Tax Law Update 2019

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Dramatic new individual and business tax law changes took effect on January 1, 2018 (Tax Cut and Jobs Act) with some minor modifications for 2019. Individual tax rates decreased (see tables at end), but so did allowable deductions. Corporate tax rate dropped to 21% flat rate and new 20% deduction for qualified business income on pass through entities was enacted (Section 199A Qualified Business Income Deduction aka QBID). Many forms of property can now be depreciated faster or expensed in first year, except certain tenant improvements. The new tax law adds layers of complexity that offer new, creative ways of structuring your businesses, investments and income that will require very detailed analysis to identify optimal structure.

Winners and Losses Under New Tax Code

Winners	Losers
Commercial real estate developers – Benefit by (1) allowing for new Section 199A deduction on pass through income, and (2) creating more lucrative expensing rules in Bonus Depreciation and Section 179 for qualified improvements of nonresidential property.	**Residents of states with high state and local taxes** (itemized deduction for state and local income taxes (SALT) are capped at $10,000). While tax rates are lower, the substantial capping of deductions will make many people's taxable income and taxes paid increase.
Wealthy families with large estates – Benefit by (1) Significantly raising estate tax exemption, and (2) allowing for new Section 199a deduction for trust income.	**Home owners** – reduced mortgage interest deduction and severely capped real estate tax deduction. Harder to claim capital gain exclusion for sale of principal residence (must now be principal residence 5 of last 8 years)
High income earners (over $200k single/$400k family) – Lower marginal tax rates benefit high income earns. AMT tax credits will allow for recovery of some of prior year AMT paid.	**Middle class & working class after Dec 31, 2025-** Tax rate cuts will lapse and bracket creep will result in more income being taxed at higher rates.
People who receive pass-thru income on K-1 from businesses, investments, estates and trusts now get 20% deduction (some limits apply) under new Section 199a.	**W-2 employees with unreimbursed business expenses** (unreimbursed employee business expenses are eliminated).
Large families – child tax credit doubled to $2,000 with refundable amount increased to $1,400	**Civil Plaintiffs** – Proceeds from many legal settlements exceeding actual damages are now taxable as are the contingency legal fees in most cases (except federal civil rights violations).
C Corporations – Now 21% flat tax, no AMT.	**Professionals** – Professionals involved in accounting, law, medicine, consulting, performing arts are excluded from new tax benefits of 199A, thus politically determining different tax rates for different industries.

Winners	Losers
Attendees of private school (Up to $10,000 in qualified distributions from 529 College Savings Plans can now be used for elementary and secondary education.	**Citizens concerned about national debt** (adds $1.4 trillion to national debt in a decade. Interest on national debt and Defense are largest budget items paid by general revenues). Federal Reserve already raising rates to counteract monetary stimulus of deficit spending.

Tax Law Summary by Income Type

Wage Income	Lower marginal tax rates until 2025. Change in inflation calculation means tax brackets rise slower, meaning stealth tax increases as wages rise faster than tax bracket cut offs. ACA additional Medicare tax remains in effect.
Capital Gains	Capital gains rates unchanged. For assets held over one year, rates are 0%, 15% and 20% depending on your taxable income and filing status. Short term gains still taxed as ordinary income marginal tax rates (10%, 12%, 22%, 24%, 32%, 35%, 37%). ACA net investment income tax remains in effect.
Rental Property	New "below the line" deduction of 20% of pass through income under Section 199A Qualified Business Income Deduction (QBID) if actively managed, not passive activity. Bonus depreciation makes for faster expensing of certain assets.
Self Employed	New QBID "below the line" deduction of 20% of pass through income. Bonus depreciation makes for faster expensing of assets. Still paying double FICA tax.
Estates &Trusts	New QBID "below the line" deduction of 20% of pass through income.
K-1 Investments	New QBID "below the line" deduction of 20% of pass through ordinary income, but not capital gains, dividends and interest that receive preferred rates.

