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JUNE 2018

FULL WRITE-OFF OF CERTAIN DEPRECIABLE PROPERTY

The Tax Cuts and Jobs Act (the 2017 Act) effective for 2018 makes significant changes in depreciation of capital acquisitions.

Bonus Depreciation

A 100 percent deduction (bonus depreciation) with no dollar or total investment limit is available to all taxpayers for qualifying property (includes most equipment other than light vehicles) 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 2017 Act increases the bonus depreciation from 50 percent to 100 percent for qualified property. Qualified property generally includes tangible personal property with a useful life of 20 years or less, including equipment, furnishings, livestock, 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.

Used property is eligible for 100 percent expensing if the taxpayer did not use the property at any time before acquiring it, did not acquire the property from a related party or affiliate, or 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 2017 Act and remains in the law. However, the significance of qualifying for expensing under Section 179 has been greatly diminished by the availability of 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 2017 Act, depreciation on luxury passenger vehicles (generally all vehicles weighing less than 6,000 pounds) is subject to an overall limitation for depreciation and immediate expensing. That limitation for these light vehicles has been increased for 2018 to $10,000 ($18,000 using bonus depreciation) in the first year, $16,000 in year two, $9,600 in year three, and $5,760 for year

(Continued on reverse)

four and thereafter until the vehicle is fully depreciated. For 2017, total allowable deductions were $3,160 ($11,160 using bonus depreciation) in the first year, $5,100 for year two, $3,050 for year three, and $1,875 for year four and thereafter until fully depreciated. In other words, for light vehicles, the limits generally increased to over three times the prior amounts.

For heavy SUVs, pick-ups, and vans used over 50 percent in business, 100 percent bonus depreciation is allowed – that is, the 2017 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

The new law does not allow bonus depreciation on newly acquired or constructed real estate. The recovery periods remain 39 years for non-residential real estate and 27.5 years for residential rental property.

2018 is obviously a good year to obtain a significant tax saving from the acquisition of necessary qualifying property. We will be happy to answer your questions and help with your planning for capital expenditures.

SELECTING INVESTMENTS

The accompanying *Tax & Business Alert* includes an article titled, "How To Be Tax Smart When It Comes To Mutual Funds" containing some useful ideas for mutual fund selection. We would like to add a few comments.

Tax Sheltered Accounts – Tax efficiency is irrelevant in selecting investments for IRAs, 401(k)s, and other tax deferred or tax-free accounts. Amounts distributed from traditional tax-deferred accounts are taxed as ordinary income, and amounts from Roth accounts are tax-free. Accordingly, tax inefficient investments such as bond funds (both high-yield and investment grade), actively managed (high turnover) stock funds, and other high current taxable income securities, where appropriate for the taxpayer, are best owned inside a tax-deferred account, traditional IRAs, 401(k)s, etc. or in a tax-free account, Roth IRAs or Roth 401(k)s.

Currently Taxable Accounts – For accounts subject to current taxation, tax efficiency is, as indicated in the article, important. However, the emphasis on tax due diligence is, in our view, misplaced. The first and most important consideration is not income tax consequences but is the net-of-tax return. One might conclude, as do Warren Buffett (Chairman of Berkshire Hathaway), John Bogle (Founder of Vanguard), David Swensen (manager Yale Endowment), and most other independent analysts, that a passive, diversified equity index fund is the best choice for long-term investment horizons. If one chooses index funds for long-term commitments, no further tax consideration is required as index funds are

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inherently tax efficient both during ownership and on sale.

William Harding of *Morningstar* has stated that the average turnover rate for managed domestic stock funds is 130 percent. Such a turnover ensures that the taxable owner of actively managed funds will pay tax currently on almost all, if not all, of the investment return. The tax cost while holding an index fund is generally limited to a tax-favored rate (federal 23.8% max) applied to only the dividend income because index funds have generally been successful in avoiding capital gains as they have no need for significant sales. For example, one S&P 500 Index fund returned 9.49 percent before income tax for the 10 years ended March 31, 2018. After current income tax but before sale of the owner's shares, the fund returned for the same 10 years 9.04 percent. In other words, the current tax cost of owning the shares was only 0.45 of one percent per year for that 10 year period allowing after-tax compounding at 9.04 percent per year for the 10 years. If an actively managed fund achieved the same 9.49 percent pre-tax return achieved by the S&P 500 Index fund (most actively managed funds underperform the S&P 500 Index) and the owner pays tax at a 30 percent rate, its current after-tax return will be reduced by 2.85 percent to 6.64 percent. $1,000 compounded for 10 years at 9.04 percent grows to $2,376 and for 20 years to $5,646. The same $1,000 compounded for 10 years at 6.64 percent grows to only $1,902 (34% less growth) and for 20 years to $3,617 (44% less growth). This significantly smaller after-tax return (34% for 10 years and 44% for 20 years) assumes that the actively managed equity fund achieves the S&P 500 Index fund pre-tax return. The actual pre-tax return of the vast majority of actively managed equity funds is less than the pre-tax return of an S&P 500 Index fund.

