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NEWSLETTER

WINTER 2018

2018 Year End Tax Planning

Inside

The Tax Cuts and Jobs Act (TCJA) has materially changed the tax rules for individuals and businesses for 2018 and beyond. The following year-end tax reduction strategies include some that result from TCJA provisions. We recommend you discuss these with your tax professional before the end of 2018.

Maximize Pre-Tax Deductions. Determine if you are set-up to have 2018 maximum amounts withheld from your paycheck for your retirement plan deferrals, HSAs, and other pre-tax options with your employer. If you are not on track to maximize these, consider having additional amounts withheld from year-end bonuses, if possible. Also, consider increasing these amounts for next year.

Qualified Business Income Deduction. Beginning for 2018, you may be entitled to a deduction of up to 20% of your qualified business income. This deduction is dependent on multiple factors, including the type of your business, your taxable income, the amount of W-2 wages paid by your business, and the unadjusted cost basis of certain property used in your business. The intent of this deduction is to reduce the tax burden of certain businesses other than C corporations, which had their tax rates reduced by TCJA. If you haven't already, you may want to assess your expected ability to use this new deduction to reduce your income tax.

Capital gains and losses. If you have realized net capital gains during 2018, consider realizing capital losses before the end of the year to offset the gains. Remember that net long-term losses can be used to offset net short-term capital gains which otherwise would be taxed as ordinary income. Also, be aware of the "wash sale" rules if you are inclined to reinvest in a security you sell at a loss.

Section 179 & Bonus Depreciation. Businesses should consider these tax breaks related to fixed asset acquisitions:

- *Section 179 depreciation deduction.* In 2018, individuals and business entities can elect to deduct up to $1,000,000 of qualifying business property cost in the year the property is placed-in-service. The deduction is reduced dollar-for-dollar for qualifying property cost greater than $2,500,000. This deduction is available only to the extent of positive business taxable income.
- *Special "bonus depreciation" allowance.* For 2018, 100% of the cost of qualifying property (includes used assets) is deductible if the property is placed-in-service by year end. This deduction can create or increase an existing business loss. Note: Because its requirements are much less restrictive, 100% bonus depreciation usually will make Section 179 not applicable.

Self-employed retirement plans. If you have self-employment income and don't have a retirement plan in place to shelter any of it, you may qualify to use a Self-Employed Plan (SEP). A SEP contribution deduction is allowed for 2018, even if the SEP is created and funded at any time up to the due date, including extensions, of the 2018 income tax return in 2019. Depending on the amount of self-employment income, you could potentially fund (and deduct from taxable income) $55,000 for 2018.

Required minimum distributions (RMDs). Individuals with retirement plan accounts (employer qualified plans or IRAs) generally are required to take minimum annual distributions upon reaching age 70 ½. Steep penalties apply to noncompliance, and not all IRA custodians or plan sponsors actively communicate the applicability of the rules to account holders and plan participants. Please note that if you turned 70 ½ during 2018, you have until April 1, 2019 to receive your 2018 RMD. Future year RMDs must be received before the end of the year. If you wait until 2019 to receive your 2018 RMD, your 2019 RMD and the 2018 RMD received during 2019 will be included in 2019 taxable income.

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2018 Year End Tax Planning (continued)

Charitable contributions. The standard deduction has increased significantly for 2018 to $12,000 for single and $24,000 for joint filers. Depending on your situation, it may be beneficial to accelerate planned 2019 charitable contributions into 2018 or to defer 2018 contributions into 2019 to bunch them into the same year for greater tax savings.

Annual gifting. You may give your children and others up to $15,000 each in 2018 without any gift tax consequences. This annual exclusion is calculated on a per donee basis and no carryover is allowed for the unused exclusion. Consider making year-end gifts to fully utilize this year's annual exclusion.

Alimony. The tax treatment of alimony (deductible by payer and taxable income of recipient) will be changed for divorce agreements after December 31, 2018. For agreements reached after this year, payments will not be deductible by the payer or included in taxable income of the recipient. Couples in the process of divorcing need to consider this change.

S corporation and partnership losses. If your S corporation will generate a tax loss this year, consider whether you have enough basis in the stock (or in loans you've made to the corporation) to take the full loss. If you don't, additional investments should be considered. Similar considerations can arise in some situations with partnerships expecting tax losses.

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Updated Amounts for 2019

FICA base – Annual compensation to which Social Security tax applies is $132,900 for 2019 (up from $128,400 in 2018).

