On December 22, 2017 the President signed the Tax Cuts and Jobs Act (TCJA) into law. It is the most comprehensive change to our income tax code since 1986. Despite politician’s comments and promises to the contrary, the law is massively complex. To make implementation even more difficult, substantially all states failed to pass conforming legislation. This means that most states (including Arizona) have not adopted many of the changes that apply to your federal income taxes. This will be particularly evident in the area of standard deduction or itemized deductions. With the limit on state tax deductions at the federal level of $10,000 we expect that in many cases clients will end up with a standard deduction on their federal return, but take itemized deductions on their state returns. Of course, the only way to know the optimal outcome for clients will be to quantify itemized deductions and then assess the best outcome on a case by case basis.

The new 20% qualified business income deduction is also exceptionally complicated. If you are engaged in the occupation of law, accounting, finance, consulting, or any other “brains for billing” services you are probably excluded from benefiting from this new deduction. However, if your income is below a specific threshold, the exclusion may not apply and you may actually be eligible after all. This means that with proper planning you may be able to avail yourself of this deduction. If you’re a service professional, it is probably in your best interest to schedule a tax planning appointment so we can review your specific situation with you and advise on the proper course of action.

If after reading this you feel you can benefit from anything contained herein or require clarification, please give us a call. Most of the items addressed require action prior to year-end. If you wait until we meet next year, it may be too late.
A summary of certain major changes to tax law follow:

SIGNIFICANT CHANGES AFFECTING INDIVIDUALS:

Changes in tax rates
You may have heard in the news that the goal of tax reform was to reduce the number of tax rates from the existing seven rates to three. While that was discussed, the bill that was signed into law still has seven rates, but they are now generally lower with the highest rate being reduced from 39.6% to 37%. The tax rates applicable to net capital gains and qualified dividends did not change.

Increased standard deduction

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<thead>
<tr>
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<th>2018</th>
<th>2017</th>
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<tbody>
<tr>
<td>Head of Household</td>
<td>$18,000</td>
<td>$9,350</td>
</tr>
<tr>
<td>Married Filing Jointly</td>
<td>$24,000</td>
<td>$12,700</td>
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<tr>
<td>Single</td>
<td>$12,000</td>
<td>$6,350</td>
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</table>

Although you may have historically had itemized deductions exceeding these amounts, other changes to itemized deductions may affect whether you are above the standard deduction in a given year. The increased standard deduction is effective through Dec. 31, 2025.

Elimination of personal and dependent exemptions

In the past, taxpayers received an exemption for themselves, their spouse and each of the eligible dependents that they claimed on their tax return. The TCJA eliminated these exemptions through Dec. 31, 2025.

Child and family tax credit

The TCJA increased the child credit for children under age 17 to $2,000 and also introduced a new $500 credit for a taxpayer’s dependents who are not their qualifying children. In addition, the phase-out limits for these credits have increased to $400,000 for joint filers ($200,000 for others), so that more individuals will be able to take advantage of this credit.

Changes to itemized deductions

- The overall phase out of itemized deductions has been repealed.
- The itemized deduction for state and local taxes (including income, personal property and real estate taxes) is limited to a total of $10,000 ($5,000 for those using the filing status of married filing separately). For example, if you paid $15,000 in state income taxes and $6,000 in real estate taxes on your home ($21,000 in total), you would not be able to deduct the $11,000 that exceeds the deduction threshold.
- Mortgage interest on loans used to acquire a principal residence and a second home is only deductible on debt up to $750,000 (down from $1 million). Loans in existence on December 14, 2017 are grandfathered (balance up to $1 million still allowed). More detail below…
- Interest on home equity indebtedness (such as a home equity line of credit) is no longer deductible unless the debt is really acquisition indebtedness (used for home improvement). Consider whether the indebtedness was used for business or investment purposes to determine if an interest deduction may be available in a different category. More detail below…
- Cash donations to public charities are now deductible up to 60% of adjusted gross income.
- Donations to colleges and universities for ticket or seat rights at sporting events are no longer deductible.
- Miscellaneous itemized deductions, such as investment management fees, tax preparation fees, unreimbursed employee business expenses and safe deposit box rental fees are no longer deductible.
- Medical expenses are deductible by the amount the expenses exceed 7.5% of adjusted gross income (AGI) for 2018 (the limit changes to 10% in excess of AGI starting in 2019).

These changes (except as noted) to itemized deductions are in effect from Jan. 1, 2018 through Dec. 31, 2025.

New deduction for qualified business income

A new deduction, effective for tax years 2018 through 2025, was introduced in the TCJA that allows individuals a deduction of 20% of qualified business income from a partnership, S corporation or sole proprietorship, as well as 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.
This deduction will reduce taxable income, but not adjusted gross income, and is available regardless of whether you itemize your deductions. There are many limitations and restrictions to this provision, so we advise that you schedule a personal consultation with us to fully understand the impact on your situation.

**Sec. 529 plans**

Sec. 529 plans have been a widely used tool to help taxpayers save money for college, presuming they distribute that money for qualified higher-education costs. Depending on your Sec. 529 plan, you may be eligible for a state tax deduction for contributions to the plan. The TCJA expanded the opportunities available for education tax planning by permitting $10,000 per year to be distributed from Sec. 529 plans to pay for private elementary and secondary tuition.

**Alimony**

Under the prior law, individuals who paid alimony to an ex-spouse received a deduction for the alimony paid, while the individuals receiving the alimony treated those payments as income. Tax reform has eliminated the deduction for alimony paid and the recognition of income for alimony received effective for divorce decrees executed after Dec. 31, 2018. We highly recommend that if you are in the midst of divorce proceedings, please have a conversation with us and your divorce attorney to fully understand the financial impacts that this could have.

**Estate and gift tax exemptions**

Estate and gift tax laws have undergone a number of changes over the past decade. Under the TCJA, the estate and gift tax exemption almost doubled to $11.18 million per person effective as of Jan. 1, 2018. There is still guidance necessary to reconcile gifts made and estates that occurred prior to the increased exemption and the impact on portability. The annual gift limit was increased to $15,000 for 2018 and will remain unchanged in 2019.

