CPA

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Client Tax Letter

Smart tax, business and planning ideas from your Trusted Business Advisor[SM]

October/November/December 2018

Year-end planning under the new tax law

The Tax Cuts and Jobs Act of 2017 (TCJA), passed at the end of last year, generally took effect in 2018. Therefore, the fourth quarter of this year provides the first real opportunity for year-end planning under what has been called the most important tax law passed in more than 30 years.

Broadly, the TCJA lowered income tax rates for individuals and for businesses. As you'll read in this issue of the *CPA Client Tax Letter*, the standard deduction has been substantially increased, but many deductions have been trimmed or eliminated, and some innovative tax benefits have been introduced.

Still, much of the tax code remains the same, and so does year-end planning. Retirement plans are largely unchanged. Business equipment purchases still qualify for favorable tax treatment, although the exclusion amount has doubled (a big tax break), and the federal estate tax is still combined with the gift tax. The articles in this issue will provide tips for blending new tax-saving opportunities with old, reliable strategies.

Sizing up the standard deduction

Under the new, as well as prior, tax law, taxpayers can either take a standard deduction or itemize deductions on Schedule A of IRS Form 1040. Typically, tax preparation involves comparing the total of itemized deductions with the standard deduction and choosing the larger amount.

Most people have used the standard deduction and that probably will continue to be true, even more so for 2018 returns. If you plan to use the standard deduction, you can bypass planning for items on Schedule A and move on to other areas.

Larger and smaller

One reason that the standard deduction likely will be more widely used is the increase under the TCJA. In 2018, the standard deduction is $12,000 for single taxpayers and married individuals filing separately (up from $6,350 in 2017), $24,000 for couples filing jointly (up from $12,700), and $18,000 for heads of household (up from $9,350).

Unmarried individuals who are not surviving spouses and who are 65 or older can add $1,600 to the preceding numbers. This

continued on next page →

In this issue

Special issue 2018 tax planning roundup

1 Year-end planning under the new tax law
1 Sizing up the standard deduction
2 Year-end tax planning for charitable donations
3 Year-end tax planning for investors
4 Year-end retirement tax planning
5 Year-end business tax planning

Bad news

Although October is known for market crashes (1929 and 1987), September has had more downward moves in stocks.

amount is reduced to $1,300 per married taxpayer. The same additions to the standard deduction also apply to those who are blind.

The other reason for increased focus on the standard deduction is the reduction in potential itemized deductions. State and local tax deductions now are capped at $10,000 ($5,000 for married individuals filing separately). Miscellaneous itemized deductions, such as unreimbursed employee business expenses and tax preparation fees can no longer be deducted; the same is true for the interest paid on home equity debt that is *not* used to buy, build, or substantially improve the home that secures the loan. Other cutbacks also apply.

The bottom line is that the 2018 standard deduction has a greater chance of exceeding your 2018 itemized deductions.

Example: Paul and Diane Brown have always itemized deductions on Schedule A, largely due to the amounts they pay in state income tax and local property tax. Both are over age 65, so their standard deduction this year is $26,600: $24,000 + $1,300 + $1,300.

Besides their capped $10,000 itemized deduction for taxes paid, the Browns expect to be able to deduct only modest amounts of mortgage interest and charitable contributions. They anticipate taking their standard deduction, so they won't do any planning for itemized deductions in 2018.

Close calls

The situation would be different, say, if the Browns expected to pay $20,000 in home mortgage interest and make $10,000 in charitable gifts. They would be well over the standard deduction amount, including their $10,000 deduction for taxes paid, so planning could be useful. Depending on their situation, the Browns might want to choose elective medical procedures and accelerate charitable donations into 2018 to pay with tax-deductible dollars.

Planning is possible if the Browns project a total of, say, $23,000 in itemized deductions. They could move some deductible outlays into 2018 or defer some expenses into 2019 in order to itemize deductions in one of the two years. If you are on the borderline between itemizing or taking the standard deduction in 2018, our office can help you make tax-effective decisions at year-end.

Year-end tax planning for charitable donations

As explained in the article, "Sizing up the standard deduction," more taxpayers are likely to take the standard deduction for 2018, rather than claim itemized deductions. Therefore, they'll lose the tax benefits from their charitable contributions.

Example 1: Art and Beth Dean are in their 40s and have paid off their home mortgage. They seldom have substantial unreimbursed medical expenses and typically contribute around $7,000 a year to charity. In prior years, they have itemized deductions because of large payments for state income tax and local property tax.