Social Security benefits – Individuals who are drawing Social Security benefits prior to attaining full retirement age will begin to suffer reductions in payments if they have earned income exceeding $17,640 in 2019 (up from $17,040 in 2018).

Adjustments for retirement accounts – The maximum annual addition to a defined contribution plan is increased to $56,000 for 2019 (up from $55,000 for 2018), and the corresponding maximum amount of compensation that can be considered as the base for retirement plan contributions is $280,000 for 2019 (up from $275,000 for 2018).

The maximum amounts that individuals can elect to contribute to employer-sponsored plans and IRAs for 2019 have also increased, as shown in the chart below. Catch-up contribution amounts, which are available to those age 50 or over, have remained unchanged.

Year	IRAs		Simple IRA Plans		Other Employer Plans	
	Annual Contribution	Catch-Up Contribution	Elective Deferral	Catch-Up Contribution	Elective Deferral	Catch-Up Contribution
2018	$5,500	$1,000	$12,500	$3,000	$18,500	$6,000
2019	$6,000	$1,000	$13,000	$3,000	$19,000	$6,000

Health savings accounts – The limits on contribution deductions for 2019 are $3,500 for self-only coverage (up $50 from 2018) and $7,000 for family coverage (up $100 from 2018). The additional "catch-up" contribution allowable for those age 55 or older remains $1,000.

Health flexible spending arrangements – The maximum voluntary employee salary reduction for employer-adopted FSAs (flexible spending arrangements) is $2,700 for 2019 (up $50 from 2018).

Estate tax – Federal estate, gift, and generation-skipping taxes will apply to cumulative subject transfers exceeding $11,400,000 in 2019, up from $11,180,000 in 2018.

Gift taxes – The annual exclusion for gifts per donee remains $15,000 for 2019.

Nanny tax – Cash wages paid for domestic service in the employer's home of less than $2,100 are not subject to FICA in 2019 (no change from 2018).

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Stock Market Returns – What Should One Expect?

Whether a millennial just beginning to contribute to her employer's 401(k) plan or a baby-boomer nearing retirement, most adults have at least some knowledge of the stock market. However, few investors understand, or even care to understand, the complexities of the market. Instead, most are primarily concerned with earning investment returns that enable them to achieve their financial goals. This begs the question: What rate of return should an investor expect from investing in the stock market?

As you might imagine, this is a difficult question to answer. Equity investments by their nature are risky, and the returns they generate tend to be volatile and unpredictable. In addition, past performance is no guarantee of future results. No matter how much historical evidence or current data is analyzed, it is impossible to predict with any degree of confidence what future returns will be. We can, however, share with you a few facts about historical returns that you may find to be helpful as you and your financial advisor plan for your future and make investment decisions.

The public "stock market" is comprised of various components, often called asset classes. Domestic stocks (i.e., U.S. based companies) comprise about 51% of the stock market, and international stocks comprise the other 49%. Analysts have "sliced and diced" stock performance in efforts to gain an understanding of what types of stocks are most likely to outperform. Stocks typically are further divided according to company size into large-cap, mid-cap, and small-cap stocks; according to whether the stocks are considered growth stocks or value stocks; and according to industry sectors. International stocks often are divided between those of companies in established markets and those of companies in emerging markets. Sometimes "the stock market" is also defined as a particular group of representative stocks, like the 30 stocks comprising the "Dow Jones" or the 500 stocks comprising the "S&P 500." Accordingly, when we speak of stock market returns, we either must recognize they reflect the blend of returns from all these various components or we must specifically define which component we are addressing.

We note these observations about stock returns over a long time period (1927-2017):

- The S&P 500 Index (a proxy for large-cap stocks, and often considered a proxy for the U.S. stock market) produced an annualized total return of 10.1% (comprised of dividends and appreciation).
- The Small-Cap Index of the Center For Research in Security Prices (CRSP) (a proxy for small-cap stocks and reflecting CRSP size deciles 6-10) generated an annualized total return of 11.7% - suggesting that smaller (generally considered to be higher-risk) companies produce higher returns.
- Small-cap value stocks outperformed small-cap stocks as a whole, and large-cap value stocks outperformed large-cap stocks as a whole – suggesting that value stocks as a whole tend to outperform growth stocks.

Over shorter time frames, however, asset classes which have outperformed long-term should not be expected to outperform other asset classes. For example, stocks classified as growth generally have outperformed value stocks in the most recent years.