**Affordable Care Act - Individual shared responsibility payment**

The TCJA repealed the individual shared responsibility payment for failure to have minimal essential healthcare coverage. However, this repeal does not take effect until Jan. 1, 2019. This means that if you did not have minimal essential healthcare coverage in the 2018 calendar year, you will still be subject to the penalty if you do not meet one of the exceptions from coverage. Good news is that a new “hardship” exception has been added and may be available to taxpayers to avoid the penalty.

**Moving Expenses**

The TCJA generally eliminates the deduction for moving expenses after 2017. The exception would be for members of the armed forces pursuant to a permanent change in station.

**SIGNIFICANT ITEMS AFFECTING BUSINESSES:**

**New corporate tax rate for “C” Corps**

The prior-law graduated corporate tax rates have been consolidated into one 21% flat rate. The separate rate for personal service corporations of 35% has been repealed. These changes are effective for tax years beginning after Dec. 31, 2017. For fiscal-year corporations, the calculation of tax will be determined using a blended rate based on the number of days at the old versus the new rate structure.

**Bonus depreciation and Sec. 179 expensing of fixed assets**

Bonus depreciation and Sec.179 expensing of property have been available in varying amounts for quite a while. The new tax law has increased the bonus depreciation percentage to 100% until 2023, when it will decrease by 20% per year until it reaches zero. Bonus depreciation now applies to both new and used qualified property. The Sec.179 expense limit is now $1 million of allowable expensing with a total purchase threshold of $2.5 million. If you purchase more than $2.5 million in eligible fixed assets during the taxable year, the expense limit allowed will be reduced. The higher limits and expansion in the definition of property that qualifies for these deductions allow for tax planning opportunities. As part of your planning, we’d like to understand your asset purchasing behavior and plans for the future so we can maximize these deductions for you.
Net operating losses (NOLs)
Under the prior tax law, NOLs could be carried back two years or carried forward for 20 years. Unfortunately, the TCJA repealed the ability to carry back a NOL and claim a refund for already-paid taxes, effective for tax years ending after Dec. 31, 2017. If you have a tax situation that resulted in a NOL, we can advise you of the best options. For tax years beginning after 2017, the NOL may offset up to 80% of taxable income.

Interest expense deductibility
The TCJA introduced a limit in the deductibility of business interest to 30% of taxable income (with adjustments). However, this limitation does not apply to most taxpayers with gross revenues of $25 million or less. If your gross revenues exceed $25 million, we recommend having a discussion with us about the impact on your business. Regardless, with careful planning, we can help you maximize your deduction.

Entertainment expenses
The TCJA repealed the deduction for business entertainment. This includes expenditures such as taking clients to sporting events and shows and paying for season tickets for various entertainment events. Since these items are no longer deductible, it is very important to have your company’s internal accounting set up appropriately. We can help you identify these expenses and treat them correctly on your tax return. And, we are happy to discuss how to account for these internally to streamline your tax compliance reporting.

This revision did not remove the 100% deduction for the costs of recreational, social or similar activities primarily for the benefit of employees (other than owners and highly compensated employees). Therefore, you may still deduct 100% of the cost of holiday parties, outdoor picnics, golf outings or team building activities. Remember that all employees must be eligible to participate and cannot ultimately include only owners or highly compensated employees who do participate.

Like-kind exchange restrictions
The new tax law restricts a like-kind exchange to real property (e.g., buildings and land) only. Under the prior law, you could utilize a like-kind exchange for tangible personal property and intangible property used in a business or held for investment. Trade-ins of vehicles and equipment are now taxable, but the replacement probably qualifies for bonus depreciation and Sec. 179. Be aware of this change and contact us so we can help you plan accordingly.

Items Affecting Individuals & Businesses:
Annual Reminders (as always, we’ve slipped a few new ones in here this year):

**Meals & Entertainment** – The 50% deduction for business related entertainment was removed effective January 1, 2018. Therefore, entertainment is no longer deductible. We expect meals deductions to continue to be an area of audit focus for the IRS. To ensure your deductions are not disallowed, you must maintain a detailed log of your meals including the requisite details (1) who the meal was with, (2) what the business purpose was, (3) the cost of the event, and (4) where the costs were incurred. Also, please remember that actual receipts are adequate support; copies of credit card statements are not.

**Retirement Plans** – Qualified retirement plans must be established by December 31, 2018. An exception does exist for a SEP which may be established by the due date of the return (including extensions). SIMPLE plans must have been established no later than October 1, 2018.

**Social Security Wage Base** – For 2018 is set at $128,700 and for 2019 the social security wage base is set at $132,900.

**Mileage Rates** – The business reimbursement rate for 2018 is 54.5 cents per mile. Also, please don’t forget to provide us with your medical and charity mileage so we can take the appropriate deduction on your 2018 return. 2019 rates have not yet been issued by the IRS.
Charitable Contributions –

- The IRS applies a strict interpretation of the contribution rules and will aggressively adjust returns based on this policy. The courts have consistently sided with the IRS in these cases. The law states that no deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution with a contemporaneous, written acknowledgment from the donee organization. The written acknowledgment is required to include the amount of the cash donation and a description of any property received, whether the donee organization provides any goods or services in consideration for the cash or property received and a description and good-faith estimate of the value of any goods or services provided by the donee organization. Documentation recommendation:

  (1) be sure to obtain receipts for your charitable contributions, (2) be certain those receipts are dated prior to the filing date of your timely filed tax return, and (3) be sure the receipt contains the required statement in regards to goods or services received in exchange for the contribution.

- Donations of appreciated stock – If you are considering making cash contributions to a charity and also hold appreciated property (stock, mutual funds, etc.), you may want to consider gifting the appreciated property as opposed to selling cash, or worse, selling the appreciated property and donating the proceeds. A taxpayer may gift a certain level of assets to charity and can take the fair market value of the asset as a charitable deduction. The charity can then sell the asset and avoid paying any taxes too. The net result is the asset transfers to the church or charity you intend and the capital gain (and Net Investment Income tax) ends up disappearing. However, do not donate stock that you have a loss in as you will not be able to deduct the loss. Instead, sell the stock and contribute the proceeds.

