12 meal and/or entertainment events.

	Amount Deductible for Tax Year 2018		
Description	**100%**	**50%**	**Zero**
Meals with clients and prospects		X*	
Entertainment with clients and prospects			X
Employee meals for convenience of employer		X	
Employee meals for required business meeting		X	
Meal served at chamber of commerce meeting		X	
Meals while traveling away from home overnight		X	
Year-end party for employees and spouses	X		
Golf outing for all employees and spouses	X		
Year-end party for customers			X
Meals for general public at marketing presentation	X		
Team-building recreational event for all employees	X		
Golf, theater, or football game with your best customer			X

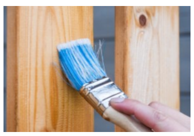
* Technically, the TCJA made meals with clients and prospects not deductible. We understand that the tax writers will modify the law to make “so-called non-entertainment meals” with clients and prospects deductible. We do not know when we will see this change; therefore, track your meals with clients and prospects as if the tax writers will truly make them deductible.

Depreciation Changes

100% Bonus Depreciation

- Includes "20 Year" Property such as general purpose barns.
- Includes "15 Year" Property such as paving, sidewalks, wells, and septic systems.
- Property with the life of 10 Year and shorter is eligible for both Bonus and Section 179 expensing (see notes on S179 below).
- Bonus Depreciation can create a loss; however the TCJA eliminates loss carrybacks and only allows 80% of future year income to be offset by losses carried forward.
- The following are excluded from Bonus treatment:
  - Used prior to purchase (rent to own).
  - Purchased from a related party.
  - Gifted / Inherited.
  - Basis carried forward in a Like-Kind-Exchange (LKE). Only "new" money is eligible.

Qualified Improvement Property



- Improvements (not enlargements) made to property after it is placed in service.
- Applies to owners and/or tenants.
- 15 year recovery and eligible for Section 179 and Bonus.

Section 179 Expensing

- Increased from $500,000 to $1,000,000.
- Applies to equipment, not real estate. Generally that means an IRS class life <10 years.
- The taxpayer may elect the amount of deduction to take. Section 179 is more flexible than the all or nothing Bonus Depreciation.
- Section 179 cannot create a loss. This characteristic can create a planning opportunity as Section 179 elected in excess of business income is carried forward.
- After 2017, Section 179 can now be used for non-real estate assets where lodging is provided. Examples include flooring or appliances in residential rentals, but not roofs or HVAC.
- After 2017, Section 179 can be used on NON-residential (i.e., commercial property) roofs, HVAC, and alarm systems if added after the building is placed in service.

Tax Reform Allows Bigger Vehicle Deductions

Finally, lawmakers did the right thing by increasing the luxury auto depreciation limits on business cars. The old luxury limits were unrealistic, punitive, unfair, and discriminatory against any car that cost more than $15,800. The new limits do not create parity in all respects, but they are a big improvement.

If you bought a car in 2017 and paid more than $15,800, you were driving a luxury car that lawmakers punished you for by putting a lid on your depreciation. For example, say in 2017 you bought a $40,000 car and drove it 100 percent for business. Your maximum depreciation deductions for the first five years would total only $15,060. To fully depreciate this car under the old rules would have taken 19 years.

It was ridiculous to take 19 years to depreciate that $40,000 car. And now, finally, lawmakers have fixed a big part of what the tax code calls "luxury automobile limits". Under the new law, this $40,000 vehicle is fully depreciated in six years. Think about that: old law, 19 years; new law, six years. Essentially, the new law sets the so-called luxury automobile limit at $50,000. This means any vehicle that costs $50,000 or less is not penalized by the luxury vehicle limits when you are using MACRS depreciation.

Under the new law the annual limits are : Year 1: $10,000 / Year 2: $16,000 / Year 3: $9,600 / Year 4 and each succeeding year: $5,760.

