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Deductions Eliminated Under Trump's Tax Reform Proposal

Article Highlights:
Deductions the Proposal Retains

- Itemized Deductions the Proposal Eliminates
- Other Deductions the Proposal Eliminates

One of President Trump's key tax reforms is to eliminate all individual tax deductions except for those that incentivize home ownership, charitable contributions and retirement contributions. Although the administration's one-page outline of the proposed tax reforms provides little detail, if all of the deductions except those noted are eliminated, the reform will impact both itemized deductions and income adjustments. This article will explore the deductions that the president's proposal retains and those that it would eliminate, so you will be able see how these changes could play out for your particular circumstances.

Deductions the Proposal Retains

Incentives for Home Ownership – Although Trump's proposal provides no details about what "incentives for home ownership" means, this category would presumably include deductions for home-mortgage interest and property taxes. However, it is unknown if the plan will include the existing restrictions that limit the home-mortgage interest deduction to $1 million of home-acquisition debt and $100,000 of equity debt. It is also unclear if the incentives for home ownership would include second homes.

Charitable Contributions – Presumably, the plan would continue to be subject the 50%, 30% and 20% adjusted gross income (AGI) limits. The proposal does not address one of the most complicated areas (and one that is significantly abused) –contributions of overly valued property.

Retirement Contributions – Retirement contributions are deducted as an adjustment to income; this is frequently referred to as an above-the-line-deduction. Presumably, in the new plan, this still would include traditional IRAs and self-employed retirement plan contributions.

Itemized Deductions the Proposal Eliminates

Medical Itemized Deductions – Currently, medical deductions are already limited to those that exceed 10% of a taxpayer's AGI. The Trump plan eliminates the medical deduction altogether, which would significantly impact senior citizens, especially those requiring significant elder care, and taxpayers who have incurred extraordinary medical expenses. What is curious about the elimination of the medical deduction is that, just a couple of months ago, as part of the failed ACA repeal, the administration wanted to reduce the medical AGI limitation and allow larger medical deductions. Now, it wants to eliminate them altogether.

Deduction for State and Local Taxes – Currently, deductions are allowed for state income tax, city and other income taxes, real and personal property taxes and (under certain circumstances) sales taxes.

Eliminating this deduction would have the most significant impact on taxpayers living in states that have income taxes. Taxpayers residing in those states would no longer be able to deduct their state and local income taxes and thus would be double-taxed on the same income. All but seven states have income tax, with California, New York and New Jersey imposing the highest rates. Support for this change is questionable, even among Republican senators, as representatives from states with income taxes will certainly want to retain the state income-tax deduction for their constituents.

Investment Interest Deduction – Currently, a deduction is allowed for investment interest in the amount of net investment income (investment income minus investment expenses). This means that the interest taxpayers pay on money that they borrow to purchase investments would no longer be deductible.

Casualty & Theft Losses – Every year, Americans deal with casualty losses from accidents, fires, floods, tornados, hurricanes, earthquakes and other natural disasters. Currently, those taxpayers can deduct casualty losses – generally to the extent that they exceed $100 per event and 10% of their AGI. Under Trump's plan, this deduction would be eliminated, which penalizes taxpayers who are in the greatest need – those who are recovering from a disaster.

Employee Business Expenses – Currently, employee business expenses, including the home-office deduction for employees who work out of their own homes, are deductible as miscellaneous itemized deductions, but these deductions are limited to those expenses that exceed 2% of AGI. Under the Trump plan, this deduction would be eliminated. This could pose a serious handicap for telecommuting employees, who would then have the bear the cost of their own offices, office equipment and supplies. Another example are mechanics who must pay for their own (expensive) tools.

Legal Fees – Currently, legal fees are deductible when they are incurred for the protection or production of taxable income. This includes taxable awards as a result of winning or settling a lawsuit. Typically, legal fees are contingent upon the taxpayer winning the suit; they often represent a large percentage of the award. Without this deduction, the taxpayer would have to pay taxes on the entire award even though a significant portion went toward attorneys' fees.

Gambling Losses – Currently, gambling losses are only deductible in an amount equal to gambling winnings. Under Trump's plan, these losses would no longer be deductible, meaning that taxpayers would have to pay taxes on all their winnings – even if they have net losses. Senior citizens and others who gamble recreationally could be hit with significant taxes even when they actually lose money.