- Contributions of clothing and household items – Remember that contributions of clothing and household items must be in good used condition or better. If you claim a deduction of less than $250, you are required to obtain a receipt from the donee, or maintain reliable written records of the contribution, including a description of the condition of the item. If you claim a deduction of $250 or more, you must obtain a contemporaneous written acknowledgment. For contributions of goods or property (other than stock of a publicly traded company) in excess of $5,000, in addition to a written acknowledgment, a qualified appraisal must be conducted by a qualified appraiser in accordance with generally accepted appraisals standards.

Corporate Governance – If you are incorporated, don’t forget to get your annual minutes from Board & Stockholder’s meetings drafted. Also, if you are an LLC and your operating agreement calls for annual meetings of members, you too need to memorialize these meetings with minutes.

Check Your Credit Report For Free – In light of the increasing levels of identity theft, it is a particularly good idea to check your credit report each year. The three (Equifax, Experian and TransUnion) national credit reporting companies are required to provide you with one free report each year. You can request your report online at annualcreditreport.com or by phone at 1-877-322-8228.

Estate Planning – If you haven’t done so yet, this is our annual reminder to prepare a will and revocable living trust. In addition, you should also consider an advance directive/medical proxy. You do not want the state determining (1) who will raise your children, (2) how your assets will be distributed, or (3) if your doctors should “pull the plug” should you become incapacitated. Estate planning is especially critical if you have or expect to have a taxable estate.

You also want to be sure your assets are properly titled and consistent with your estate planning documents. We have observed two situations in the past few months where clients have died and their home/investment accounts were not titled in the name of their trust. In both cases the estate had to go through probate to sell the respective assets.

Inventory Held For Sale – Don’t forget to take a count (physical inventory) of goods on hand for sale as of December 31, 2018.

How To Deduct Health Insurance For S Corporation Owners and Partners in Partnerships –

If an S corporation shareholder or a partner in a partnership maintains health insurance in his or her name and pays the premiums personally (including Medicare premiums), the S corporation or partnership should reimburse the owner before the end of 2018. In addition, the reimbursement should be included in the S corporation shareholder’s 2018 W-2 or reported as a “guaranteed payment” to the partner.
Medicare premiums paid by self-employed taxpayers are also eligible for the self-employed health insurance deduction as long as the premiums are reimbursed and the above procedures are followed.

Be certain to advise your payroll processor of these amounts so that 2018 W-2’s properly include health insurance paid for any greater than 2% owner-employee. This addition to wages is not subject to FICA so will not increase your payroll taxes. In addition, in order to claim the self-employed health insurance deduction, your actual paid wages must be no less than the amount of health insurance being paid/reimbursed.

**Tax Scams** – The IRS never contacts people by email and almost never via telephone. Should you receive an email or call from “the IRS” it is someone Phishing for information. There are currently a variety of tax related scams people are being victimized by. Please don’t fall victim to these. If you are contacted by email or telephone, and are not absolutely certain what you are doing is legitimate, please give us a call.

**Divorced Or Separated Parents Rules For Claiming A Child’s Dependency Exemption** – Under very stringent reporting rules, in the eyes of the IRS, the custodial parent is generally entitled to the dependency exemption of a child, even if a divorce decree contains a contrary directive. As a non-custodial parent, to ensure you get to keep your dependency exemption you should obtain the custodial parent’s consent to the exemption by completing Form 8332 with the non-custodial parent’s signature and including it with your return. Otherwise, your only other alternative is to include the pages of a divorce decree or separation agreement executed prior to July 2, 2008 so long as the document states (1) the noncustodial parent is unconditionally allowed to claim the exemption, (2) the custodial parent will not claim the exemption, (3) the years for which the claim is released, and (4) the document contains the signature of the custodial parent.

**Take Advantage Of Retirement Plans** – Retirement plans remain among the best methods of deferring income taxes.

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<thead>
<tr>
<th>Maximum Retirement Plan Contribution Amounts:</th>
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<tr>
<td>Under Age 50</td>
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<tr>
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</tr>
<tr>
<td><strong>2018</strong></td>
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<tr>
<td>401(K)</td>
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<tr>
<td>Simple Plan</td>
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<tr>
<td>IRA</td>
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- Roth IRA limits are the same as for traditional IRAs. For 2018, the adjusted gross income (AGI) phase out range for married filing joint for a Roth is $189,000 to $199,000 and for single taxpayers is $120,000 to $135,000. For 2019, the phase out range is $193,000 to $203,000 for married filing joint, while single taxpayers phase out range is $122,000 to $137,000. Remember that as long as your AGI is below or within the range of phase-out, you may contribute to a Roth even if you participate in another retirement plan.

- The Roth 401(K): Unlike a traditional Roth IRA, income limitations will not interfere with your ability to participate in this type of plan. Distributions from a Roth 401(K) are tax free if made after (a) 5 years and (b) age 59 ½, death, or disability. Remember that employer matching contributions and earnings on these contributions will be taxed when withdrawn. Non-qualified distributions will be pro-rated between earnings in the account and employee contributions. Roth 401(k) plans are subject to the minimum required distribution rules that qualified plans are for participants who reach age 70 ½. Generally, rollovers can be made from one Roth 401(k) to another Roth 401(k) or a traditional Roth IRA. The maximum amount of Roth 401(k) deferrals are the same as those of a regular 401(k) plan (see above). Please remember that retirement plan withdrawals may be subject to taxation and penalties when withdrawn early.

**“Kiddie Tax”** – Another Change… Unearned income over $2,100 of children under the age of 24 (full-time students) is now generally taxed under the trust and estate tax rate tables (instead of under their parent’s rates). The rate tables are more onerous than individual tax rates. You may want to consider shifting income from UGMA accounts to a 529 college savings plan or prepaid-tuition plan; invest child funds in stocks or mutual funds that seek capital appreciation and produce little or no current income, tax-exempt municipal bonds, or U.S. Series EE savings bonds where the income may be deferred.

We are awaiting IRS clarification regarding if a parent may still elect to report the child’s unearned income on their personal return.
These rules provide additional incentive to employ the child in your trade or business and pay the child reasonable compensation. The earnings are not subject to the kiddie tax and your business will obtain a deduction for the compensation paid. In addition, to the extent of the child’s unused standard deduction, the earnings will not be taxable to the child.

