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NEWSLETTER

SUMMER 2018

Significant Changes to Kentucky's Tax Code

Inside

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casalon@deandorton.com

After late introduction of a tax bill, vigorous debate, a gubernatorial veto, a veto override, and then passage of a *different* tax bill, Kentucky has new tax legislation. The major changes are summarized in this article.

Individual Income Tax

In large part, changes made in December 2017 to the federal tax code by the Tax Cuts and Jobs Act (TCJA) to the federal tax code are incorporated into the state tax code. Two significant ways in which Kentucky will not follow the TCJA are (1) Kentucky will not allow the increased expensing and depreciation provisions for capital improvements and (2) Kentucky will not permit the new 20% qualified business income deduction.

The current graduated tax system, with rates ranging from 2% to 6%, is converted to a flat rate of 5% for 2018. (New Kentucky withholding tables have been published.) This flat rate will help offset what otherwise may be a tax increase resulting from elimination of the $10 per person tax credit and all itemized deductions other than deductions for mortgage interest and charitable contributions. This means all other itemized deductions, that is, deductions for medical expenses, local occupational taxes and property taxes, investment interest expense, casualty and theft losses and other miscellaneous deductions are eliminated. Also, deductions for long-term care and health insurance premiums are no longer allowed.

Finally, while Kentucky has permitted $41,110 per person of pension income to be excluded from taxable income, that exclusion is reduced to $31,110 per person. Social Security income continues to be fully exempt from Kentucky income tax.

Corporation Income Tax

As with the individual income tax, the corporation income tax is conformed to the federal tax code as amended by the TCJA. Again, the primary exception is Kentucky did not adopt the increased expensing and depreciation deductions for capital improvements. As with the TCJA, the deduction for domestic production activities is eliminated.

The current graduated tax system, with a top rate of 6%, is converted to a flat rate of 5% for tax years beginning on or after January 1, 2018.

Limited Property Tax Credit Against State Income Tax

A new non-refundable tax credit is allowed for property taxes paid on business inventory. Kentucky is one of only a handful of states that imposes such a tax. The credit is phased in over four years beginning at 25% in 2018 and increasing by 25% each year until reaching 100% for years beginning on or after January 1, 2021. Business will still pay the property tax (due to its importance to local governments), but will receive this non-refundable credit to offset, in part initially, the property tax paid. Because the credit is non-refundable, it may provide little or no benefit to businesses which are producing little or no taxable income.

An additional property tax change exempts custom software from Kentucky's tangible personal property tax.

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Significant Changes to Kentucky's Tax Code (continued)

Sales and Use Tax

Perhaps the changes that are generating the most discussion are the new services subject to sales tax. Effective for transactions occurring on or after July 1, 2018, here is the list of newly taxable services:

- Labor associated with the repair, installation, and maintenance of taxable tangible personal property
- Extended warranties
- Landscaping and lawn care
- Janitorial
- Small animal veterinarian
- Pet care
- Industrial laundry
- Dry cleaning and laundry
- Linen supply
- Pet grooming and boarding
- Diet and weight-reducing
- Tanning
- Limousine, if a driver is provided

The list raises a myriad of questions, which the Kentucky Department of Revenue is trying to answer. For example, "landscaping and lawn care services" is defined to include: lawn care and maintenance services; tree trimming, pruning, or removal services; landscape design and installation services; landscape care and maintenance services; and snow plowing or removal services. But, questions have arisen as to whether "landscaping and lawn care services" includes the clearing or removal of brush, or mosquito control treatments. The Department plans to establish a website showing questions they are being asked and answers they are giving. The website address is to be *www.taxanswers.ky.gov*. As of the writing of this article, the website was not yet live. An online portal for submitting questions also is planned.

In addition to this list of services, a category of items classified as "admissions" will be subject to tax beginning on July 1. "Admissions" include entrance to a display, program, sporting event, music concert, performance, play, show, movie, exhibit, fair, or other entertainment or amusement event or venue. Admissions to these events are taxable under current law, but this specific list was not part of the law. Also taxable is admission to or use of the following:

- Campsites, campgrounds, and recreational vehicle parks
- Bowling centers
- Skating rinks
- Health spas
- Swimming pools
- Tennis courts
- Weight training facilities
- Fitness and recreational sports centers
- Golf courses and country clubs

Admission to or use of these facilities is taxable regardless of whether the fee is paid per use or in any other form, including an initiation fee, monthly fee, membership fee, or some combination thereof.