What do the new limits mean? Before 2018, many business taxpayers were buying vehicles with gross vehicle weight ratings (GVWRs) greater than 6,000 pounds to escape the draconian luxury limit of roughly $15,000. Even today, SUVs, crossover vehicles, and pickup trucks can avoid the automobile luxury limits and even qualify for immediate write-offs of the full business cost using bonus depreciation or Section 179 expensing. Cars do not qualify for unlimited bonus depreciation or any added benefits from Section 179 expensing.

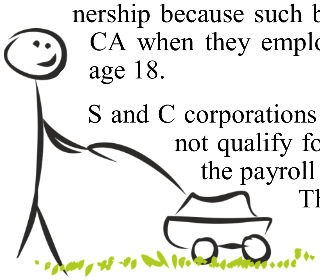
Tax Reform Increases the Tax Benefits of Employing Your Child

The recent tax reform eliminated personal exemptions for taxable years after December 31, 2017, and before January 1, 2026. This makes your child worthless to you on your Form 1040. But there is a way to get even or, perhaps, much more than even.

Let us set the stage first. For taxable years after December 31, 2017, and before January 1, 2026, the standard deduction for a single taxpayer begins at $12,000 in 2018 and increases every year for inflation. The new standard deduction means that a single taxpayer such as your child can earn up to $12,000 in W-2 wages and pay not a penny in federal taxes.

As the owner of a business, you have the advantage of being able to hire your child to work in your business, and that creates tax-saving opportunities for both you and your child. The big dollar benefits of hiring your child go to the Form 1040, Schedule C taxpayer and the husband-and-wife partnership because such businesses are exempt from FICA when they employ their children who are under age 18.

S and C corporations and non-spouse partnerships do not qualify for this benefit. They have to pay the payroll taxes on all employees—period. There is no parental benefit.



Tax Reform Puts Screws to Hobbies

The tax law has mistreated hobbies for a long time. But the most recent tax reform brings the grim reaper to the party, and it is not pleasant. This means you need to focus on making your activity a business and not a hobby.

Under both prior law and the new law after the recent tax reform, your activity is either a business (for profit) or a hobby (not for profit). With the hobby classification, tax law makes you suffer. Your taxable gross income includes income from any source unless there is a specific exclusion, and there is none for hobby income. Thus, tax law taxes your hobby income.

Do not think that you need a hobby to have what is called hobby income. In an article in Tax Notes titled "Potential Pitfalls for Direct Sellers," author Monika Turek states that there are 15.2 million direct sellers who fall into the tax law–defined hobby category. Direct sellers include distributors for companies such as Amway, Herbalife, and Mary Kay. For sure, many of the 15.2 million are going to feel cheated by the recent tax reform. At the other end of the spectrum, you find many hobby-loss tax cases that involve doctors or lawyers who like racehorses or ranching. They too will feel cheated.

Under the recent tax reform, the law taxes your hobby income and gives you a zero deduction for any business expenses to produce that income. That is about as draconian as the law can get. The only out is to establish your activity as a business. This may or may not be possible, but it is certainly something I might be able to help you with and that we should discuss.

Like Kind Exchange (AKA 1031)

The demise of the Like Kind Exchange (LKE) has been greatly exaggerated. While it is true that TCJA eliminated LKE treatment for equipment and requires the old assets to be considered sold for the trade in value and a gain recognized, the increased depreciation deductions discussed earlier will allow greater deductions to offset the gain.

Real estate was spared by the TCJA. LKE gain deferral for real estate is still alive and well.

More businesses can use Cash Basis

The cash basis of bookkeeping is the easiest to use and by far the most prevalent in small business settings. As businesses grew, the IRS required them to switch to the more complicated *accrual* method of accounting.
TCJA raised the ceiling allowing businesses with revenue under $25MM to continue using cash basis. Congress did something nice, not accrual!

Call us to see if a switch in accounting method could benefit you.

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Willow Street – 2733 Willow Street Pike, PO Box 250, Willow Street, PA 17584
Phone: 717-464-2951 / Fax: 717-464-2013

Ephrata – 226 South Reading Road, PO Box 359
Ephrata, PA 17522
Phone: 717-733-2218 / Fax: 717-464-2013

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