Other Deductions the Proposal Eliminates

The following deductions are not itemized deductions but are considered adjustments to income. This includes retirement-plan deductions (such as those for IRAs and self-employed retirement plans, including SEPs, SIMPLE and other qualified plans); all of these deductions would be retained. However, if all other deductions are eliminated, the eliminated deductions would include:

Teacher's Expenses – This is the educator's deduction for classroom supplies (up to $250 per year). The 2015 PATH Act recently made this deduction permanent.

Health Savings Account (HSA) Deduction – Individuals with high-deductible health insurance can currently deduct contributions to HSA plans when the funds are used to pay qualified medical expenses. It is doubtful that this deduction will actually be eliminated, as HSAs are a key element of the administration's plan to replace Obamacare.

Moving Expenses – Individuals who move over 50 miles as a result of a change in work location and who work at the new location for a minimum period of time can deduct the cost of the move.

Self-Employed Health-Insurance Deduction – Self-employed individuals, including partners and those who hold more than 2% of an S corporation's shares, can deduct the cost of their own medical insurance as well as that of their spouse and dependents, subject to certain conditions.

Penalty for Early Withdrawal of Savings – When taxpayers withdraw from term savings accounts, they may incur interest penalties, which are deductible. This deduction was implemented to avoid having taxpayers pay taxes on interest income that they did not receive.

Alimony Paid – When a taxpayer pays alimony to a former spouse, that alimony is taxable for the recipient. To avoid taxing both parties on the same income, the one who makes the payments is allowed to deduct the alimony paid. Eliminating this deduction would have a significant impact on taxpayers who pay alimony.

Student-Loan Interest Deduction – These rules allows for a deduction of up to $2,500 for interest paid on student loans.

Domestic-Production Activities Deduction – Tax law includes a special tax deduction that encourages domestic production (as opposed to foreign production). C-corporations take this deduction on their corporate tax returns; self-employed individuals, partners and S-corporation shareholders must take this deduction on their 1040. It is doubtful that Congress would continue to allow this deduction for corporations while also discriminating against self-employed taxpayers by not allowing them to take the deduction.

We can only wonder if the president expects all of these deductions to be eliminated; perhaps he only proposed the eliminations as a tool to start negotiations with Congress. Details are not promised to arrive until June, so we will have to wait and see how this plays out.

Big Tax Break for Adoptive Parents

Article Highlights:

- Qualifying Adoptions
- Credit Amount
- Credit Carryover
- Qualifying Expenses
- High-Income Credit Phase-out
- Employer Adoption-Assistance Program

If you are an adoptive parent or are planning to adopt a child, you may qualify for a substantial income-tax credit. The amount of the credit is based on any expenses incurred that are directly related to the adoption of a child under the age of 18 or a person who is physically or mentally incapable of self-care.

This is a 1:1 credit for each dollar of qualified expenses up to a maximum for the year, which is $13,570 for 2017 (up from $13,460 in 2016). The credit is nonrefundable, which means it can only reduce tax liability to zero (as opposed to potentially resulting in a cash refund). But the good news is that any unused credit can be used for up to five years to reduce future tax liability.

Qualified expenses generally include adoption fees, court costs, attorney fees and travel expenses that are reasonable, necessary and directly related to the adoption of the child, and may be for both domestic and foreign adoptions; however, expenses related to adopting a spouse's child are not eligible for this credit. When adopting a child with special needs, the full credit is allowed whether or not any qualified expenses were incurred. A child with special needs is, among other requirements, a child who the state has determined (a) cannot or should not be returned to his or her parents' home and (b) that the child won't be adopted unless assistance is provided to the adoptive parents.

The credit is phased out for higher-income taxpayers. For 2017, the AGI (computed without foreign-income exclusions) phase-out threshold is $203,540, and at the AGI of $243,540, the credit is completely phased out. Unlike most phase-outs, this one is the same regardless of filing status. However, the credit cannot be claimed by taxpayers using the filing status *married filing separately*.

If your employer has an adoption-assistance program, up to $13,570 of reimbursements by the employer are excludable from income. Both the tax credit and the exclusion may be claimed, though not for the same expenses.

If you think you qualify for this credit or are planning an adoption in the future, please contact this office for further credit details and to find out how this credit can apply to your particular circumstances.