Our research also revealed the following:

- Even though the S&P 500 Index historically has generated an annualized return approximating 10%, actual annual returns are quite volatile from year to year. They rarely fall in the range of 8%-12% (occurring only six times in the last 90 years), and the return in any given year can be very large, positive or negative. For example, in 1995 the S&P 500 produced a 38% return and in 2008 it lost 37%.
- Which asset class(es) will perform the best in any given year is unpredictable.
- International returns tend to have greater dispersion than domestic returns. For example, the MSCI Em Index (a collection of securities from emerging markets) generated an annual return of 35% or more six times since 1993 (with a single year high of 79% in 2009), but it also experienced the largest loss of all major asset classes in 2008, when it lost over 53%.
- In the 1970s, 1980s, and the 2000s, international stocks modestly outperformed domestic stocks, while in the 1990s and during the eight years 2010-2017, domestic stocks significantly outperformed international stocks. Over the last 40 years, the S&P 500 has generated an annualized total return of 12%, while international stocks have produced an annualized total return of just under 9%.
- The cost of mistiming the market can be significant. Missing the 25 best days of the market during the period 1980-2017 would have reduced an S&P 500 investor's annualized compound return from 11.7% to 7.6%.

To repeat an earlier point, these historical returns do not guarantee comparable future returns, but they may be helpful in providing a framework for setting expectations. More importantly, they reinforce several key and commonly-accepted principles. First, when discussing and comparing investment returns, it is extremely important to define terms and to compare "apples to apples." Second, equity markets are highly volatile, but tend to reward the disciplined investor over time. Similarly, equity markets tend to reward risk-takers with greater returns over time, as illustrated by the premiums realized by those who invest in small-cap and value stocks.

Stock Market Returns – What Should One Expect? (continued)

Finally, given the risks and volatility associated with investing in stocks, diversification across various markets, asset classes, and industries is a prudent strategy for mitigating concentration risk.

Readers should recognize that while this article addresses only returns on common stocks, other asset categories exist within an investor's universe of possible investments. Such asset categories as fixed income, real estate, and private equity have their own investment characteristics and historical returns.

If you would like to discuss investment matters, please contact David Parks, a senior wealth advisor with our affiliate firm, Dean Dorton Wealth Management, LLC, at 859-425-7782 or at dparks@deandortonwealth.com.

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New Tax Law Changes Underscore the Importance of Using Accountable Plans

A less-publicized impact of the Tax Cuts and Jobs Act (TCJA) passed last December relates to whether, and how, employers choose to reimburse their employees for business expenses. For 2018 through 2025, the TCJA eliminated miscellaneous itemized deductions subject to the 2% of adjusted gross income limit, including the deduction for unreimbursed employee business expenses. This includes expenses for business travel, lodging, and meals; dues paid for memberships in professional societies; subscriptions to professional journals; tools and supplies used in the workplace; and any other unreimbursed job-related expenses. Prior to the TCJA, employees could deduct these expenses (to the extent they and other similarly classified miscellaneous itemized deductions exceeded the 2% floor) for regular tax purposes, but not for alternative minimum tax.

Because employees no longer will be able to deduct these expenses in all cases, at least through 2025, employers that do not already have an accountable plan in place should consider establishing one. Expenses reimbursed to employees through an accountable plan generally are deductible by the employer (subject to certain limitations, such as the 50% limit for business meals) and excluded from the employee's gross income.

To qualify as an accountable plan, an employer's reimbursement arrangement must meet certain requirements. The plan must reimburse employees only for otherwise deductible business expenses, require substantiation of the expenses by employees within a reasonable time, and require employees to return any advances that exceed substantiated amounts. In addition, employers should specify in the plan document which expenses will be reimbursed.

Expenses reimbursed through a non-accountable plan, i.e., a reimbursement arrangement that does not meet the above requirements, are gross income to employees and, at least for the next several years, non-deductible by them. Because reimbursements made through a non-accountable plan are considered compensation, they also are subject to withholding and payroll taxes. In addition to a more satisfied workforce, employers also may benefit financially from the use of an accountable plan by avoiding payroll taxes on the reimbursed amounts.

Using an accountable plan to reimburse employees for business expenses is even more important following the passage of the TCJA. For further information or assistance with establishing an accountable plan, please contact your Dean Dorton advisor.

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Changes in Lease Accounting are Just Around the Corner

In an article published in the Summer 2016 edition of our newsletter titled "Be Aware of Changes in Lease Accounting," we introduced readers to upcoming changes in lease accounting under Generally Accepted Accounting Principles (GAAP). The effective date for the new lease accounting standard – known as FASB Accounting Standards Codification (ASC) 842, Leases – is rapidly approaching.

