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NOVEMBER 2018

Courtnie Nelson – CEP Data Processing

We were very pleased to learn that Courtnie Nelson has recently passed the Certified Professional Coder (CPC) examination. Passing this examination confirms Courtnie's expertise and proficiency in the correct application of medical codes for billing professional medical services to insurance companies and other third-party payers.

We are happy with Courtnie in her success and are very fortunate to have her services providing physician client support in our CEP Data Processing division.

2018 TAX CHANGES

There is still time to take action on some of the tax law changes applicable to 2018 returns. A few of the changes from the Tax Cuts and Jobs Act (the Act) and some planning suggestions are discussed below:

Full Write-Off for Equipment and Some Real Estate Improvements

Bonus Depreciation – A 100 percent deduction (bonus depreciation) with no dollar or total investment limit is available to all taxpayers for qualifying property, which includes almost all equipment (other than light vehicles). Qualifying property also includes real estate improvements with useful lives of 20 years or less acquired and placed in service after September 27, 2017 and before January 1, 2023, when a phase-down reduction of the bonus percentage will begin.

The Act increases the bonus depreciation from 50 percent to 100 percent for qualified property. Qualified property generally includes tangible property with a useful life of 20 years or less, including equipment, furnishings, livestock, fences, certain real property improvements, off-the-shelf computer software, etc. but excludes light vehicles discussed below. The 100 percent bonus depreciation is not limited to small businesses nor is it capped at certain dollar levels. Bonus depreciation also is not limited because of the amount of a business's total investment in qualified property, and it can be used to generate net operating losses. It is, as the result of the new law, available for new and most used property. Qualified property must be placed in service during 2018 to obtain the 2018 deduction.

Used property is eligible for 100 percent expensing if the taxpayer did not use the

(Continued on reverse)

property at any time before acquiring it, did not acquire the property from a related party or affiliate, by inheritance, or in a transaction involving any amount of carryover tax basis.

Section 179 Expensing – The depreciation rules have, for many years, allowed a special expensing election (Section 179 Expensing) for small businesses. Taxpayers could elect to treat up to $500,000 (adjusted for inflation) of the cost of any qualifying Section 179 property as an expense in the year of acquisition. This election was phased out for taxpayers acquiring more than $2 million (adjusted for inflation) of property in any year. Section 179 Expensing was modified by the Act and remains in the law. However, the significance of qualifying for expensing under Section 179 has been greatly diminished by the availability of the unlimited 100 percent deduction for new and used qualified property discussed above.

Business Vehicles – There is a larger depreciation and expensing allowance for vehicles used more than 50 percent in a business. Under both the old rules and the Act, depreciation on luxury passenger vehicles (generally all vehicles weighing less than 6,000 pounds) is subject to limitations for depreciation and immediate expensing.

For heavy SUVs, pick-ups, and vans used over 50 percent in business, 100 percent bonus depreciation is allowed – that is, the Act allows the deduction of the business-use portion of the cost in the year of acquisition for such a vehicle (whether new or used) unless it was acquired used from a related party or affiliate, by inheritance, or in a transaction involving carryover tax basis. Vehicles not subject to the luxury car limitation are SUVs, pick-ups, and vans having a manufacturer's gross vehicle weight rating over 6,000 pounds. Examples of suitable heavy vehicles include a Chevy Tahoe, Audi Q7, Buick Enclave, Toyota Sequoia, Ford Explorer, Jeep Grand Cherokee, and most full-size pick-ups. Verification of the gross vehicle weight rating can usually be found on the inside edge of the driver's vehicle door by the hinges.

For example, if in 2018 you buy a new $60,000 heavy SUV used 100 percent in your business, you can deduct the entire $60,000 in 2018. If you used the vehicle 60 percent for business, your first-year bonus depreciation is 60 percent of $60,000 or $36,000. If you buy a used $45,000 heavy SUV, you can deduct the entire cost in 2018 assuming it is 100 percent used in the business. If used 60 percent for business, your deduction would be $27,000 – that is, 60 percent of $45,000.

Real Estate Improvements – The new law does not allow bonus depreciation on newly acquired or constructed real estate with a recovery period of more than 20 years. The recovery period remains 39 years for non-residential real estate and 27.5 years for residential rental property. Significant real estate improvements (for example, most farm and ranch buildings) can be depreciated over 20 years and are eligible for bonus depreciation. Depreciable land improvements, roads, bridges, etc. are 15-year property and, accordingly, are also subject to bonus depreciation.