Deductions Capped or Eliminated

State and local income taxes	Pre-2018, tax law contained principle that double taxation was wrong, thus state income taxes (or sales taxes) and real estate taxes were fully allowed as itemized deductions. Now you can only deduct $10,000 ($5,000 for married filing separately). This is a significant blow to residents of states that pay for schools and services through income and real estate taxes instead of business and payroll taxes.
Mortgage interest	Pre-2018, you could deduct mortgage interest on up to $1 million dollars of mortgage indebtedness as well as $100,000 of HELOC indebtedness. New law caps at $750K mortgage indebtedness for all mortgages originated December 15, 2017 and later, and eliminates HELOC interest unless you can prove loan proceeds were used to "buy, build or substantially improve" the residence that secures the underlying loan.
Personal Exemption	Eliminated. The elimination of personal exemption is not offset by larger standard deduction by people who itemized before. This results in higher taxable income for many taxpayers.

Unreimbursed employee business expenses	Eliminated
Miscellaneous itemized deductions	Eliminated
Moving expenses	Eliminated
Casualty and theft losses	Eliminated
Employer subsidized parking & transportation	Eliminated

Deductions & Credits Expanded

Charitable Contributions	Expanded to 60% of income, up from 50%. Old law had cap of 30% of income for appreciated assets. We are researching new law for donating appreciated assets.
Child Tax Credit	Tax credit for qualified children under 17 doubled to $2,000 per child and refundable portion increased to $1,400 (refundable means government pays you difference if your income was not high enough to use it all).
Standard Deduction 2019 (inflation adjusted from 2018)	Increased to $12,200 single, 18,350 head of household and $24,400 married filing jointly. Factoring in the loss of $4,150 personal exemption per taxpayer, claiming "doubling exemption" is misleading.

Retirement Funding Limits 2019

Traditional IRA Roth IRA	$6,000 contribution limit plus $1,000 catch up contribution if you are over age 50.
401(k)	$19,000 elective deferral limit plus catch up contribution of $6,000 if you are over age 50.
Maximum Defined Contribution Limit	The overall defined contribution limit from all qualified plans is $56,000. This is most relevant to self-employed SEP/IRA who are funding based on percentage of profit up to this limit.
SECURE Act of 2019	Raises age for Required Minimum Distributions (RMD) to 72. Repeals the 70 ½ age limit for making contributions to Traditional IRA starting in 2020. Accelerates the RMD for non-spousal inherited IRAs to not exceed 10 years. Creates some new limitations on Qualified Charitable Distributions from IRA.

Tax Optimization Considerations

The new tax law adds layers of complexity that offer new, creative ways of structuring your businesses, investments and income that will require very detailed analysis to identify optimal structure. We offer Tax Restructuring Services to help guide clients through adopting the ideal business structure that lawfully minimizes taxes.

Some major tax planning challenges are:

1. Proper structuring of business income and active real estate investing to qualify for new Section 199A deduction of 20% of qualified business income. This includes assessment of benefits of being LLC vs S corporation vs C corporation from the vantage point of all taxes and deductions, including income vs. FICA tax and deductions for QBID and retirement funding. Additionally, there are partial capital gain exclusions for sale of small business C corporation that do not apply to pass through entities. Therefore, careful long-term planning and optimization is recommended.

2. Long term planning to see if it makes sense to claim Section 179 and bonus depreciation to the limit, which could create net operating losses which can only offset 80% of future income. In many cases, especially start-ups, it makes sense to slow down the depreciation so it is claimed more evenly across years when profit is being earned.

3. Home ownership benefits are reduced by limiting state and local tax deductions. Benefits of rental property increase with new Section 199A QBI deduction under the assumption of net income from rental activities (most rental property operate at a loss given depreciation required). As a result, some clients have asked us to analyze if it makes more sense to not own a primary residence and to concentrate their real estate holdings into rental properties instead of homes. This could produce current year tax savings, but you would forfeit capital gain exclusions of $500,000 ($250,000 if single owner).

4. If you are an employee no longer will you be able to deduct unreimbursed employee business expenses. You are better off negotiating expense reimbursement plan with employer as part of your compensation.