When it comes to being "investment smart," the fees and other expenses of selling and administering actively managed funds result in an additional compelling reason for selecting index funds over actively managed funds. Understanding the highly favorable taxation of index equity funds adds to the overwhelming case for their selection over actively managed funds. When it comes to being "tax smart," index funds are the obvious answer – less tax during ownership and tax-free appreciation if held to death or the death of a community property spouse.

INVESTMENT SELECTION AND TAX COMPLIANCE

Of much less significance than the improved net-of-tax investment returns of passive index funds discussed above, but still worthy of consideration is the relative ease and diminished fee cost of tax compliance when investing through index funds rather than in a portfolio of individual marketable securities or master limited partnerships. Taxpayers investing through index funds have less investment "paperwork" and incur less tax preparation fees than taxpayers with brokerage transactions (often voluminous), publicly traded partnership interests, multiple consolidated Forms 1099, and the possibility of corrected consolidated Forms 1099 that may occur after the tax return has been drafted, completed, or, in the worst cases, filed.

In summary, passive index funds consume less of the taxpayer's and tax preparer's time than is consumed by the actively managed alternative investment vehicles.

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Tax & Business Alert

JUNE 2018

HOW TO BE TAX-SMART WHEN IT COMES TO MUTUAL FUNDS

Mutual funds are so common these days that many people overlook the tax considerations involved. Here are some tips on how to be tax-smart with these investment vehicles.

AVOID YEAR-END INVESTMENTS

Typically, mutual funds distribute accumulated dividends and capital gains toward the end of the year. It's generally wise to avoid investing in a fund shortly before such a distribution. Why? Because you'll end up paying taxes on gains you didn't share in.

Don't fall for the common misconception that investing in a fund just before a distribution date is like getting "free money." True, you'll receive a year's worth of income right after you invest, but the value of your shares will immediately drop by the same amount, so you won't be any better off. Plus, you'll be liable for taxes on the distribution as if you had owned your shares all year.

You can get a general idea of when a fund anticipates making a distribution by checking its website periodically. It's also important to make a note of the "record date" — because investors who own shares of the fund on that date participate in the distribution.

INVEST IN TAX-EFFICIENT FUNDS

When it comes to tax efficiency, not all funds are created equal. Actively managed funds tend to be less tax efficient — that is, they buy and sell securities more frequently, generating a greater amount of capital gains, much of it short-term gains taxable at ordinary-income rates. To reduce your tax liability, consider investing in tax-efficient funds, such as index funds, which generally have lower turnover rates, and "passively managed" funds (sometimes described as "tax managed" funds), which are designed to minimize taxable distributions.

Another option is exchange-traded funds (ETFs). Unlike mutual funds, which generally redeem shares by selling securities, ETFs are often able to redeem securities "in kind" — that is, to swap them for other securities. This limits an ETF's recognition of capital gains, making it more tax efficient.

BUT DON'T IGNORE TAX-INEFFICIENT FUNDS

Tax-inefficient funds may have a place in your portfolio. In some cases, actively managed funds may offer

REINVESTED DISTRIBUTIONS CAN LEAD TO DOUBLE TAXATION

Many investors elect to have their distributions automatically reinvested in their mutual funds. But it's important to remember that those distributions are taxable regardless of whether they're reinvested or paid out in cash.

Reinvested distributions increase your cost basis in a fund, so it's critical to track your basis carefully to avoid double taxation. If you fail to account for these distributions, you could end up paying tax on them twice — once when they're paid and again when you sell your shares in the fund.

benefits, such as above-market returns, that outweigh their tax costs.

If you invest in actively managed or other tax-inefficient funds, ideally you should hold them in nontaxable accounts, such as traditional IRAs or 401(k) plan accounts. Because earnings in these accounts are tax-deferred, distributions from funds they hold won't have any tax consequences until you withdraw them. And if the funds are held in a Roth account, qualifying distributions will escape taxation altogether.

MAKE NO ASSUMPTIONS

It's important to do your due diligence on mutual funds. Don't assume that a fund that historically has been tax efficient will stay that way in the future. Feel free to contact our firm for help. ■

DEDUCTING HOME EQUITY INTEREST UNDER THE TAX CUTS AND JOBS ACT

Passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 has led to confusion over some longstanding deductions. In response, the IRS recently issued a statement clarifying that the interest on home equity loans, home equity lines of credit and second mortgages will, in many cases, remain deductible.

HOW IT USED TO BE

Under prior tax law, a taxpayer could deduct "qualified residence interest" on a loan of up to $1 million secured by a qualified residence, plus interest on a home equity loan (other than debt used to acquire a home) up to $100,000. The home equity debt couldn't exceed the fair market value of the home reduced by the debt used to acquire the home.