**Review Retirement Plan Beneficiaries** – Be sure that the beneficiaries in your plan documents reflect your current wishes. Case law is clear; the named beneficiaries (even if that beneficiary is an ex-spouse) are entitled to receive the plan benefits. You generally want individuals named as beneficiary of retirement plan accounts as opposed to your trust. Naming an individual generally allows distributions to take place over a longer period of time than a trust. Should your trust be the beneficiary, the funds generally must be distributed over no more than 5 years.

**1099 Questions on Business Tax Returns** - Business tax returns, including sole proprietorships, now include what many refer to as a “perjury trap”. The first question asks if you (the business) were required to issue 1099s for the tax year, and the second question asks if you did issue 1099s or intend to issue 1099s for that tax year. It would be nothing short of the equivalent of picking up the phone and asking the IRS to come audit you to answer the questions in such a way that you were obligated to issue 1099s but did not or do not intend to. If you indicate that you were not under such an obligation, and in fact were and sign the tax returns, you subject yourself to not only the 1099 failure to file penalties, but also a perjury charge. Further, if you indicate that you are obligated to issue 1099s and you did or intend to and then don’t, you are exposed to the same penalties and line of attack. With the penalties for failure to file 1099s so high, we strongly suggest that you carefully review your 2018 disbursement information and issue 1099s to all required.

Late 1099s begin to accrue penalties at the rate of $100 per return and climb to up to $530 per return if filed after August 1, 2019. Further, the penalty for intentional failure to file 1099s has increased to the greater of (1) $530 per 1099 not issued or (2) 10% of the amount that should have been reported on the 1099.

**Employee Or Independent Contractor** – The IRS continues to aggressively attempt to reclassify contractors as employees. If you want to mitigate your risk you should (1) document your arrangement with a contract and preferably state that the contractor will be paid on a project basis and not hourly, (2) obtain a Form W-9 from the contractor and be certain to issue 1099s at year-end, (3) pay the contractor through your accounts payable system supported by an invoice from the contractor and not your payroll system, and (4) don’t give the contractor company tools or equipment or a company e-mail address. Many companies that utilize independent contractors who are then challenged by the IRS try to rely on the “safe-harbor” relief written into the code to avoid penalty assessment. If you use independent contractors and you want to sleep well at night, you must issue them 1099s.

**Foreign Account Disclosure** – In addition to the current law that requires disclosure of foreign accounts in excess of $10,000, if the aggregate value of all “Specified Foreign Financial Assets” exceeds $50,000, individuals must attach details of the foreign assets with their income tax return. A Specified Foreign Financial asset includes an account maintained in a foreign financial institution, and any of (1) a stock or security issued by a foreign person, (2) any financial instrument where the issuer is not a US person, and (3) any interest in a foreign entity. The penalty for failure to comply starts at $10,000 and climbs to $50,000. Please be sure to alert us if you have any Specified Foreign Financial Assets.

**Trade or Business or Hobby Losses** – The IRS has aggressively audited and won significant court cases for those involved in film making, car racing, horse breeding and racing as well as other “personal hobbies” that many attempt to deduct by characterizing such activities as a business. If you are in a business that may be considered a hobby and you are losing money, please give us a call to discuss some of the lessons learned from these cases.

**Certain Tax Provisions That Expired At The End Of 2017 and will not be available to you for 2018** - There are a number of income tax provisions that absent extension, expired at the end of 2017. Those that we believe are most likely to impact our clients follow:

1. The $4,000 deduction for higher education expenses – commonly referred to as the “tuition deduction” (higher education credits do remain intact going forward).
2. The deduction of Mortgage Insurance Premiums as qualified residence interest.
3. Debt forgiveness income exclusion for Qualified Principal Residence Indebtedness of up to $2,000,000.

Each of the above items were also slated to expire at the end of 2016 and were subsequently extended after the fact. Many commentators believe this will happen again in 2019 for tax year 2018.
Certain Tax Provisions That Remain in Effect Related to the Affordable Care Act (“Obamacare”) - In case you haven’t heard, these rules are “crazy complicated”. Following is a brief and incomplete summary of some pertinent items.

1. The “Individual Mandate” – Under Obamacare, there is a penalty, known as the "shared responsibility payment," for not having health insurance coverage. You may be liable for this penalty if you didn't have health insurance for two or more months in 2018. However, depending on your income, you may be eligible for an exemption from the penalty. The penalty is 2.5 percent of your 2018 income or $695 per adult, whichever is higher, and $347.50 per uninsured dependent under 18, up to $2,085 total per family.

2. “Premium Assistance Credit” – The act provides for a refundable tax credit for eligible individuals who purchase health insurance through a qualified health insurance exchange. The Premium Assistance Credit (PAC) is generally available to individual taxpayers with “household incomes” of at least 100% but not more than 400% of the Federal poverty line. Additionally, the PAC is only available if the insurance is purchased from the new insurance exchanges for the individual and/or the individual’s family. If you believe your household income falls below the Federal poverty line, or are unsure, several health care providers have developed an on-line interactive calculator for estimating the amount, if any, of the PAC. For example, the Kaiser Family Foundation has an interactive online calculator at www.kff.org. You want to be sure you are eligible to receive the credit.

The “Employer Mandate” – Provides for an excise tax against any Applicable Large Employer who fails to offer Eligible Employer-Sponsored Health Plan Coverage. An applicable large employer that does not offer coverage for all its full-time employees, offers minimum essential coverage that is unaffordable, or offers minimum essential coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent, is required to pay a penalty if any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

3. Employer reimbursement of employee health insurance – Recently issued regulations make this a bit complicated, but we'll try to simplify the rules.

   a. If you are an Applicable Large Employer (i.e. you are subject to the employer mandate), you are not permitted to reimburse an employee for their individual health insurance coverage. The penalty for failing to comply with this provision is $100 per employee per day.

   b. If you are not an Applicable Large Employer, you may now reimburse medical insurance premiums of an Eligible Employee by adopting a Qualified Small Employer Health Reimbursement Arrangement. Under such a structure, a company may reimburse up to $5,050 of employee ($10,250 for family) payments made in the tax year. If the employee is covered for less than 12 months, the limits must be prorated based on the number of months covered. This is a very complex set of rules, a summary of which is too long for this communication. If it's of interest to you, please let us know and we'll send you information. You should not reimburse employees under these regulations without a complete understanding of the rules. Failure to comply puts you squarely in the $100 per day per employee penalty bull’s eye.