Small Businesses are Now Allowed Immediate Inventory Write-Off

Businesses with gross receipts of less than $25 million are not required to capitalize inventories but rather may deduct inventory when purchased. For a business that has been using an

(Continued)

inventory method, an automatic approval of the change is available by filing Form 3115, *Application for Change in Accounting Method*, with its 2018 income tax return. The business may then deduct in 2018 its beginning inventory cost along with all of the current year inventory purchases. Taxpayers who are acquiring inventory for the first time may elect a full write-off of inventory acquisitions.

Other Major Changes

Increased Standard Deductions – Many taxpayers without significant itemized deductions will benefit from the new standard deduction amounts of $24,000 for married couples filing jointly, $12,000 for individuals, and $18,000 for heads of households. The standard deduction amounts for years beginning after 2018 are indexed for inflation.

Personal Exemption Deduction Eliminated – For 2018 through 2025, personal exemption deductions ($4,050 for each individual for 2017) are suspended.

Miscellaneous Itemized Deductions are Disallowed – The Act disallows formerly deductible miscellaneous itemized deductions including unreimbursed employee business expenses, investment expenses, expenses for production or collection of income, tax determination expense, and expenses allowed under the "hobby loss" rules. With the disallowance of these deductions, the most common itemized deductions remaining are mortgage and investment interest, medical expenses (above the threshold of 7.5 percent of Adjusted Gross Income (AGI)), charitable contributions limited to 60 percent of AGI, and state and local taxes subject to the limit discussed below.

Charitable Contributions – Bunching – The new standard deduction creates a planning opportunity for a taxpayer whose total itemized deductions are less than but near the new standard deduction amounts ($24,000 for married couples filing jointly; $12,000 for individuals, and $18,000 for heads of household), who might consider staggering ("bunching") charitable donations every other year so that the taxpayer claims itemized deductions with a higher charitable contribution in one year and the standard deduction the next year.

Direct Charitable Contribution from an IRA – Taxpayers who are over 70½ and will be taking the standard deduction and have an IRA with required minimum distributions might consider making charitable contributions directly from an IRA. Such IRA distributions made directly to a qualified charity are treated as non-taxable income and the taxpayer still enjoys the full standard deduction.

Limited Itemized Deduction for State and Local Taxes – The new law limits the total itemized deduction of personal state and local income, property, and sales taxes to $10,000. For investment property, however, state and local property taxes and other taxes remain fully deductible as an itemized deduction. Taxpayers whose itemized deduction for state and local income, property and sales taxes would exceed $10,000 will want to be certain to separate those taxes that are applicable to their investments from their personal taxes to obtain the maximum combined itemized deduction amounts. State and local taxes related to a taxpayer's business remain fully deductible against business income.

Excess Business Loss – After the Act, business losses (including farm losses) can fully offset other business income but can reduce taxable income from non-business sources (e.g., dividends, royalties, rentals, etc.) only by the maximum of $250,000 for a single taxpayer or, for a married couple filing jointly, $500,000. Non-deductible business losses above the limit

(Continued)

will be treated as net operating losses and carried forward to the subsequent taxable year.

The Hobby Trap – Taxpayers with small, sideline, or start-up businesses operating at a loss have long been vulnerable to an assertion by the Internal Revenue Service (IRS) that the activity was not an activity engaged in for profit but was instead a "hobby." When taxpayers with a loss from such an activity are audited, the IRS will often assert that the activity is a hobby and disallow the loss deduction. Under the law prior to the Tax Cuts and Jobs Act, the disallowance of the loss generally resulted in increasing taxable income by the excess of the activity expenses over the activity income. For example, assume a taxpayer has an activity of raising race horses with $20,000 of sales revenue and $52,000 of expenses resulting in a loss and a reduction in net taxable income of $32,000. If, on examination, the activity was ultimately determined to be a "hobby," the taxpayer's income would, under prior law, only increase by the $32,000 net loss. Now, if such an activity is adjusted on audit, the results are different. The $20,000 of sales revenue will be fully included in taxable income, but none of the $52,000 of deductions will be allowed. Thus, the taxpayer's income increases after audit not by the net loss of $32,000, but by the disallowance of the expenses of $52,000. In other words, the "hobby" resulted in an economic (net-of-tax) loss of $32,000 plus the tax on $20,000 revenue ($8,000 for a 40 percent taxpayer), or $40,000. If the activity was not a hobby but was a business, the net-of-tax loss would be $19,200 ($32,000 x .60 = $19,200) or less than one-half as much as "hobby" status classification.

Under the prior law, the deductible expenses were limited to the revenue from the activity and were deductible as other itemized deductions – that is, prior law allowed deductions sufficient to offset the included income. Now, with the disallowance of virtually all miscellaneous itemized deductions (which includes hobby expenses), the income tax consequence of an activity that is ultimately determined to be a hobby is extreme – that is, taxpayers must include their hobby gross income but may not deduct any of the expenses necessary to produce the included income.