Conclusion

The tax changes, including raising the state's cigarette tax by 50 cents to $1.10 per pack, are estimated to provide additional revenue of about $200 million in each of fiscal years 2019 and 2020. The Tax Foundation, an independent tax policy research organization, moved Kentucky from 33rd to 18th on the State Business Tax Climate Index it publishes as a result of the changes.

Erica Horn, *ehorn@deandorton.com*

TAX QUOTE

"Every American—especially those who are running for public office—is in favor of 'tax reform' and 'tax simplification.' No one has ever come out against tax reform or tax simplification, and no one ever will. The terms have little or no real meaning. In most contexts and for most purposes, tax reform and tax simplification are code words."

– Jeffrey L. Yablon
(tax partner in the Washington office of the law firm Pillsbury Winthrop Shaw Pittman LLP)

Safeguarding Data: Are You Really Prepared for a Cyber Attack?

"One and done" doesn't work here

Cybersecurity is not a one-time project; it is a continual evolution and initiative. While an organization's IT department plays a huge role in cybersecurity, those charged with governance are responsible to ensure compliance. Board members and senior leadership need to confirm the organization is devoting proper resources and attention to cybersecurity.

Costs associated with cybersecurity activities can be substantial; for some organizations, such as colleges and universities, they are not optional. Across public and private sectors, organizations must continue to enhance cybersecurity to meet evolving threats.

When focused on the bottom line, it may be tempting to defer projects related to cybersecurity to reduce current expenses. However, doing so could put an organization in a position where it is not prepared, or even worse, in noncompliance with certain industry specific regulations. Cutting corners on cybersecurity compliance can cost more in the end.

The "I'm covered already" approach

When evaluating cybersecurity preparedness, several factors must be considered. Your business and the threat landscape around you are constantly changing. Your organization should conduct a cyber risk assessment at least annually to identify current and foreseeable risks and to develop plans to mitigate identified risks.

Some businesses acquire multiple solutions they believe will protect their organizations from cyber risks. While having a multi-layered approach to cybersecurity is important, it is equally important to have an organized approach using tools designed to work together. If your solution is not designed properly, you could end up with what we call the "security effectiveness gap." As you add solutions that don't work together, complexity increases exponentially. Every time you add another solution or another vendor, you may create another vulnerability.

A robust cybersecurity solution will:

- Stop threats at the edge
- Protect users where they work (especially when team members are working remotely or on a personal device)
- Find and contain problems quickly
- Control who gets on your network and from where
- Simplify network segmentation
- Provide compressive monitoring and detection

But I have cybersecurity insurance

That insurance probably doesn't cover anywhere near what you think it does. Should you invest in cybersecurity insurance? That's a topic for a different day.

Your business, no matter its size or type, needs to be prepared to handle a cyber attack at a moment's notice. Working with credentialed professionals with cybersecurity expertise and experience helps you maximize your investment and minimize your risk of being hacked.

Our Dean Dorton Technology team will be glad to discuss these issues with you.

Jason Miller, *jmiller@deandorton.com*

New IRS Withholding Tax Calculator

As you know, many federal income tax changes are in effect this year. Some of the changes are likely to decrease your taxes, while others may increase them. The overall impact is dependent on your specific circumstances. As of February 15, 2018, employers were required to update withholding amounts based on newly-issued withholding tables which reduced withholding levels. Employees should update their W-4 forms, which employers use to determine how much tax to withhold.

To help navigate these changes, the IRS has released a new tax withholding calculator that takes the changes into account. We recommend that you use the calculator to help determine the appropriate number of withholding exemptions to use. Doing so may help avoid unpleasant surprises about any balance due or underpayment penalties when you file your return next year or unintended overwithholding. You may want to have a copy of your 2017 tax return with you when you access the calculator. Please contact one of our tax professionals with any questions you may have about this.

To access the new IRS withholding calculator online, visit *https://apps.irs.gov/app/withholdingcalculator*.

Jon Tennent, *jtennent@deandorton.com*

Basics of a New Deduction

Federal tax legislation enacted late last December (the Tax Cuts and Jobs Act, or TCJA) introduced a new deduction, the qualified business income deduction (QBID), which will reduce taxes on income earned by many businesses operating in partnerships, S corporations, and sole proprietorships (but not C corporations, beneficiaries of lower tax rates under TCJA). The deduction first applies for tax years beginning after 2017.