Section 199A QBID: 20% Deduction for Pass Through Income

Section 199A Qualified Business Income Deduction (QBID) is a complex formula to provide tax relief to unincorporated business owners and investors in qualified real estate investment trusts (REITs) and partnerships by excluding up to 20% of the qualified business income from taxation. While Congress sold this as a method to provide tax relief to small business owners organized as sole proprietors, LLCs, partnerships and S corporations as a companion to lowering C corporation tax rate to 21%, the Section 199A QBID is a complicated set of calculations to limit the deduction.

Section 199A taxes different professions and industries at different tax rates. Professionals in accounting, law, medicine, brokerage, investment advising, athletics, performing arts and consulting (producing advice instead of tangible deliverables) are deemed “specialized service trade of business” (SSTB) that are subject to income phase outs presented below. Architects, engineers and real estate professionals are specifically excluded from the SSTB income limitations by statute.

Non-service businesses, such as rental property, hotels/resorts, and K-1 ordinary income from publicly traded partnerships, are subject to a wage and capital tests, which provide advantages to capital intensive businesses, including commercial real estate.

The QBID is limited by income tests for SSTB service businesses, a wage and capital test for non-service businesses, and overall limitations based on taxable income (total income less adjustments to income such as retirement contributions, less either standard deduction or itemized deductions).

1. Income limits apply to specialized service trade of businesses (SSTB) claiming Section 199A QBI deduction.
   - Single/HOH/MFS filer starts phasing out at $160,700 and is completely phase out at $210,700.
   - Married filing jointly filers start phasing out at $321,400 and completely phased out at $421,400.
   - If taxable income is greater than $160,700/$321,400 but less than $210,700/$415,000, then a partial deduction is available based on wage and capital test applicable to non-service businesses.

2. Income from non-service pass through businesses is limited by wages paid and cost basis:
   - Taxpayer either claims 50% of employer wages paid or 25% of wages plus 2.5% of the value of qualified property purchased and compare it to 20% of the taxpayer's qualified business income. You can claim the lower amount of the adjustment.

3. Overall limitation that applies to all scenarios is that QBID cannot exceed 20% of taxable income, which is income after adjustments to income and standard or itemized deductions. Suppose taxpayer is Schedule C with $100,000 net profit, fully funds SEP/IRA at $20,000, has self-employed health insurance premiums of $6,000, can automatically claim half self-employment tax ($7,500) and claims standard deduction of $12,200. That results in taxable income of $54,300. While 20% of QBI is $20,000, 20% of taxable income is $10,860, so you can only claim the lower amount of $10,860 as the QBID deduction. These numbers would flow a bit differently on a S corporation.

4. QBID losses carryforward so if you are self-employed or have qualified rental property that lost $10,000 in 2018 but made $15,000 in 2019, your qualified business income for 2019 decreases to $5,000 due to loss carryforward.

The new 20% net qualified business income deduction can be tremendous tax benefit if properly structured. If you earn $100,000 of income from pass-thru business, rental real estate or estate/trust, you are receiving a $20,000 tax deduction before the limitations listed above are applied. When multiplied against a 22% marginal tax rate, that's $4,400 in federal tax savings.

IRS regulations are still ambiguous and largely untested in certain areas. IRS Reg 107892-18 and Publication 535 Business Expenses (with new QBID section and expanded clarifications of SSTB) are the current guidance.

We can speculate on how the IRS will develop audit programs for QBID and exhibit extreme care in reporting to minimize audit risk.

Tax Planning Tips to Maximize QBID Benefits and Avoid Limitations

The S corporation is now a more powerful tax savings tool. As before, the pass-through income from an S corporation is not subject to FICA tax (15.3% for self-employed). The new 20% net qualified business income deduction of 20% has additional value (the QBI deduction amount times your marginal tax rate which is about 5 cents on the dollar for 24% marginal tax rate).