Thinking of Tapping Your Retirement Savings? Read This First

Article Highlights:

- Early-Withdrawal Penalties
- Reduction in Retirement Savings
- Exceptions from the Early-Withdrawal Penalty

If you are looking for cash for a specific purpose, your retirement savings may be a tempting source. However, if you are under age 59½ and plan to withdraw money from a traditional IRA or qualified retirement account, you will likely pay both income tax and a 10% early-distribution tax (also referred to as a penalty) on any previously untaxed money that you take out. Withdrawals you make from a SIMPLE IRA before age 59½ and those you make during the 2-year rollover restriction period after establishing the SIMPLE IRA may be subject to a 25% additional early-distribution tax instead of the normal 10%. The 2-year period is measured from the first day that contributions are deposited. These penalties are just what you'd pay on your federal return; your state may also charge an early-withdrawal penalty in addition to the regular state income tax.

Thus, before making any withdrawals from an IRA or other retirement plan, including a 401(k) plan, a 403(b) tax-sheltered annuity plan, or a self-employed retirement plan, carefully consider the resulting decrease in retirement savings and increase in taxes and penalties.

There are a number of exceptions to the 10% early-distribution tax; these depend on whether the money you withdraw is from an IRA or a retirement plan. However, even if you are not subject to the 10% penalty, you will still have to pay taxes on the distribution. The following exceptions may help you avoid the penalty:

- Withdrawals from any retirement plan to pay medical expenses—Amounts withdrawn to pay unreimbursed medical expenses are exempt from penalty if they would be deductible on Schedule A during the year and if they exceed 10% of your adjusted gross income. This is true even if you do not itemize.
- Withdrawals from any retirement plan as a result of a disability—You are considered disabled if you can furnish proof that you cannot perform any substantial gainful activities because of a physical or mental condition. A physician must certify your condition.
- IRA withdrawals by unemployed individuals to pay medical insurance premiums—The amount that is exempt from penalty cannot be more than the amount you paid during the year for medical insurance for yourself, your spouse, and your dependents. You also must have received unemployment compensation for at least 12 weeks during the year.
- IRA withdrawals to pay higher education expenses—Withdrawals made during the year for qualified higher education expenses for yourself, your spouse, or your children or grandchildren are exempt from the early-withdrawal penalty.
- IRA withdrawals to buy, build, or rebuild a first home—Generally, you are considered a first-time homebuyer for this exception if you had no present interest in a main home during the 2-year period leading up to the date the home was acquired, and the distribution must be used to buy, build, or rebuild that home. If you are married, your spouse must also meet this no-ownership requirement. This exception applies only to the first $10,000 of withdrawals used for this purpose. If married, you and your spouse can each withdraw up to $10,000 penalty-free from your respective IRA accounts.
- IRA withdrawals annuitized over your lifetime—To qualify, the withdrawals must continue unchanged for a minimum of 5 years, including after you reach age 59½.
- Employer retirement plan withdrawals—To qualify, you must be separated from service and be age 55 or older in that year (the lower limit is age 50 for qualified public-service employees such as police officers and firefighters) or elect to receive the money in substantially equal periodic payments after your separation from service.

You should be aware that the information provided above is an overview of the penalty exceptions and that conditions other than those listed above may need to be met before qualifying for a particular exception. You are encouraged to contact this office before tapping your retirement funds for uses other than retirement. Distributions are most often subject to both normal taxes and other penalties, which can take a significant bite out of the distribution. However, with carefully planned distributions, both the taxes and the penalties can be minimized. Please call for assistance.

Want to Reduce Required Minimum Distributions and Extend Your Retirement Benefits?

Article Highlights:

- Required Minimum Distributions (RMDs)
- Qualified Longevity Annuity Contracts
- Reduced RMDs
- A Form of Longevity Insurance
- Delayed Taxes

If you are one of the boomer generation, and if you find that your required minimum distributions (RMDs) from qualified plans and IRAs are providing unneeded income (along with a high tax bill), or if you are afraid that the government's RMD requirements will leave too little in your retirement plan for your later years, you can use a qualified longevity annuity contract (QLAC) to reduce your RMDs and extend the life of your retirement distributions.

The government allows individuals to purchase QLACs with their retirement funds, thus reducing the value of those funds (subject to the RMD rules) and in turn reducing the funds' annual RMDs.