When it is fully available the QBID is 20% of net business income (or, if less, 20% of taxable income, excluding net capital gains and before the QBID). For pass-through entities (partnerships and S corporations), the deduction is taken at the partner or shareholder level. The deduction is computed for each separate business in which one is an owner.

This article is not intended to cover many aspects and impacts of the QBID, but hopefully will provide readers with an understanding of its basics.

Let's start with a very simple example:

Qualified business income (QBI)	$ 100,000
Nonbusiness interest income	10,000
Net capital gains	10,000
Itemized deductions	<30,000>
Taxable income before QBID	$ 90,000
Tentative QBID ($100,000 x 20%)	$ 20,000
Applicable limitation (20% of taxable income, excluding net capital gains and before the QBID (or $80,000))	$ 16,000
QBID	$ 16,000
Taxable income ($90,000 – $16,000)	$74,000

In effect, the business owner in this example pays income tax on only 84% of business income. For the single or joint filer in the example, that concludes the not-very-complicated computation of the QBID. However, read-on for the rest of the story. If taxable income (again, before the QBID) exceeds $157,500 for a single filer or $315,000 for a joint filer (in both cases adjusted for inflation after 2018), two additional limitations must be considered.

Additional Limitations

One of the additional limitations, which applies only if taxable income exceeds the threshold, concerns what types of business qualify for the QBID:

- Any trade or business qualifies **other than a specified service** trade or business, which:
    - Includes services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investment management, and brokerage services, and
    - Also includes any trade or business in which the principal asset is the reputation and skill of one or more employees or owners.

Thus, many businesses will not qualify. It bears repeating, however, that type of business is a limiting factor only if the applicable income threshold is exceeded.

The second additional limitation applicable when taxable income exceeds the threshold is quantitative and only needs to be considered if the business is of a type not already disqualified for the QBID. The 20% of QBID is limited to the greater of:

1. 50% of the owner's share of W-2 compensation paid to employees of the qualifying business, or
2. The sum of 25% of such wages and 2.5% of the cost of the business' depreciable business assets.

Basics of a New Deduction (continued)

An example may help:

- Taxable income (before the QBID and excluding net capital gains) $600,000.
- Two qualified businesses conducted: A with QBI of $200,000 and B with QBI of $300,000.
- Joint filing status.
- Allocated W-2 expense: A $50,000 and B $20,000.
- Cost of depreciable business assets: A $100,000 and B $600,000.

	Business	
	A	**B**
A. QBI	$ 200,000	$ 300,000
B. Tentative QBID (20% of QBI)	$ 40,000	$ 60,000
C. W-2 wage limitation (50%)	$ 25,000	$ 10,000
D. Alternative W-2 wage limitation (25%)	$ 12,500	$ 5,000
E. Property limitation (2.5%)	$ 2,500	$ 15,000
F. Wage + property limitation (D+E)	$ 15,000	$ 20,000
G. Limitation (greater of C or F)	$ 25,000	$ 20,000
QBID, before taxable income limitation (lesser of B or G)	$ 25,000	$ 20,000

The combined QBID from the two businesses ($45,000) is less than the overall taxable income limitation of $120,000 ($600,000 x 20%), so the QBID in this example is $45,000.

The qualified business and quantitative limitations for those with taxable income exceeding the aforementioned thresholds based on filing status are fully applicable when taxable income exceeds $207,500 single and $415,000 joint. These limitations reduce the QBID pro rata when taxable income is between $157,500 and $207,500 single and $315,000 and $415,000 joint.

Other QBID Features

- Whether or not the owner is active or passive in the business is not relevant to the QBID.
- Investment income, whether reported directly or through a pass-through entity, is not QBI.
- W-2 compensation received is not QBI.
- Income from REIT dividends and business income reported by publicly-traded partnerships receives QBI treatment.
- If a person has multiple trades and/or businesses, some with negative QBI and others with positive QBI, the new rules effectively require a netting of the positive and negative QBI amounts. The negative QBI amounts will offset the positive QBI amounts and reduce the QBID amounts otherwise computed on the trades or businesses with positive QBI. If the netting results in a combined negative QBI, the net negative QBI is carried over to the following year's QBID computation.
- The QBID does not reduce self-employment income.

Many questions have arisen and remain unresolved about details involved in determining the QBID. Until these are resolved, planning relating to optimizing the deduction often will be difficult.

Our tax professionals are glad to assist you in assessing your potential tax benefits from the QBID.