Items Affecting Businesses/Self-Employed:

Tax Return Filing Deadlines – Partnership income tax returns are generally now due by March 15.

1099s are now required to be issued to recipients and submitted to the IRS by January 31, 2019. There is no longer a timing difference between issuance and submission. As noted above, late filing penalties can be onerous. Please plan accordingly.

S Corporation Shareholder Salaries – For any business operating as an S corporation, it's important to ensure that shareholders involved in running the business are paid an amount that is commensurate with their workload. The IRS scrutinizes S corporations which distribute profits instead of paying compensation subject to employment taxes. Failing to pay arm's length salaries can lead not only to tax deficiencies, but penalties and interest on those deficiencies as well. The key to establishing reasonable compensation is being able to show that the compensation paid for the type of work an owner-employee does for the S corporation is similar to what other corporations would pay for similar work.
Business Property Expensing (Section 179) – A business that buys machinery, equipment and certain real property generally deducts its cost over a number of years via depreciation. The expensing election permits a business to expense (that is, deduct immediately rather than depreciate over several years) a certain amount of the cost of tangible depreciable personal property (typically furniture, fixtures or equipment) or qualified real property purchased and placed in service during the year. For 2018, the maximum annual expensing limit is $1,000,000, and the maximum annual expensing amount begins to phase out dollar-for-dollar when the business places in service during the tax year expensing-eligible property in excess of $2,500,000. For 2019, the expensing limit remains the same as 2018.

Keep in mind the tax return that takes the deduction must show a profit from earned income in order to take the deduction. This means if you have a partnership or business and it has a loss, you won’t be able to take the write-off on your personal return against income from your wages or other self-employment business. If you own multiple entities with varying operating results, this may present a planning opportunity.

If you plan on updating or adding some equipment in the near future and the business will have taxable income and want to avoid yourself of this deduction, get it done by December 31; just remember that buying equipment solely to save taxes does not make good sense. Yes, the tax savings will make the equipment cheaper, but you will never save as much in tax as you spend on the equipment, so always make good business decisions first and don’t let the tax tail wag the dog.

Bonus Depreciation – 100% bonus depreciation was implemented for property acquired and placed in service after September 27, 2017 for eligible property. Thereafter, the 100% bonus expensing method is effective through 2022. If you are a fiscal year taxpayer, please remember that these percentages apply on a calendar year basis.

To qualify for the 100% bonus depreciation, the property must meet (1) the “acquisition requirement”, (2) the “placed in service requirement”, (3) the “original use requirement”, and (4) must be qualified property. Qualified property is broadly defined under these provisions and includes computers, software, equipment, trailers, office furniture and fixtures, agricultural structures, land improvements (which includes sidewalks, shrubbery fences, landscaping, etc.), farm buildings and qualified leasehold improvements. Recent rule changes now allow the qualified property to be either new or used. While you must have profit to offset with Section 179 deductions, this provision has no such limitation. Therefore, as long as you have sufficient basis, you can produce a tax loss by taking advantage of this deduction. With the new limitation on loss carrybacks, this opportunity does not present the value it once did.

Under the ordering rules, if you wish to take both a Section 179 deduction and bonus depreciation, you must take Section 179 first.

Vehicle Deductions and Substantiation – Expenses relating to vehicles used in a business can add up to major deductions. The deductible vehicle expenses of a business are generally calculated using one of two methods: the standard mileage rate method or the actual expense method. If the standard mileage rate is used, parking fees and tolls incurred for business purposes can be added to the total amount calculated.

Since the IRS tends to focus on vehicle expenses in an audit and disallow them if they are not properly substantiated, you should ensure that the following are part of your tax records with respect to each vehicle used in your business: (1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance); (2) the amount of mileage for each business or investment use and the total miles for the tax period; (3) the date of the expenditure; and (4) the business purpose for the expenditure. The following are considered adequate for substantiating such expenses: (1) records such as an account book, diary, log, statement of expense, or trip sheets; and (2) documentary evidence such as receipts, canceled checks, bills, or similar evidence.

Records such as an account book, diary, log, statement of expense, or trip sheet are considered adequate to substantiate the element of an expense only if the records are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred. We have a number of clients who have begun to use mileage tracking apps on their smartphones. In most cases their reported mileage amounts have gone up. So, we encourage you to use one. MileIQ is a highly rated smartphone app that eases the burden of tracking mileage.
**Deducting Prepaid Expenses** – Under a special 12-month rule, corporations can deduct a prepaid expense when its benefit does not extend beyond the earlier of (1) 12 months after the first date on which the corporation realizes a benefit from the expenses, or (2) the end of the tax year following the tax year in which the payment is made. Want to deduct a portion of your 2019 rent in 2018? Simply cut the check and be sure to mail it before December 31, 2018. Remember that unless you replicate this process at the end of 2019, you will reduce your 2019 deductions by the amount accelerated into 2018.

**Home Mortgage Interest**

- **Principal Mortgage Limits** – The TCJA reduces the $1,000,000 limitation for home “qualified acquisition indebtedness” to $750,000 (incurred after December 15, 2017). The $1,000,000 remains in place for loans incurred prior to December 15, 2017.

Qualified acquisition indebtedness generally means debt incurred to purchase, construct or substantially improve the taxpayer’s qualified residence that is secured by that residence.

- **Home Equity Loans (HELOC)** – Taxpayers are no longer eligible to deduct interest on up to $100,000 in HELOC debt without regard to the use of the proceeds. Any HELOC interest on mortgage debt that is not qualified acquisition indebtedness is no longer deductible unless it can be characterized as trade or business interest expense or investment interest expense. If you used your HELOC to improve your residence on or before December 15, 2017, it would continue to qualify as qualified acquisition indebtedness and the related interest would continue to be deductible.

**Miscellaneous Itemized Deductions** – The TCJA suspends all miscellaneous itemized deductions from 2018 through the end of 2025. Examples of items no longer deductible include an employee’s auto expenses, travel, transportation, lodging, work clothes, uniforms, union dues or home office expenses. Consistent with prior law, an employee who is reimbursed for legitimate business expenses by an employer under an accountable reimbursement arrangement receives that reimbursement tax free.