Should everyone seek to become an S corporation? Not so fast. There are a lot of rules on different entities that have unforeseen effects. If you are committed to paying out your income in the form of wages and maximum funding a retirement plan (fully deductible employer contribution of 25% of wages paid for C corporation vs 20% for other entities), then you are probably fine as a C corp. Additionally, S corporations can be higher audit risk since there is an ambiguous rule about owner paying themselves wages at levels deemed "reasonable compensation," which is a judgmental standard open to interpretation. For the purpose of QBID, S corporation owner wages should exceed K-1 pass through. For general audit risk under "reasonable compensation" rules, officer wages should be closer to two-thirds of profit. Accordingly, there are different rules and audit risks for pass through entities depending on the purpose. These considerations are all layered.

Some may seek to form multiple entities to create maximum flexibility. One example could be owner of rental real estate who also performs their own property management, opportunities exist to have separate entities own the real estate who in turns hires the management company (an S-corporation that will pay W-2 wages). If your business has revenues streams from specified trade or business and non-SSTB, then you likely want to separate those income streams into separate business entities. Additionally, if you have business activities that are SSTB and others that are non-SSTB, separating them into separate legal entities is likely advisable.

If you are a real estate investor, in order to qualify you must be able to demonstrate you are actively operating a real estate business, instead of merely a passive investment, by proving you are spending substantial time actually engaged with the real estate. There are some separate rules (not fully written) that will apply to what is required for income from publicly traded REITS and partnerships to qualify.

Most of our clients with rental property, however, are probably in the passive income category but since most of those rental properties operate at a loss (after depreciation is considered) we do not see much impact on the QBI deduction. However, as always, we will be vigilant in claiming what you are legally able to.

Capital Gains Tax

Capital gains tax rates remain unchanged. Short-term capital gains are for property held under one year and are taxed at ordinary income rates (see income tax rate charts at end of this article). Long-term capital gains rates apply for holding periods over one year.

Long Term Capital Gains Tax Rates 2019

	Single	Married Filing Jointly	Married Filing Separately	Head of Household
Long Term Rate	Your Income	Your Income	Your Income	Your Income
0%	$0-$39,375	$0-$80,000	$0-$39,375	$0-$51,700
15%	$39,376-$434,550	$80,001-$496,600	$39,376-$244,425	$51,701-$452,400
20%	$434,551 or more	$496,601 or more	$244,426 or more	$452,401 or more

Tax minimization strategy is to try to offset capital gains with capital losses by timing sales.

Cryptocurrency Sales: The IRS considers sale of cryptocurrency like Bitcoin sale of property and taxes it as a capital gain. Technically, every time you spend Bitcoin or similar cryptocurrencies for goods and services you are creating a sale. For example, if you have a Coinbase account and a Swift Card attached, every time you buy something, the federal government considers it a sale subject to capital gains. This is a reporting nightmare. Do your best to organize your account info for reporting of sales.

Changes to Sale of Principal Residence

New tax law makes it harder to claim capital gain exclusion on sale of principal residence. Prior to January 01, 2018, you could sell your primary residence and avoid capital gains tax (on up to $250,000 in gains for single filers, $500,000 in gains for joint filers) if you held the property as a primary residence for two of the last five years. Under the new law, you must use the property for five years as your primary residence out of past eight years to qualify for the Section 121 capital gain exclusion for sale of primary residence. After tax laws are past, there are IRS rules and regulations issued to interpret law and create examples. One area for clarification is the types of allowable proration when the character of the property changes over time.

Net Investment Income Tax

In addition to capital gains tax and income taxes on dividends and interest, there is a Net Investment Income Tax (NIIT) at a rate of 3.8% that applies to certain investment income of individuals, estates and trusts that have modified adjusted gross income above the following statutory threshold amounts:

Filing Status	Modified AGI Threshold Amount
Single	$200,000
Married Filing Jointly	$250,000
Married Filing Separately	$125,000
Head of Household (with qualifying person)	$200,000
Qualifying Widow(er) with dependent child	$250,000

These threshold amounts are NOT indexed for inflation.