Doug Dean, *ddean@deandorton.com*

Share of Overall Federal Income Tax Paid by Top Earners Predicted to Increase in 2018

Most of us are aware the structure of the U.S. income tax system is progressive. By *progressive*, we mean the system is based on income brackets (or ranges) and increasing tax rates for each higher bracket of income. As taxable income increases, the portion of income that exceeds the lower bracket is taxed at the higher rate of the next bracket. To help illustrate this, consider the following example:

> *For 2018, the single bracket taxes the first $9,525 of income at 10%, income over $9,525 but under $38,700 at 12%, income over $38,700 but under $82,500 at 22%, income over $82,500 but under $157,500 at 24%, income over $157,500 but under $200,000 at 32%, income over $200,000 but under $500,000 at 35%, and income over $500,000 at 37%.*
>
> *Andrew is single and has taxable income of $75,000. The tax on this is $12,439.50 ($9,525 of income at 10% + $29,175 of income at 12% + $36,300 of income at 22%). The overall tax is 16.6% of taxable income.*
>
> *Anne is single and has taxable income of $250,000. The tax on this is $63,189.50 ($9,525 of income at 10% + $29,175 of income at 12% + $43,800 of income at 22% + $75,000 of income at 24% + $42,500 of income at 32% + $50,000 of income at 35%). The overall tax is 25.3% of taxable income.*

In the example Anne is paying a higher overall percentage of her income in tax than Andrew (25.3% vs. 16.6%). If Anne receives a $5,000 raise at work, she would be taxed at 35% on her additional earnings. The additional tax would raise her average tax rate slightly higher than the current overall rate of 25.3%.

According to the Tax Policy Center, a nonpartisan research group, households earning above $150,000 (which represents the top earning 20% of households) would pay 83.6% of overall federal income tax of all households for 2017 while receiving 52.1% of overall income of all households. This demonstrates the progressiveness of our tax system. For 2018, the Tax Policy Center projects this same group would pay 86.9% of overall federal income tax of all households while representing 52.2% of total income of all households.

The same study indicates that the top 1% of earners, those with household income of at least $730,000, would pay 38% of overall federal income tax of all households for 2017, while total income of this group would have been 15.3% of all households. For 2018, this group would pay 43.3% of overall income taxes, while earning 15.9% of 2018 income of all households.

While it appears that most of us will pay less tax under 2018's new rules, the share of income taxes paid by higher earning households will continue to be large (and apparently growing) relative to household income.

Matthew Smith, *msmith@deandorton.com*

Recent Firm Accolades

Best Places to Work

For the fourteenth consecutive year, we have been named one of the "Best Places to Work in Kentucky" by the Kentucky Society for Human Resources Management State Council and the Kentucky Chamber of Commerce. We are one of 100 companies recognized for our commitment to focus, measure, and move our workplace environment toward excellence. A member of the Best Places to Work Hall of Fame, we also were recognized as one of only three companies (and the only medium-sized company) which has been a Best Place to Work for all 14 years of the program!

Dean Dorton Among Top Firms to Watch

We were recently named to the "Beyond the Top 100: Firms to Watch" list by Accounting Today, a national publication. We were also listed as a Top Firm in the Southeast.

Kentucky's Best Bets

Business growth throughout Kentucky is critical to the continued expansion of Kentucky's economy and vital to job creation throughout the Commonwealth. In conjunction with The Lane Report, Dean Dorton recognized the distinct and esteemed companies that are impacting Kentucky's economic development through Best Bets 2017. The Best Bets list of 11 winning companies was based on several metrics, including, but not limited to, revenues over the last three years, employee investment, and re-investment in the company. The list of winners can be found at www.kybestbets.com/best-bets-winners.

Doug Dean Inducted into Bluegrass Business Hall of Fame

Doug was recently inducted into Junior Achievement's Bluegrass Business Hall of Fame. Doug's leadership, high standards, and devotion to client service and staff development led to the emergence of our firm as one of the largest professional service firms based in Kentucky. Doug was honored for his achievement in his career, service to the community, and his part as a role model for our youth.

Farewell to Three Retiring Directors

We wish the very best to three of our directors who are retiring on June 30, and we express our appreciation to each of them for their considerable contributions to our firm's success.

Chris Anderson, Director of Business Consulting Services, has worked in public accounting for more than 40 years. He came to us in 2016 when the firm of Barr Anderson & Roberts PSC merged with Dean Dorton. Chris serves on the Kentucky Society of Certified Public Accountants' Business Valuation and Litigation Committee and the Unified Financial Services board of directors, and he is a former board member of the Kentucky Society of Certified Public Accountants and of CPA Associates International.

