

YEAR-END TAX PLANNING

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It has now been almost two years since the Tax Cuts and Jobs Act (TCJA) passed at the end of 2017. The stated intention of the TCJA was to simplify the tax code by lowering the base rates and eliminating many longstanding deductions. While the base rates are lower, and many taxpayers who previously itemized now take the standard deduction, the new tax law is anything but simple. Consider that the TCJA introduced complex new tax savings possibilities in the form of Opportunity Zone investments and the pass-through entity business deduction (Section 199A). Even with the changes to itemized deductions, the standard principles that have traditionally driven year-end tax planning still apply. Generally, income should be deferred, and deductions should be accelerated to limit current year adjusted gross income (AGI) and taxable income. The concept of “bunching” expenses in the same year, particularly medical and charitable, is more important than ever.

Reducing AGI

The TCJA eliminated many itemized deductions, and, as a result, many taxpayers who had previously itemized are now taking the standard deduction. Given that there are less opportunities to use deductions to reduce taxes, it is more important than ever to lower AGI. AGI generally can be thought of as gross income less “above the line deductions” for items such as contributions to IRAs, health savings accounts, and self-employed health insurance. Alimony payments related to divorce or separation agreements executed after December 31, 2018 are no longer deductible. Payments related to agreements finalized prior to that date have been grandfathered in and are still deductible.

To reduce AGI, taxpayers should focus on reducing items such as taxable wages, self-employment income, or capital gains. Employees looking to reduce taxable wages should try to maximize their pre-tax deductions by contributing to flexible spending accounts and maximizing their 401(k) contributions. One of the new ways to defer capital gains is through investment in Qualified Opportunity Funds (QOFs). This is a great time of year for taxpayers to review their investment portfolios.

Taxpayers may want to consider gifting appreciated securities to charity. Donating appreciated securities that have been held for over one year provides a double tax benefit. Taxpayers using this strategy realize a deduction for the full fair market value of the securities while not paying income tax on the inherent gain. If your portfolio has significant *realized* capital gains, you should consider selling securities whose value has decreased relative to the cost.

Smart Tax-Planning Tips

- ▶ Make annual exclusion gifts. Up to \$15,000 can be given to each recipient without using any of your lifetime gift and estate tax exemption.
- ▶ Consider donating appreciated securities to charities instead of cash. There is no tax due on the appreciation, and a deduction can be taken for the full value of the donation if itemizing.
- ▶ Contribute to a 529 plan. The funds can accumulate tax-free, and distributions are not taxable if used for qualified education expenses. Up to \$10,000 can be distributed to pay K-12 tuition tax-free.

Recognizing capital losses can offset your capital gains for the year and reduce AGI.

Taxpayers taking discretionary distributions from their retirement plans could defer a year-end distribution until January to help lower AGI. Even those over age 70½ with required minimum distributions have a significant opportunity to lower AGI by making a qualified charitable distribution. Such taxpayers may distribute up to \$100,000 directly to charity from their IRAs and exclude 100% of the distribution from income.

One of the tax law changes that went somewhat overlooked was the increase to the child tax credit. Before the TCJA, many families were phased out of the credit. The new tax law increased the starting phase-out for a married couple to \$400,000 with the credit completely phasing out at \$440,000. The credit itself has also increased to \$2,000 per qualifying dependent child under the age of 17. For many families this has offset the loss of exemptions for dependents.

Self-employed individuals and owners of pass-through entities potentially have even more incentive to decrease their taxable income to be under the phase-outs of the new Section 199A deduction.

Opportunity Zones

Opportunity Zones were created to promote economic development and job creation in economically distressed areas by providing tax benefits to investors. A QOF is an investment vehicle that holds at least 90% of its assets within an Opportunity Zone. Taxpayers who recognize a gain on the sale or exchange of any property may reinvest that gain into a QOF. If the gain is invested in a QOF within 180 days, it is excluded from income in the year of sale and can be deferred until the earlier of the date the QOF investment is sold or December 31, 2026.

Deferring income alone is a significant benefit, however investments in QOFs go further. If the investment is held for over 5 years, basis in the deferred gain is increased by 10%. If the investment is held for at least 7 years, the basis is again increased by an additional 5%. If the investment is held for 10 years, an election may be made to step up the basis to the fair market value. This means that no additional gain is recognized on the QOF investment, potentially providing a big tax benefit.

Section 199A Deduction

The TCJA introduced a new 20% deduction for qualified business income from pass-through entities. The deduction applies to partnerships, S-corps and sole proprietors. Under the new rules, dividends, capital gains, and other preferential income are not considered qualified business income and will continue to be taxed at preferential rates. Guaranteed payments for partners are also specifically excluded from qualified business income.

In practice, this deduction has been somewhat less impactful than many initially believed it would be. The main reason for this is that qualified business income needs to be reduced by deductions not reported on Schedule K-1 or Schedule C. These deductions include unreimbursed partnership expenses, business interest expense, the deductible part of self-employment tax, the self-employment health insurance deduction, and self-employed retirement plan contributions.

- ▶ The deduction is a post-AGI item, similar to the standard deduction or itemized deductions. Even taxpayers who do not itemize can still qualify for this deduction.
- ▶ The deduction is subject to several W-2 wage and business capital limitations for taxpayers with taxable income greater than \$321,400 if married filing jointly or \$160,725 for others.
- ▶ A specified service trade or business in the fields of accounting, health, law, consulting, athletics, financial services, and brokerage services is only entitled to the full deduction if the taxpayer's taxable income is less than \$321,400 if married filing jointly or \$160,725 for others.
- ▶ Trusts and estates that own business interests also qualify for the deduction.