In general, investment income subject to NIIT includes capital gains, dividends, interest, rental and royalty income, non-qualified annuities, income from businesses involved in traded of financial instruments or commodities, and businesses that are passive activities to the taxpayers. Excluded from

NIIT are active income such as wages, operating income from an active trader business, tax-exempt interest and Alaska Permanent Fund Dividends.

Alternative Minimum Tax

The Alternative Minimum Tax is better understood as an additional marginal tax, as it creates a modified flat tax system next to progressive rate system and whatever amount is highest is what you pay. The difference is AMT. Those claiming large itemized deductions for state and local taxes and unreimbursed employee business expenses are hit the hardest. Under the new tax law, state and local income taxes are capped at $10,000 and unreimbursed employee business expenses are eliminated. AMT exemption amounts also increased. Accordingly, fewer people will pay AMT in the future. The good news is if you paid AMT in the past, we may be able to recover some of those amounts in 2019 under the new tax law unless we have already recovered this when filing the 2018 tax returns. In many cases, the AMT recovery amounts to a "sugar high" since without the AMT recapture from prior years many clients would otherwise experience an increase in taxes owed given the chronic under withholding on payroll that occurs. Please be sure to adjust your federal and state withholding to compensate for the lower amounts withheld under the new tax code. AMT recapture is less likely in 2019 for most of our clients given that we have already claimed it for the 2018 taxes. No more "sugar coating".

Businesses Tax Law Changes

The most significant changes in new tax law apply to business income, deductions and tax rates.

Lower Corporate Tax Rate: New corporate income tax rate (C corporations) for 2018 and beyond is 21% flat tax, down from graduated rates structure with 35% top rate also served as flat rate for all qualified personal service corporations. This is designed to make the USA competitive with the rest of the world which averages 22.5%. While owner-operators of C corporations typically drain income as salary and retirement plan contributions to avoid double taxation, larger enterprises cannot do so and will substantially benefit from rate reduction. Accumulated Earnings Tax still applies to prevent businesses from hoarding income beyond the reasonable needs of the business (a complicated subject and subjective standard that will not apply to most C corporation small business owners).

New Personal Tax Deduction for 20% of Pass Through Qualified Business Income: There will be a new "below the line" (i.e. after calculation of adjusted gross income) equal to 20% of qualified business income from a pass-through entity such as a sole proprietorship, LLC or partnership (Section 199A).

Businesses Can Immediately Expense More Property Under New Tax Law: Under accounting standards, when businesses acquire assets, they recognize the cost over the useful life of the asset, not upon purchase. We call this depreciation and amortization. Tax law seeks to accelerate the speed of write off through **Section 179** immediate expensing and **Bonus Depreciation** rules to encourage more fixed investments. Not all states recognize federal rules.

Section 179 limit is increased to $1 million for 2018 and $2.5 million thereafter. Bonus Depreciation percentage is increased from 50% to 100% for certain qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. After 2022, the allowable bonus depreciation percentage decreases by 20 percent per year.

For bonus depreciation the "new property" requirement is removed and replaced with taxpayer's first use. Bonus depreciation applies to eligible personal property under section 1245 of tax code, generally considered movable property such as equipment and furniture. Special rules and limitations apply to vehicles. To qualify for 100 percent bonus depreciation, all of the following conditions must be met: (i) taxpayer or its predecessor did not use the property at any time before acquiring it; (ii) the taxpayer did not acquire the property from a related party; (iii) the taxpayer did not acquire the property from a component member of a controlled group of corporations; (iv) the taxpayer's basis of the used property is not figured in whole or in party by reference to the adjusted basis of the property in the hands of the seller or transferor; (v) the taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent; and (vi) the cost of the used property eligible for bonus depreciation does not include basis of property determined by reference to the basis of other property held at any time by the taxpayer (e.g. in a like-kind exchange or involuntary conversion).

As a result of these provisions, new investments of qualified property, plant and equipment (excluding real estate) can be immediately expensed when taxpayer first use is after September 27, 2017 and before January 1, 2023.