Additionally, the deduction also suspends the deduction for safe deposit box fees, investment advisory fees and income tax preparation fees.

**Safer Harbor Deduction Rules issued for Home-Office Expense** – Taxpayers who operate as a sole proprietorship (not available to W-2 employees) who have a home office and otherwise qualify for the home-office deduction may apply the safe-harbor method in lieu of the traditional method for computing the deduction. The safe-harbor deduction is equal to $5 per square foot of qualified home office not to exceed 300 feet. Therefore, the maximum allowable deduction is limited to $1,500. The potential advantage of this approach is that it preserves 100% of the allowable mortgage interest and real estate taxes to be deducted as itemized deductions (instead of prorating them between home-office deduction and itemized deduction). No depreciation is allowed under the safe-harbor method, which also means there is no depreciation recapture (a potential source of taxable income) for the years the safe-harbor method is used upon the ultimate disposition of the home.

Given the ability to choose between methods annually, it appears that going forward, we will need to compute the deduction using both the traditional method and safe-harbor method and then make a determination as to which produces the best current and long-term result. Like many tax filing positions, this decision will require some judgment on your part and may be impacted by any potential aversion to depreciation recapture upon the ultimate sale of the home.

**Sole Proprietors** – If you have a SIMPLE plan, remember that you must deposit your elective deferrals by January 31 of the year following the year for which the contribution is made (i.e. for 2018, you must fund the elective deferrals by January 31, 2019).

**De Minimis expensing rule** – Regulations include a de minimis expensing rule that generally allows conforming taxpayers to deduct (instead of capitalize) certain amounts paid to acquire a unit of tangible personal property. Generally, if the taxpayer has an audited financial statement, written accounting policies for expensing amounts paid for such property under certain dollar amounts and treats such property consistently for both their books and income taxes, the regulations allow up to $5,000 to be deducted per invoice. For businesses that do not have an audited financial statement, the per item or invoice threshold amount is reduced to $2,500.

The regulation requires that the taxpayer have an accounting policy in place as of the first day of the year providing for the expensing of items with a useful life of less than twelve months or a cost below $2,500. We strongly recommend you put this policy in writing and retain in your files.
**Items Affecting Individuals:**

**Alimony** – For any divorce or separation agreement executed after 2018 the TCJA eliminates the deduction for alimony paid and such payments would not be included in income of the recipient. This can have a significant impact on any pending divorces.

In addition, if someone receives alimony under a “post 2018” agreement, because the receipts are not taxable, they would also not be considered to be earned income for purposes of IRA contributions (i.e. – can’t make one based on receipt of alimony).

**Long-Term Capital Gain and Qualified Dividend Income Tax Rates** – The income tax rates for long-term capital gains (LTCG) and qualified dividends generally remain at 15% (zero percent for net capital gains otherwise taxed in the 10% and 12% brackets); however, the LTCG is 20% for net taxable LTCG and qualified dividends that would otherwise be taxed in the 37% bracket. Following is a summary of the various income tax rates that may apply to long-term capital gains and dividends in 2018:

<table>
<thead>
<tr>
<th>Taxable Income (including LTCG &amp; Dividends)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
</tr>
<tr>
<td>----------------</td>
</tr>
<tr>
<td>0% - Up to</td>
</tr>
<tr>
<td>15% - From</td>
</tr>
<tr>
<td>To</td>
</tr>
<tr>
<td>20% - Greater than</td>
</tr>
</tbody>
</table>

Therefore, for taxpayers subject to the 3.8% Net Investment Income tax, the overall tax rate on LTCG will be 23.8%.

Arizona now allows a subtraction from Arizona gross income for a percentage of any net long-term capital gain included in the resident’s federal AGI that is derived from assets acquired after December 31, 2011. The subtraction is 25% of the qualifying gain in Arizona gross income for 2018.

**9% Medicare Surtax on Earned Income** - Taxpayers will be assessed an additional Medicare surtax of .9% by the amount an individual’s W-2 wages or self-employment income exceeds (1) $250,000 if married filing joint or (2) $125,000 if married filing separately, or (3) $200,000 for other individuals.

For married filing a joint return, the W-2 earnings of both husband and wife are aggregated in determining if the earnings exceed the $250,000.

For self-employed taxpayers, the additional .9% will apply to the extent the sum of the wages (their own or those of their spouse) and net self-employment income exceeds the threshold amounts noted above.

**3.8% Tax on Net Investment Income** - Taxpayers with modified adjusted gross income (generally AGI for most taxpayers) will be assessed an additional 3.8% tax on the lesser of (1) Net Investment Income, or (2) modified adjusted gross income in excess of $250,000 for married taxpayers ($125,000 for married filing separately and $200,000 for others).

Net Investment Income includes interest, dividends, annuities, royalties, passive rental income, and passive activity trade or business income, net of allocable expenses.

Some thoughts about this tax – In general, strategies that reduce current AGI may result in reducing exposure to both the .9% Medicare Surtax and the 3.8% tax on Net Investment Income. In addition, by reducing your AGI, you may also benefit from reduced impact on the phase-outs of itemized deductions and personal exemptions. We would welcome the opportunity to further explore the following items, as well as others, which may be viable strategies for you.

Tax-exempt income becomes more attractive – Higher income taxpayers who are subject to this tax will have added incentive to pursue “tax-exempt” income and should definitely consider the after-tax return on their fixed income investment choices taking the potential additional 3.8% tax into consideration.
Roth IRA’s and Roth Conversions – Since tax free distributions from a Roth IRA are exempt from the Medicare surtax and do not increase modified AGI, this will enhance the value of a Roth IRA. However, if you are contemplating a conversion, the income triggered would increase modified AGI for the year of conversion and therefore increase your exposure to the Medicare surtax in the year of conversion. **See Anyone Can Convert A Regular IRA To A Roth IRA below.**

Benefits of Qualified Retirement Plans – Deductible contributions to qualified retirement plans (traditional IRA’s, 401(K’s), SEP’s or Simple Plans) will potentially provide individuals with two benefits. (1) the contributions will reduce modified AGI and, therefore, reduce the chance of exceeding the income thresholds for the 3.8% and .9% Medicare surtax, and (2) retirement plan distributions received later will be exempt from the Medicare surtax Note that although such distributions would be exempt from the Medicare surtax, they could push individuals over the modified AGI threshold subjecting their investment income to the 3.8% Net Investment Income tax.