A discussion of the factors that indicated that engagement in an activity is for profit and is not a hobby are included with some suggestions for documenting profit motives in our August 2018 Newsletter which is available at www.cepcpa.com/Resources/Newsletters.

Estate Tax Changes – The lifetime estate and gift tax exemption for transfers after 2017 and before 2025 has been increased, indexed for inflation, and for 2018 is $11,200,000. The annual exclusion for 2018 is $15,000. A married couple has twice those limits and, accordingly, can, in 2018, give $30,000 by annual exclusion to a donee and have a lifetime exemption of $22,400,000.

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Tax & Business Alert

NOVEMBER 2018

TAXABLE VS. TAX-ADVANTAGED: WHERE TO HOLD INVESTMENTS

When investing for retirement or other long-term goals, people usually prefer tax-advantaged accounts, such as IRAs, 401(k)s or 403(b)s. Certain assets are well suited to these accounts, but it may make more sense to hold other investments in traditional taxable accounts.

KNOW THE RULES

Some investments, such as fast-growing stocks, can generate substantial capital gains, which may occur when you sell a security for more than you paid for it.

If you've owned that position for over a year, you face long-term gains, taxed at a maximum rate of 20%. In contrast, short-term gains, assessed on holding periods of a year or less, are taxed at your ordinary-income tax rate — maxing out at 37%. (Note: These rates don't account for the possibility of the 3.8% net investment income tax.)

CHOOSE TAX EFFICIENCY

Generally, the more tax efficient an investment, the more benefit you'll get from owning it in a taxable account. Conversely, investments that lack tax efficiency normally are best suited to tax-advantaged vehicles.

Consider municipal bonds ("munis"), either held individually or through mutual funds. Munis are attractive to tax-sensitive investors because their income is exempt from federal income taxes and sometimes state and local income taxes. Because you don't get a double benefit when you own an already tax-advantaged security in a tax-advantaged account, holding munis in your 401(k) or IRA would result in a lost opportunity.

Similarly, tax-efficient investments such as passively managed index mutual funds or exchange-traded funds, or long-term stock holdings, are generally appropriate for taxable accounts. These securities are more likely to generate long-term capital gains, which have more favorable tax treatment. Securities that generate more of their total return via capital appreciation or that pay qualified dividends are also better taxable account options.

TAKE ADVANTAGE OF INCOME

What investments work best for tax-advantaged accounts? Taxable investments that tend to produce

DOING DUE DILIGENCE ON DIVIDENDS

If you own a lot of income-generating investments, you'll need to pay attention to the tax rules for dividends, which belong to one of two categories:

1. **Qualified.** These dividends are paid by U.S. corporations or qualified foreign corporations. Qualified dividends are, like long-term gains, subject to a maximum tax rate of 20%, though many people are eligible for a 15% rate. (Note: These rates don't account for the possibility of the 3.8% net investment income tax.)
2. **Nonqualified.** These dividends — which include most distributions from real estate investment trusts and master limited partnerships — receive a less favorable tax treatment. Like short-term gains, nonqualified dividends are taxed at your ordinary-income tax rate.

much of their return in income. This category includes corporate bonds, especially high-yield bonds, as well as real estate investment trusts (REITs), which are required to pass through most of their earnings as shareholder income. Most REIT dividends are nonqualified and therefore taxed at your ordinary-income rate.

Another tax-advantaged-appropriate investment may be an actively managed mutual fund. Funds with significant turnover — meaning their portfolio managers are actively buying and selling securities — have increased potential to generate short-term gains that ultimately get passed through to you. Because short-term gains are taxed at a higher rate than long-term gains, these funds would be less desirable in a taxable account.

GET SPECIFIC ADVICE

The above concepts are only general suggestions. Please contact our firm for specific advice on what may be best for you. ■

IS NOW THE TIME FOR SOME LIFE INSURANCE?

Many people reach a point in life when buying some life insurance is highly advisable. Once you determine that you need it, the next step is calculating how much you should get and what kind.

CAREFUL CALCULATIONS

If the coverage is to replace income and support your family, this starts with tallying the costs that would need to be covered, such as housing and transportation, child care, and education — and for how long. For many families, this will be only until the youngest children are on their own.

Next, identify income available to your family from Social Security, investments, retirement savings and any other sources. Insurance can help bridge any gaps between the expenses to be covered and the income available.

If you're purchasing life insurance for another reason, the purpose will dictate how much you need:

Funeral costs. An average funeral bill can top $7,000. Gravesite costs typically add thousands more to this number.

Mortgage payoff. You may need coverage equal to the amount of your outstanding mortgage balance.