A QLAC is a deferred-income annuity that begins at an advanced age and that meets the stringent limitations included in the tax regulations. One benefit of a retirement-planning strategy involving QLACs is that they provide a form of longevity insurance, allowing taxpayers to use part of their retirement savings to buy an annuity that helps protect them from outliving their assets.

The tax-planning benefits of QLACs are twofold:

(1) Because the QLAC is purchased using funds from a qualified retirement plan or IRA, that plan's year-end balance (value) is lowered. This causes the RMDs for future years to be less than they otherwise would be, as the RMD is determined by dividing the account balance (from 12/31 of the prior year) by an annuity factor that is based on the retiree's age.

Example: Jack is age 74, and the annuity table lists his remaining distribution period as 23.8 years. The balance of his IRA account on 12/31/2016 is $400,000. Thus, his RMD for 2017 would be $16,807 ($400,000 / 23.8). However, if Jack had purchased a $100,000 QLAC with his IRA funds during 2016, his balance would have been $300,000, and his 2017 RMD would be $12,605 ($300,000 / 23.8). By purchasing the $100,000 QLAC, Jack would have reduced his RMD for 2016 by $4,202 ($16,807 – $12,605). This reduction would continue for all future years. Later, the $100,000 QLAC would provide retirement benefits, likely beginning when Jack reaches age 85.

(2) Tax on the annuity will be deferred until payments commence under the annuity contract.

A deferred-income annuity must meet a number of requirements to be treated as a QLAC, including the following:

Limitation on premiums – When buying a QLAC, a taxpayer can use up to the lesser of $125,000 or 25% of his or her total non-Roth IRA balances. The dollar limitation applies to the sum of the premiums paid on all QLAC contracts.

When distributions must commence – Distributions under a QLAC must commence by a specified annuity starting date, which is no later than the first day of the month after the taxpayer's 85th birthday.

For additional details about how QLACs might fit into your retirement strategy, please give this office a call.

Using Home Equity for Business Needs

Article Highlights:

- Business Interest
- Home Mortgage Interest
- Excess Interest
- Standard Deduction
- Alternative Minimum Tax
- Self-Employment Tax
- Allocations

Small business owners frequently find it difficult to obtain financing for their businesses without pledging their personal assets. With home mortgage interest rates at historic lows, tapping into your home equity is a tempting alternative but one with tax ramifications that should be carefully considered.

Generally, interest on debt used to acquire and operate your business is deductible against that business. However, depending upon the circumstances of the loan structure, debt secured by your home may be nondeductible, only partially deductible or wholly deductible against your business.

Home mortgage interest is limited to the interest on $1 million of acquisition debt and $100,000 of equity debt secured by a taxpayer's primary residence and designated second home. The interest on the debts within these limits can only be treated as home mortgage interest and must be deducted as part of your itemized deductions. Only the excess can be deducted for your business, provided that the use of the funds can be traced to your business use. This creates a number of problems:

- **Using the Standard Deduction** – If you do not itemize your deductions, you will be unable to deduct the interest on the first $100,000 of the equity debt, which cannot be allocated to your business.
- **Subject to the AMT** – Even if you do itemize your deductions, if you happen to be subject to the alternative minimum tax (AMT), you still would not be able to deduct the first $100,000 of equity debt interest, since it is not allowed as a deduction for AMT purposes.
- **Subject to Self-Employment (SE) Tax** – Your self-employment tax (Social Security and Medicare) is based on the net profits from your business. If the net profit is higher, because not all of the interest is deductible by the business, your SE tax may also be higher.

Example: *Suppose the mortgage you incurred to purchase your home (acquisition debt) has a current balance of $165,000 and your home is worth $400,000. You need $150,000 to acquire a new business. To obtain the needed cash at the best interest rates, you decide to refinance your home mortgage for $315,000. The interest on this new loan will be allocated as follows:*

New Loan:	*$ 315,000*	
Part Representing Acquisition Debt	*<165,000>*	*52.38%*
Balance	*$ 150,000*	
First $100,000 Treated as Home Equity Debt	*<100,000>*	*31.75%*
Balance Traced to Business Use	*$ 50,000*	*15.87%*

If the interest for the year on the refinanced debt was $10,000, then that interest would be deducted as follows:

Itemized Deduction Regular Tax	*$ 8,413*	*84.13%*
Itemized Deduction Alternative Minimum Tax	*$ 5,238*	*52.38%*
Business Expense	*$ 1,587*	*15.87%*

There is a special tax election that allows you to treat any specified home loan as not secured by the home. If you file this election, then interest on the loan can no longer be deducted as home mortgage interest, since tax law requires that qualified home mortgage debt be secured by the home. However, this election would allow the normal interest tracing rules to apply to that unsecured debt. This might be a smart move if the entire proceeds were used for business and all of the interest expense could be treated as a business expense. However, if the loan were a mixed-use loan and part of it actually represented home debt (such as a refinanced home loan), then the part that represented the home debt could not be allocated back to the home, and the interest on that portion of the debt would become nondeductible and would provide no tax benefit.