Trade or business income from an S Corporation or Limited Partnership will be subject to the 3.8% Net Investment Income tax unless the owner materially participates in the business (i.e. generally works at least 500 hours each year).

For those of you that own rental property, it may be possible to take the position that your net rental income is a trade or business, and therefore, not subject to the 3.8% Net Investment Income tax. To achieve this objective, you will need to overcome the “passive activity” rules that relate to rental real estate. In addition, as a matter of law, failure to issue 1099s, which is required for all trades or businesses, will negate your ability to take this favorable position. Proactive planning is necessary if you wish to attempt to take advantage of this filing position.

For Arizona individuals, the allowable deduction for contributions to an Arizona 529 plan remains at $4,000 for joint filers ($2,000 for single and head of household).

**Individual Retirement Accounts (IRAs):**

**Rollovers** – An individual may roll over qualifying distributions from a traditional IRA to another IRA or qualified retirement plan without being taxed, if made within 60 days of receipt of the distribution. Please remember that a taxpayer may only make one rollover per year. Be careful here – the clock starts ticking on the one year waiting period on the date you receive the distribution. Therefore, the limitation is not based on a calendar year. Further, all IRAs are considered to be a single IRA for purposes of this limitation.

**Longevity Annuity in IRA** – In July 2014 the IRS issued regulations that allow the cost of a longevity annuity inside an IRA to be excluded from the computation of the required minimum distribution at age 70 ½ as long as the longevity annuity satisfies certain requirements. These rules are very complicated, but should prove beneficial to those that want to purchase a longevity annuity and have funds concentrated in their tax deferred accounts.

**Required Minimum Distributions (RMD’s)** – Taxpayers must start taking annual RMDs from their traditional IRAs by April 1 following the year in which they attain age 70 1/2. As for qualified plans like a 401(k), 5% owners are subject to the same rules as apply for IRA owners. However, for a non-5% owner, RMDs must commence by April 1 of the year following the later of the year in which the taxpayer (a) reaches age 70 1/2, or (b) retires. Failure to withdraw the annual RMD could expose you to a penalty tax equal to 50% of the excess of the amount that should have been withdrawn over the amount that actually was withdrawn. If required, be sure to take your RMD by December 31, 2018.

**Tax-Free IRA Distribution to Charities of up to $100,000 for those at least 70 ½** - Individuals who are at least 70 ½ may have their IRA trustee make a tax-free distribution up to $100K directly to a charitable organization. This direct payment does qualify as a component of your required minimum distribution.

If you are required to take required minimum distributions, and take the standard deduction, but still engage in charitable giving, this is a great way for you to make some or all of your required minimum distribution requirement tax free.

**Hardship Distributions** – We continue to see situations where employees pull funds from their employer retirement plan (typically 401(k)) pursuant to the hardship rules of the plan. Please remember that there is no hardship exception to the 10% penalty. If funds are pulled from a plan you will be subject to both the 10% penalty plus income taxes on the amount of the distribution.
$250 Deduction for Teachers – Beginning in 2016, the rules of what constitutes a deductible item for teachers was expanded to include expenses paid by an eligible educator for professional development courses related to the curriculum in which the educator provides instruction.

Threshold for Medical Expenses is 7.5% of AGI – For taxpayers of any age, medical expenses will be deductible only to the extent they exceed 7.5% of AGI for 2018 and 10% for 2019.

Investments – If you have carryover losses from 2017 or your portfolio holds positions which are currently at a loss, and you are considering selling some of your losers, you may deduct $3,000 of losses in excess of gains. To get the deduction on your 2018 returns, you must dispose of existing positions before the end of the year. Be careful of the wash sale rules; if you wish to repurchase the stock or mutual fund (or comparable mutual fund) you sold for a loss, you must wait 31 days before you buy it back. If possible, try to utilize your long-term capital losses against short-term capital losses which are taxed at a higher rate than long-term capital gains.

Be careful if you purchase a mutual fund and it pays a dividend before the end of 2018. You will owe tax on the payout this year. To avoid this exposure, purchase the fund after the dividend date.

With the real estate market recovering, real estate investors looking to re-invest in another property may want to consider selling their property and repurchasing a replacement property using a 1031 exchange. A 1031 exchange can be used to defer capital gains taxes until the sale of the replacement property. There are some procedures and timelines that need to be followed to properly complete a 1031 exchange but this may be a great strategy for real estate investors who plan to buy more real estate when selling a property. Please do not attempt to engage in a 1031 exchange without first considering the income tax implications or consulting a professional. Section 1031 is not available for the sale of a principal residence.

Sale of Principal Residence – You may exclude up to $500,000 of gain ($250,000 if single) on the sale of your residence, as long as you owned and lived in your home for at least 2 out of the previous 5 years. Additional limitations may apply.

Flexible Spending Account (FSA) Changes – The $2,650 cap on contributions to your FSA for medical reimbursement purposes remains unchanged. However, this limit does not apply to the amount permitted for other benefits allowed under the FSA such as dependent care assistance or adoption assistance and the limit does not apply to salary reduction contributions to a cafeteria plan used to pay an employee’s share of health coverage premiums.

Health Savings Account (HSA) - Contribute to an HSA for a qualified high deductible insurance plan. Maximum deductible contributions in 2018 are $6,900 for families or $3,450 if single and in 2019, limits are $7,000 for families or $3,500 if single (and an additional $1,000 if at least 55 years old). Contributions are due by April 15th of the following year.

Tax Free Gifts – Anyone may make a tax-free gift to any other individual of up to $15,000 each year without impacting their lifetime estate limit under the estate tax rules. Beginning in 2018, if you have a larger estate but would like to assist a loved one with college, you may fund up to $75,000 ($150,000 for married filing joint) to a 529 account in a single year, but then cannot make a gift to that beneficiary for an additional five years. This is a great way to get assets out of an estate, but still maintain control of those funds. If you believe you have a taxable estate, we may be able to assist you in reducing your tax exposure. Give us a call and let’s discuss. In addition, Arizona allows for a state income tax deduction for contributions to a Section 529 plan. The deduction is $2,000 for individual filers and $4,000 for married couples filing joint returns.