What is changing?

The new lease standard requires a lessee to **record all leases on the balance sheet**, unless the lease term is 12 months or less. This represents a significant change from historical lease accounting rules, which only required assets and liabilities to be recorded for capital leases, but not for operating leases. Overall, the new standard should not change a company's income statement or cash flow statement, but it may have material impacts to the balance sheet.

The intent of the new standard is to reduce the amount of off-balance sheet activity, providing financial statement users with greater transparency regarding the leasing activity and associated rights and obligations of lessees. Unintended consequences may include significantly impacting financial ratios and compliance with loan covenants.

When are the changes effective?

The new standard will be effective for non-public business entities beginning with calendar year 2020. Many implementation lessons can be learned from public entities, which are required to adopt the new standard one year earlier. To ease adoption, companies can elect a transition method whereby a cumulative-effect adjustment is recorded to opening retained earnings in the period of adoption, thus precluding restatement of prior periods.

Gathering the lease portfolio can be extremely difficult.

Identification of a complete lease population is the first, and often most challenging, step in implementation, due to:

- Decentralization of agreements and data for leases historically classified as operating leases
- The requirement to search for embedded leases in service agreements and other contracts

An embedded lease could be present if a contract contains an explicitly or implicitly identified asset, and the company controls the use of this asset. For example, transportation and delivery service agreements could contain an embedded lease if a specific vehicle must be used to transport your company's inventory. Cloud computing service agreements could contain embedded leases if specific IT servers are dedicated to your company.

Additional implementation challenges.

Other common issues include:

- **Extent of effort required to adopt –** Implementation frequently requires 6 – 12 months of cross-functional involvement, which can be a significant burden coming on the heels of the new revenue recognition standard.
- **Developing an IT solution to manage compliance –** Spreadsheet-based lease management tools often are no longer sufficient, given the increase in the volume of leases on the balance sheet and the complexity of measuring such assets and liabilities. Lease accounting software may be required to successfully manage all lease data.

Preparation for the new lease accounting standard should start now. We welcome any questions about how the new standard will impact your business.

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People News

We welcome the following new team members:

Alma White, a CPA, joined our Assurance team in Louisville. Alma has 22 years of work experience in a variety of financial jobs. She currently is working to earn a Master degree in Business Administration from Indiana University Southeast, and she holds a Bachelor degree in Accounting and a Master degree in Public Administration from universities in the Philippines.

Jarrod Hughes joined our Administrative team in Lexington. Jarrod has an associate degree in Business Management from Sullivan University. He is a military veteran having served with the Kentucky Army National Guard, including a deployment to Iraq.

Jeremy Raines joined us as Firm Administrator. Jeremy worked the last eight years in various administrative roles for Eastern Kentucky University, most recently serving as Executive Assistant to the President and Board of Regents.

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

Congratulations to **Chee Yin** for successfully completing the CPA exam.

Jon Blanchard, Gui Cozzi, Doug Dean, Melissa Hicks, Maddie Schueler, Jen Shah, David Smith, and David Sorrell presented at Dean Dorton's annual Equine Tax and Accounting Update at Keeneland.

David Bundy presented on physician and hospital partnerships at a Kentucky Medical Group Management Association conference.

Allison Carter joined the Board of Directors and Finance Committee of Women Leading KY.

Kevin Cornwell presented on IT policies and cybersecurity at a Louisville Society for Information Management member meeting, and he discussed Ransomware at the Hospitality Financial and Technical Professionals Annual Convention.

Gui Cozzi presented on cybersecurity at Dean Dorton's Board Oversight and Risk Management Seminar and Information Technology Managers Association Techcon, and he presented at the Association of Independent Kentucky Colleges and Universities Business Officers' Fall Meeting.

Faith Crump, Missy DeArk, and Maddie Schueler presented on new federal and state tax laws for the Louisville Bar Association.

Mike Harbold was named the Chair of KyCPA Taxation Committee for 2018-2020.

Mike Harbold and **Erica Horn** spoke at the Kentucky Chamber of Commerce's 5th Annual Kentucky Sales and Use Tax Seminar held in September.

John Herring was named Treasurer of USTA (United States Tennis Association) Southern for the 2019-2020 term.

Erica Horn was a co-presenter for the Bloomberg Tax webinar: *State and Local Taxes After The Mid-Term Elections.*

Alyssa Yozwiak joined the Girl Scouts of Kentucky's Wilderness Road Council Finance Committee.