Estate planning. If the goal is to pay estate taxes, you'll need to estimate your estate tax liability. If it's to equalize inheritances, you'll need to estimate the value of business interests going to each child active in your business and purchase enough coverage to provide equal inheritances to the inactive children.

TERM VS. PERMANENT

The next question is what type of policy to purchase. Life insurance policies generally fall into two broad categories: term or permanent.

Term insurance is for a specific period. If you die during the policy's term, it pays out to the beneficiaries you've named. If you don't die during the term, it doesn't pay out. It's typically much less expensive than permanent life insurance, at least if purchased while you're relatively young and healthy.

Permanent life insurance policies last until you die, so long as you've paid the premiums. Most permanent policies build up a cash value that you may be able to borrow against. Over time, the cash value also may reduce the premiums.

Because the premiums are typically higher for permanent insurance, you need to consider whether the extra cost is worth the benefits. It might not be if, for example, you may not require much life insurance after your children are grown.

But permanent life insurance may make sense if you're concerned that you could become uninsurable, if you're providing for special-needs children who will never be self-sufficient, or if the coverage is to pay estate taxes or equalize inheritances.

SOME COMFORT

No one likes to think about leaving loved ones behind. But you'll no doubt find some comfort in having a life insurance policy that helps cover your family's financial needs and plays an important role in your estate plan. Let us help you work out the details. ■

GETTING CAUGHT UP WITH THE LATEST CATCH-UP CONTRIBUTIONS

One could say that there are only two key milestones in retirement planning: the day you begin participating in a retirement savings account and the day you begin drawing money from it. But, of course, there are others as well.

One is the day you turn 50 years old. Why? Because those age 50 or older on December 31 of any given year can start making "catch-up" contributions to their employer-sponsored retirement plans by that date. These are additional contributions to certain retirement accounts beyond the regular annual limits.

Maybe you haven't yet saved as much for retirement as you'd like to. Or perhaps you'd just like to make the most of tax-advantaged savings opportunities. Whatever the case may be, let's get caught up with the latest catch-up contribution amounts.

401(k)s AND SIMPLEs

Under 2018 401(k) limits, if you're age 50 or older, after you've reached the $18,500 maximum limit for all employees, you can contribute an extra $6,000, for a total of $24,500. If your employer offers a Savings Incentive Match Plan for Employees (SIMPLE) instead, your regular contribution maxes out at $12,500 in 2018. If you're 50 or older, you're allowed to contribute an additional $3,000 — or $15,500 in total for the year.

But, check with your employer because, while most 401(k) plans and SIMPLEs offer catch-up contributions, not all do.

SELF-EMPLOYED PLANS

If you're self-employed, retirement plans such as an individual 401(k) — or solo 401(k) — also allow catch-up contributions. A solo 401(k) is a plan for those with no other employees. You can defer 100% of your self-employment income or compensation, up to the regular yearly deferral limit of $18,500, plus a $6,000 catch-up contribution in 2018. But that's just the employee salary deferral portion of the contribution.

You can also make an "employer" contribution of up to 20% of self-employment income or 25% of compensation. The total combined employee-employer contribution is limited to $55,000, plus the $6,000 catch-up contribution.

IRAs, TOO

Catch-up contributions to non-Roth accounts not only can enlarge your retirement nest egg, but also can reduce your 2018 tax liability. And keep in mind that catch-up contributions are available for IRAs, too, but the deadline for 2018 contributions is April 15, 2019. If you have questions about catch-up contributions or other retirement saving strategies, please contact us. ■

YEAR-END TAX STRATEGIES FOR ACCRUAL-BASIS BUSINESSES

The last month or so of the year offers accrual-basis taxpayers an opportunity to make some timely moves that might enable them to save money on their 2018 tax bills. The key to saving tax as an accrual-basis taxpayer is to properly record and recognize expenses that were incurred this year but won't be paid until 2019. Doing so will enable you to deduct those expenses on your 2018 federal tax return.

Common examples of such expenses include commissions, salaries and wages; payroll taxes; advertising; and interest. Also look into expenses such as utilities, insurance and property taxes. You can also accelerate deductions into 2018 without paying for the expenses in 2018 by charging them on a credit card. (This works for cash-basis taxpayers, too.)

In addition, review all prepaid expense accounts and write off any items that have been used up before the end of the year. If you prepay insurance for a period beginning in 2018, you can expense the entire amount

this year rather than spreading it between 2018 and 2019, as long as a proper method election is made. This is treated as a tax expense and thus won't affect your internal financials.

There are many other strategies to explore. Review your outstanding receivables and write off any receivables you can establish as uncollectible. Pay interest on all shareholder loans to the company. Update your corporate record book to record decisions and be better prepared for an audit. Interested? We can provide further details on these and other year-end tax tips for accrual-basis businesses. ■