> ***Example:*** *Using the same scenario as the previous example but electing to treat the mortgage as unsecured by the home, the deductible business interest for the year would be $4,762 [($150,000/$315,000) x $10,000]. None of the balance of the interest would be deductible.*

As you can see, using equity from your home can create some complex tax situations. Please contact this office for assistance in determining the best solution for your particular tax situation.

Financial KPIs: What They Are and What You Need to Know

As a small business owner, the importance of making purpose-driven decisions is something that cannot be overstated enough. Every choice that you make must be one with a particular goal in mind – whether it's to attract new customers, increase revenue, decrease expenditures, increase liquidity, etc. But simply making the decision itself is not enough – you also have to find a way to measure the result of your action against what you were trying to accomplish in the first place.

This, in essence, is what KPIs are all about.

Also commonly referred to as "key performance indicators," they represent the best kind of measurable value that reflect how we'll you're doing in a particular context – the kind that is objectionable, black and white, and provides you with a clear indication of what you need to be doing moving forward. Thanks, in particular, to the evolution of cloud computing and the advent of real-time accounting, it's easier than ever for business owners to monitor the health of their organization through financial KPIs.

When doing so, however, you need to keep a few key things in mind.

Financial KPI Considerations

Part of the reason why KPIs are so powerful in the first place is because they're malleable – based on exactly what you're trying to accomplish, you can take a micro look at a particular aspect of your finances to tell you how close or how far away you are from that goal.

With that in mind, it's important to realize that there is no "one size fits all" approach to KPI selection. If you looked at the financials of your closest competitors, they might be tracking wildly different data than you are – even though you're both operating in the same industry.

Because of this, you need to figure out the long-term goals that are most important to you first. Then, you can reverse engineer the KPIs that you should be watching to help guide you and your business in the right direction.

KPIs to Watch Out For

Now that you've got a deeper understanding of what KPIs measure in relation to your goals, it's time to learn more about the specific KPIs that you should be paying attention to monitor those goals in real-time.

- **Operating Cash Flow.** Also referred to as OCF, this points to the total amount of money your company is generating on a daily basis. This can be a great way to determine whether you're able to maintain the positive cash flow needed for growth, or if you should start looking for external funding. OCF adjusts your net income for factors like depreciation, inventory fluctuations, accounts receivable changes and more.

- **Current Ratio.** This KPI is an indication of whether or not your company can pay all of its financial obligations in one year. This takes into consideration all of your current assets and compares them with your current liabilities. A Current Ratio of less than one tells you that you will NOT be able to fulfill all financial obligations, thus requiring additional cash flow. For the best results, try to keep Current Ratio between 1.5 and 3.

- **Burn Rate.** This clues you in on the rate at which your company is spending money on a weekly, monthly or annual basis. This is particularly helpful for companies that don't necessarily go through extensive financial analysis, as it's a quick look into whether or not your current operating costs are sustainable in the long-term.

- **Income.** This, simply put, looks at how much money you're generating. Based on how much money you'd like to be generating, you can then make a determination about how much you need to increase sales and, thus, set about trying to figure out how to do that.

- **Profit/Loss.** This is a quick look into whether your company's expenditures are MORE than your income.

- **Cash Flow Forecasting.** Remember that improper cash flow is literally the number one reason why most businesses close prematurely. If you want to get better at cash flow management, you need to start taking a deeper look at what your cash flow is predicted to be both in the short and long-term. Diving deeper into this topic now can help you mitigate some fairly significant risks later on.

If you have any additional questions about KPIs that you'd like to see answered, or if you have other concerns that you'd like to have addressed in a little more detail, please feel free to contact our office today – someone is ready and waiting to provide you with the personalized level of care and attention to detail that you deserve.