Itemized Deductions

The TCJA capped or eliminated many itemized deductions while nearly doubling the standard deduction. The standard deduction has been further increased to \$24,400 for married couples filing jointly and \$12,200 for single taxpayers, while personal exemptions have been eliminated. Many taxpayers will easily hit the \$10,000 state and property tax limit. The challenge then is to efficiently bridge the gap between that \$10,000 and the new standard deduction threshold. The most effective way to do this is to consider bunching medical and charitable deductions into one year if possible. One of the best ways to do this for charitable contributions is through a donor-advised fund. A donor-advised fund allows you to make one large charitable gift for tax purposes up front, while spreading out the giving to end-recipients over multiple years.

Deduction Changes and Considerations:

- ▶ **State Income and Property Taxes:** The total deduction for non-business state, sales, and property taxes is now capped at \$10,000. Previously, taxpayers were encouraged to pay their 4th quarter state estimates before December 31st to maximize their current year deduction. Now the majority of taxpayers will have exceeded the \$10,000 limit so there is no added benefit to paying before the end of the year.
- ▶ **Medical Expense Deductions:** The floor for medical expenses has increased to 10% of AGI for 2019. If your medical expenses are close to that 10% threshold, you should consider paying for elective medical expenses, such as prescription eyeglasses, before the end of the year.
- ▶ **Charitable Contributions:** Contributions, including non-cash gifts, are great way to reduce your taxable income. Because of the increase in the standard deduction, many taxpayers will not receive a tax benefit for making charitable contributions. Taxpayers who are under the new itemized deduction thresholds should think about bunching multiple years' worth of contributions into one year.

▶ **Mortgage Interest:** This deduction is now limited to acquisition indebtedness used to buy, build or substantially improve a qualified residence. The debt must be secured by the residence. For loans originated after 2017, the total amount of debt used for the deduction is limited to \$750,000. Previously, taxpayers could deduct mortgage interest on up to \$1,000,000 in principal value and an additional \$100,000 for a home-equity line of credit (HELOC). As part of the TCJA, the interest deduction for

HELOCs is limited to acquisition debt, and counts against the total debt limit of \$750,000. For tax years 2018 through 2025, HELOC interest is not deductible for any portion of a debt that is used to pay personal expenses.

▶ **Miscellaneous 2% Deductions:** The TCJA suspended all miscellaneous itemized deductions including unreimbursed employee business expenses, union dues, and tax preparation fees.

2019 Tax Rates

Marginal Rate	Single	Married Filing Joint
10%	\$0 - \$9,700	\$0 - \$19,400
12%	\$9,701 - \$39,475	\$19,401-\$78,950
22%	\$39,476 - \$84,200	\$78,951-\$168,400
24%	\$84,201 - \$160,725	\$168,401-\$321,450
32%	\$160,726-\$204,100	\$321,451-\$408,200
35%	\$204,101-\$510,300	\$408,201-\$612,350
37%	> \$510,301	> \$612,351

Retirement Contribution Limits

Type of Account	2020 Contribution Limit	2019 Contribution Limit
Individual Retirement Account (IRA)	\$6,000 + \$1,000 catch up if over age 50	\$6,000 + \$1,000 catch up if over age 50
Roth IRA	\$6,000 + \$1,000 catch up if over age 50	\$6,000 + \$1,000 catch up if over age 50
401(k), 403(b) and most 457 plans	\$19,500 + \$6,500 catch up if over age 50	\$19,000 + \$6,000 catch up if over age 50
SEP IRA and Solo 401(k)	\$57,000 up to \$285K of comp	\$56,000 up to \$280K of comp
SIMPLE IRA	\$13,500	\$13,000
Defined Benefit Plans	Annual Benefit \$230,000	Annual Benefit \$225,000
Overall Qualified Plan Contribution Limit (Employer + Employee)	\$57,000	\$56,000

Alternative Minimum Tax

Few taxpayers will be subject to the AMT in 2019. This is due to a combination of the limitation or elimination of many itemized deductions (which are required AMT add backs), an increase in the AMT exemption amount, and the exemption phase-out. For 2019 the AMT exemption was increased to \$111,700 for married couples while the phase-out was increased to \$1,020,600.

Estate and Gift Tax

The lifetime gift and estate exemption is \$11,400,000 per person for 2019, up from \$11,180,000 in 2018. With careful planning a

married couple can gift up to \$22,800,000 exempt from federal estate and gift tax.

You can make annual exclusion gifts of up to \$15,000 per person (\$30,000 for a married couple) as a way to reduce your taxable estate. For donations to a Section 529 Education Plan, you may be able make gifts up to \$75,000 per person (\$150,000 for a married couple) at one time. 529 plan contributions have even more utility now that up to \$10,000 per year can be used to pay for K-12 tuition. Make sure to check with your tax advisor before doing this because several states have not adopted the new federal law. Additionally, taxpayers generally can pay medical expenses or tuition directly on behalf of a donee without any limitations.

This is a sampling of the most common year-end tax planning strategies, but it is important to note that each taxpayer has unique tax circumstances. You should contact your wealth advisor to develop the appropriate plan in conjunction with your tax advisor.

This letter is general and educational in nature and is not to be construed as investment, tax, or legal advice. Individuals should seek advice from their wealth advisor or other tax advisors before undertaking actions in response to the matters discussed.