Paula Hanson, Director of Tax Services, has more than 25 years of service with Dean Dorton after starting her career with an international firm and working in private industry. Paula has been very active in professional and community organizations, including serving as a council member and past board member of the American Institute of Certified Public Accountants, as well as a past president of the Kentucky Society of Certified Public Accountants. She also served as chairman of the board of Lexington Chamber of Commerce and as treasurer of the board of Kentucky Chamber of Commerce.

Gwen Tilton, Director of Tax Services, has worked more than 35 years in public accounting, including eight years with Dean Dorton after the Louisville firm of Cotton + Allen merged into us. Gwen is a past council member of the American Institute of Certified Public Accountants, as well as past president and board member of the Kentucky Society of Certified Public Accountants.

People News

We welcome the following new team members:

Having recently earned his Bachelor degree in Accounting from the University of Kentucky, **Chris Davis** has joined our Accounting and Financial Outsourcing group in Louisville. While in school, Chris worked as a Tournament Director for Athletx Sports Group and also served as the UK Club Baseball President.

Trevor Durbin has joined our Technology team in Lexington. He has held technology positions since 2006. Trevor earned his Bachelor degree in Telecommunications Systems Management from Murray State University.

Dawn Lenzini has joined our Accounting and Outsourcing team in Lexington. She has over 30 years of experience in accounting and finance positions. Dawn earned her Associate degree in Accounting from the University of Kentucky.

Jordan Martin joined our Office Services group in Lexington. He earned his Bachelor degree in Business Administration from Alderson Broaddus University in West Virginia.

Tiffany Smith has joined our Accounting and Financial Outsourcing group in Lexington. She earned Bachelor degrees in Accounting and in Sociology from the University of Kentucky. While at UK, Tiffany gained work experience and was active in various student organizations.

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106 West Vine Street • Suite 600 • Lexington, KY 40507

People News (continued)

We recognize the following activities and accomplishments of our team members:

Christina Westcroft passed all four sections of the CPA exam, and **Sally Johnson** earned her CPA certification. Congratulations to each of them.

Jon Tennent received the Award of Excellence by the KyCPA, in recognition of receiving the highest grade in Kentucky on the Business Environment and Concepts section of the Uniform CPA Examination in the fourth quarter of 2017.

Jay Swacker passed the Certified in Healthcare Compliance exam.

Brittany Neaves was sworn in as a Court Appointed Special Advocate (CASA) for CASA of Lexington.

Jason Miller and **Jenny Patterson** participated in a panel discussion group at Sage Intacct's Business Building Conference in Dallas.

Erica Horn spoke on state tax implications of federal tax reform at the Institute for Professionals in Taxation and American Bar Association Advanced Income Tax Conference. She also was selected to be a part of Leadership Kentucky 2018, and certainly last but not least, she received an Honorary Doctorate of Humane Letters from Transylvania University.

Erica Horn and **Kevin Cornwell** spoke at the Kentucky Occupational License Association's Spring Conference. Erica spoke on the impact of tax reform on local taxes, while Kevin spoke on cybersecurity.

Erica Horn and **Jen Shah** spoke on Equine Sales and Use Tax and Federal Tax Reform for Horse and Farm Owners, respectively, at the University of Kentucky Continuing Legal Education Conference on Equine Law.

Allison Carter hosted a webinar on the Tax Cuts and Jobs Act for tax exempt organizations for the Center for Nonprofit Excellence.

Jason Miller wrote two articles for *Louisville Business First*, relating to cybersecurity and streamlining business processes.

Bill Kohm worked with University of Kentucky accounting students on various internal audit projects.

David Smith joined the Shriners Hospitals for Children Medical Center – Lexington Corporate Council.

Doug Dean authored an article titled "Qualified Business Income Deduction Under the Tax Cuts and Jobs Act" for the American Horse Council's most recent *Tax Bulletin*.

Doug Dean and **Jen Shah** were interviewed and then quoted in a *Louisville Business First* article, "Here's What You Need to Know to Own a Racehorse."

Missy DeArk and **Faith Crump** presented on "Dealing with Taxes in Divorce Matters" at the University of Kentucky Continuing Legal Education Family Law Institute.

Adam Shewmaker, **Porter Roberts**, and **Stefan Hendrickson** presented best practices on conducting a private practice monthly financial review to members of the Lexington Medical Society.

Megan Crane and **Jason Whitaker** presented on compliance and risk management at the Kentucky Public University Business Officers meeting.