For tax purposes, a qualified residence is the taxpayer's principal residence and a second residence, which can be a house, condominium, cooperative, mobile home, house trailer or boat. The principal residence is where the taxpayer resides most of the time; the second residence is any other residence the taxpayer owns and treats as a second home. Taxpayers aren't required to use the second home during the year to claim the deduction. If the second home is rented to others, though, the taxpayer also must use it as a home during the year for the greater of 14 days or 10% of the number of days it's rented.

In the past, interest on qualifying home equity debt was deductible regardless of how the loan proceeds were used. A taxpayer could, for example, use the proceeds to pay for medical bills, tuition, vacations, vehicles and other personal expenses and still claim the itemized interest deduction.

WHAT'S DEDUCTIBLE NOW

The TCJA limits the amount of the mortgage interest deduction for taxpayers who itemize through 2025.

Beginning in 2018, for new home purchases, a taxpayer can deduct interest only on acquisition mortgage debt of $750,000.

On February 21, the IRS issued a release (IR 2018-32) explaining that the law suspends the deduction only for interest on home equity loans and lines of credit that aren't used to buy, build or substantially improve the taxpayer's home that secures the loan. In other words, the interest isn't deductible if the loan proceeds are used for certain personal expenses, but it is deductible if the proceeds go toward, for example, a new roof on the home that secures the loan. The IRS further stated that the deduction limits apply to the combined amount of mortgage and home equity acquisition loans — home equity debt is no longer capped at $100,000 for purposes of the deduction.

FURTHER CLARIFICATIONS

As a relatively comprehensive new tax law, the TCJA will likely be subject to a variety of clarifications before it settles in. Please contact our firm for help better understanding this provision or any other. ■

3 COMMON TYPES OF IRS TAX PENALTIES

Around this time of year, many people have filed and forgotten about their 2017 tax returns. But you could get an abrupt reminder in the form of an IRS penalty. Here are three common types and how you might seek relief:

1. Failure-to-file and failure-to-pay. The IRS will consider any reason that establishes that you were unable to meet your federal tax obligations despite using "all ordinary business care and prudence" to do so. Frequently cited reasons include fire, casualty, natural disaster or other disturbances. The agency may also accept death, serious illness, incapacitation or unavoidable absence of the taxpayer or an immediate family member.

If you don't have a good reason for filing or paying late, you may be able to apply for a first-time penalty abatement (FTA) waiver. To qualify for relief, you must have: 1) received no penalties (other than estimated tax penalties) for the three tax years preceding the tax year in which you received a penalty, 2) filed all required returns or filed a valid extension of time to file, and 3) paid, or arranged to pay, any tax due. Despite the expression "first-time," you can receive FTA relief more than once, so long as at least three years have elapsed.

2. Estimated tax miscalculation. It's possible, but unlikely, to obtain relief from estimated tax penalties on grounds of casualty, disaster or other unusual circumstances. You're more likely to get these penalties abated if you can prove that the IRS made an error, such as crediting a payment to the wrong tax period, or that calculating the penalty using a different method (such as the annualized income installment method) would reduce or eliminate the penalty.

3. Tax-filing inaccuracy. These penalties may be imposed, for example, if the IRS finds that your return was prepared negligently or that there's a substantial understatement of tax. You can obtain relief from these penalties if you can demonstrate that you properly disclosed your tax position in your return and that you had a reasonable basis for taking that position.

Generally, you have a reasonable basis if your chances of withstanding an IRS challenge are greater than 50%. Reliance on a competent tax advisor greatly improves your odds of obtaining penalty relief. Other possible grounds for relief include computational errors and reliance on an inaccurate W-2, 1099 or other information statement. ■

BEWARE OF TAX TRAPS WHEN MAKING AN EMPLOYEE A PARTNER

In today's competitive employment market, offering an employee an equity interest in your business can be a powerful tool for attracting and retaining top talent. If your company is organized as a partnership, however, beware of the tax traps of doing so.

Employees pay half of the Social Security and Medicare taxes on their wages, through withholdings from their paychecks. The employer pays the other half. Partners, on the other hand, are treated as being self-employed — they pay the full amount of "self-employment" taxes through quarterly estimates.

Often, when employees receive partnership interests, the partnership incorrectly continues to treat them as employees for tax purposes, withholding employment taxes from their wages and paying the employer's share. The problem with this practice is that, because a partner is responsible for the full amount of employment taxes, the partnership's payment of a portion of those taxes could be treated as a guaranteed payment to the partner.

That payment would then be included in income and trigger additional employment taxes. Any employment taxes not paid by the partnership on a partner's behalf are the partner's responsibility.

Treating a partner as an employee can also result in over-payment of employment taxes. Suppose your partnership pays half of a partner's employment taxes and the partner also has other self-employment activities — for example, interests in other partnerships or sole proprietorships. If those activities generate losses, the losses will offset the partner's earnings from your partnership, reducing or even eliminating self-employment taxes.

As you can see, there's much to consider. Please contact our firm before making this move. ■

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