Nonresidential Real Estate – New Rules for Qualified Improvement Property: Depreciation for real estate has several components. First you must separate out the value of land and are prohibited from depreciating land. Next, residential real estate is depreciated over 27.5 years and nonresidential real estate over 39 years. No changes in new tax law to these rules. What has changed is what qualifies for bonus depreciation (see above) and how you treat nonresidential leasehold improvements.

New tax law has new term **"Qualified Improvement Property"** which consists of improvements to interior of nonresidential real property. These improvements must have been placed in service after the building was first placed in service. Qualified improvement property excludes enlargements to the building, a building's elevators and escalators, changes the internal structural framework of the building, roofs, HVAC, fire protection systems, alarm systems and security systems. Qualified Improvement Property is generally eligible for Section 179 expensing up to $1 million and Bonus Depreciation, meaning depreciation of 100% in current year if placed in service after September 27, 2017 and before January 1, 2023. However, portion not qualified for 179 or bonus depreciation now 39 years.

Net Operating Loss (NOL) Carryover Limits: New tax law limits NOL carryforward or carryback to 80% of the taxpayer's taxable income for losses arising in taxable years beginning after December 31, 2017. Additionally, all carrybacks will be repealed except special two-year carryback in the case of losses incurred in the trade or business of farming, beginning after 2017. These provisions are relevant to small business owner-operators of C corporations who typically drain income at year end to prevent double taxation. Now we want to minimize amount net loss to prevent limited carryover.

Tax Rates for 2019

Single Filers Individual Tax Rates 2019

Tax Rate	Taxable Income Bracket	Tax Owed
10%	$0 to $9,700	10% of taxable income
12%	$9,701 to $39,475	$970 plus 12% of the amount over $9,700
22%	$39,476 to $84,200	$4,543 plus 22% of the amount over $39,475
24%	$84,201 to $160,725	$14,382 plus 24% of the amount over $84,200
32%	$160,726 to $204,100	$32,748 plus 32% of the amount over $160,275
35%	$204,101 to $510,300	$46,628 plus 35% of the amount over $204.100
37%	$510,301 or more	$153,798 plus 37% of the amount over $510,300

Married Filing Jointly Individual Tax Rates 2019

Tax Rate	Taxable Income Bracket	Tax Owed
10%	$0 to $19,400	10% of taxable income
12%	$19,401 to $78,950	$1,940 plus 12% of the amount over $19,400
22%	$78,951 to $168,400	$9,086 plus 22% of the amount over $78,950
24%	$168,401 to $321,450	$28,765 plus 24% of the amount over $168,400
32%	$321,450 to $408,200	$65,497 plus 32% of the amount over $321,450
35%	$408,201 to $612,350	$92,257 plus 35% of the amount over $408,200
37%	$621,350 or more	$164,709 plus 37% of the amount over $621,350

Married Filing Separately Individual Tax Rates 2019

Tax Rate	Taxable Income Bracket	Tax Owed
10%	$0 to $9,700	10% of taxable income
12%	$9,701 to $39,475	$970 plus 12% of the amount over $9,700
22%	$39,476 to $84,200	$4,543 plus 22% of the amount over $39,475
24%	$84,201 to $160,725	$14,382.50 plus 24% of the amount over $84,200
32%	$160,726 to $204,100	$32,748.50 plus 32% of the amount over $160,275
35%	$204,101 to $510,300	$46,628.50 plus 35% of the amount over $204.100
37%	$510,301 or more	$82,354.75 plus 37% of the amount over $510,300

House of Household Individual Tax Rates 2018

Tax Rate	Taxable Income Bracket	Tax Owed
10%	$0 to $13,850	10% of taxable income
12%	$13,851 to $52,850	$1,385 plus 12% of the amount over $13,850
22%	$52,851 to $84,200	$5,944 plus 22% of the amount over $52,850
24%	$84,201 to $160,700	$12,962 plus 24% of the amount over $84,200
32%	$160,701 to $204,100	$31,322 plus 32% of the amount over $160,700
35%	$204,101 to $510,300	$45,210 plus 35% of the amount over $204,100
37%	$510,301 or more	$152,380 plus 37% of the amount over $510,300