Anyone Can Convert A Traditional IRA To A Roth IRA – Anyone may now convert a traditional IRA to a Roth IRA regardless of adjusted gross income. The decision on whether or not to make a conversion is very difficult and requires the use of numerous assumptions, most of which are likely to differ from the ultimate actual amounts. In addition, potential changes in tax law such as a move to a flat tax or value added tax are almost impossible to build into your assumptions. Before making a conversion, we suggest that you use one of the many tools available on the web to evaluate the impact of a potential conversion by utilizing numerous assumptions and getting a feel for the impact that differing assumptions have on your results. Should you determine to make a Roth conversion, the amount converted will be treated as taxable income in the year of the conversion.

For those wishing to make a 2018 Roth contribution but cannot due to the AGI limitations, one option is to make nondeductible IRA contributions in 2018. Then you can roll over the accounts into a Roth IRA next year at little or no tax cost if you have no other IRAs (including Simple and SEP IRAs). This strategy does not work if you have other IRAs.
If you expect your tax rate to decline after 2018, you may want to make a deductible IRA contribution in 2018 and then convert to a Roth IRA in 2019. This would allow you to take the 2018 IRA deduction at a higher rate than you expect when you pay the tax on the conversion in 2019.

**American Opportunity Credit** – If you have yet to incur sufficient tuition and fees to qualify for the maximum credit for an eligible family member, consider paying the tuition for the second semester of the following qualifying year (i.e. the January to May semester) by December 31, 2018. The credit begins to phase out for those married filing joint with adjusted gross income of $160,000 (single $80,000). The maximum credit for 2018 is $2,500 and is equivalent to 100% of the first $2,000 of tuition and fees plus 25% of the next $2,000 of tuition and fees paid during the year. Therefore, if eligible, tuition payments of at least $4,000 are necessary to obtain the maximum credit.

**Education Credits** - Under rules issued in 2016, you must have a 1098-T Tuition Statement in your possession in order to take a tax credit on your 2018 returns. You must provide us a copy of your 1098-T in order for us to take a tax credit on your 2018 Federal income tax return.

**Solar Credits Still Available** – You can still receive a federal tax credit of 30% for the cost of installation of a qualifying solar water heater or geothermal heat pump in your residence. There is no cap on the amount of credit you can generate under these provisions. The Arizona credit is equal to 25% of the cost of the device with a maximum credit of $1,000.

**State Of Arizona Tax Credits** – You may wish to take advantage of the dollar-for-dollar state tax credits that are available for contributions to public schools, private schools and charities that benefit the working poor. You may contribute to all four… **To be eligible, unless approved under the Arizona Corporate tax credit program, these must be paid by you personally and not through your business.**

Due to regulations issued in the middle of 2018, unless contributions were made prior to August 28, 2018, you can no longer take a federal deduction for these donations. You may continue to enjoy the benefit of the state tax credit, but no corresponding federal deduction will be allowed.

**Public School Credit** – The credit for public school contributions is equivalent to the amount contributed to the public school or paid for extracurricular activities, not to exceed $400 for married taxpayers filing a joint return ($200 for single and head of household taxpayers). In order to qualify for the credit, the contribution must be paid directly to the school. Payments to the PTA or a school foundation do not qualify for the credit. You should obtain a receipt from the school for your contribution.

**Private School Tuition Credit** – An individual may claim a credit for making a donation to a School Tuition Organization for scholarships to private schools. The maximum credit amount that may be taken for tax year 2018 is $555 for single, unmarried head of household and married filing separate filers and $1,110 for married filing joint filers. This credit is taken on form 323.

An individual may claim an additional credit for making a donation to a Certified School Tuition Organization if the amount contributed is greater than the maximum amount that can be claimed on form 323. The maximum credit amount that may be taken for tax year 2018 is $552 for single, unmarried head of household and married filing separate filers and $1,103 for married filing joint filers. This credit is taken on Form 348.

**Contributions To Qualifying Charitable Organizations (QCO - formerly known as Contributions to Charities That Benefit The Working Poor)** – You may also qualify for a credit for cash contributions to a qualifying charity of up to $800 for married taxpayers ($400 for single/head of household). The charity should be able to provide you with a copy of the approval letter or certification that the Arizona Department of Revenue (AZDOR) provided them when they were approved as a qualifying charitable organization. If you are not certain as to the eligibility of the charity you wish to contribute to, AZDOR publishes a list of organizations that qualify at the AZDOR website. This credit is taken on Form 321.

**Contribution to a qualified foster care charitable organization (QFCO)** – Prior to 2016, this credit was computed on Form 321, which led to complexity and confusion. This credit is claimed on Form 352. This maximum credit is $1,000 for married filing joint ($500 for single/head of household). The Arizona Department of Revenue has compiled a 1-page list of organizations that qualify for this credit. You can refer to the AZDOR website for a listing of these approved organizations.
The deadline for making the donations listed above is April 15th of the year following the tax year. For example, for 2018 tax returns, you will have until April 15, 2019 to make a donation and claim the credit on your Arizona 2018 tax return.

**Arizona Military Relief Fund** – Unfortunately at the time of drafting this letter the fund had met the limit established by law. Therefore, if you have not already made a contribution for 2018, it’s too late.

Please be sure that your intended contribution qualifies by verifying the recipient qualifies at the Arizona Department of Revenue web site (www.azdor.gov/TaxCredits.aspx).

We thank you once again for your friendship, business and referrals…

Without you, we would not be here. It is an honor to work with all of our clients. The growth of our firm has come mostly from referrals, and we remain grateful for your trust and confidence. We will continue to do everything within our power to validate your feelings and confidence in our abilities.

We look forward to seeing everyone during the coming tax season, and we want you to know that we truly do appreciate the trust you put in us to help you with your tax, wealth management and business needs. We wish you and yours the happiest and healthiest holiday season and 2019.

**THANK YOU!!!!!!!!!!!!!!!!!!!!!!**

Note: The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation. Before making any decision, consult original source material and get advice (legal, tax, consulting, accounting, etc.) in consultation with a professional outside advisor who has knowledge of all relevant, pertinent information. These materials do not constitute legal, accounting, tax, financial or other professional advice.

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