This year, their deduction for taxes paid is capped at $10,000. If they itemize, including their charitable contributions, they would have a total of $17,000. Therefore, the Deans will instead claim the $24,000 standard deduction for couples filing jointly in 2018. They would get no tax break from their $7,000 of donations.

Thinking ahead

One possible tactic would be for the Deans to make a deductible charitable contribution of, say, $35,000 to a donor advised fund in late 2018, bringing their itemized deductions to $45,000: $21,000 over the standard deduction amount. In effect, this $35,000 outlay gives the Deans a $21,000 tax deduction.

In this scenario, the Deans could advise the charitable fund to disburse $7,000 from their donor advised fund in 2018, another $7,000 in 2019, and so on, through 2022. Because the deduction was taken in 2018,

no further deductions would be available for these transfers. They are prepaying five years' contributions in order to get some tax benefit from these expenses.

There are tradeoffs here, including forgoing the use of money by prepaying donations. The higher your tax bracket and the closer your other itemized deductions to the standard amount, the more such efforts might be tax efficient. Our office can walk you through some possible plans.

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Old story

Yet another approach may be viable for taxpayers age 70½ and older who are taking required minimum distributions (RMDs) from their IRAs. Assuming that your RMDs at least equal your planned donations, you might benefit from making your charitable contributions through qualified charitable distributions (QCDs).

Example 2: Ed and Fran Grant are in their 70s and take RMDs. This year, each spouse has an RMD of around $15,000, which is usually taken at year-end. The couple gives about $10,000 a year to charity. The Grants calculate they'll claim the standard deduction for 2018.

This year, Ed informs his IRA custodian that he wishes to make $10,000 of his RMDs as charitable contributions; he provides a list of charitable recipients. That $10,000 will count towards Ed's RMD for 2018, so he only needs to withdraw another $5,000 to avoid a 50% penalty.

QCDs provide no charitable deduction. They do, however, reduce taxable income by reducing taxable RMDs. In this example, Ed reduces his taxable income by $10,000, which reduces his tax obligation. Even though the Grants get no tax deduction for their donation, they still save tax because they report less income on their joint return.

Trusted advice

Qualified charitable distributions

- A QCD is generally a nontaxable distribution made directly by the trustee of an IRA (other than a simplified employee pension [SEP] plan or savings incentive match plan for employees [SIMPLE] IRA) to an eligible charity.
- The IRA owner must have the same type of acknowledgment of the contribution that would be required to claim a deduction for a charitable donation.
- The maximum annual QCD is $100,000 per IRA owner.
- The amount of the QCD is limited to the amount of the distribution that would otherwise be included in income.
- If an IRA includes nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income.

Year-end tax planning for investors

This year has been a roller coaster for investors, with good months followed by steep pullbacks. At this point, you may have taken some gains and losses in your taxable accounts during 2018; you also may have unrealized losses as well as gains.

The classic strategy is to tabulate all of your capital gain and loss transactions for the year to date to see the net result so far. If you own mutual funds in taxable accounts, check the fund companies' websites for projections of year-end capital gains distributions, which will count as taxable gains.

Net losses

If you have taken more losses than gains, you might want to take gains by year-end. Such gains won't increase your income tax, as long as they don't move you into positive gains for the year.

After you take gains by selling securities, you can buy them back right away if you want to maintain your investment. This will raise your basis in the reacquired shares, leading to better tax results on a subsequent sale.

If you don't want to offset net losses with gains, you can deduct up to $3,000 of net capital losses on your 2018 tax return. Excess losses can be carried over to future years.

Net gains

If you end the year with net capital gains, you'll owe tax; the tax rate might be steep if short-term capital gains (sales after a holding period of one year or less) are included. In this scenario, you might want to take capital losses by December 31 to bring down or eliminate this year's net gains.

A capital loss won't count for this year if you buy back the relinquished assets within 30 days of the sale in what is known as a *wash sale*. However, you can buy a similar asset if you wish. For instance, you can sell

Did you know

A study by the U.S. Department of Education, published every four years, found that average cumulative student loan debt at graduation for bachelor's degree recipients increased by only 1.0% from 2011-12 to 2015-16, from $29,384 to $29,669. As students hit loan limits, parents are picking up more of the cost. In the same time period, comparable federal parent PLUS loan debt increased from $27,352 to $32,596, a 19.2% increase.

Source: savingforcollege.com

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an emerging markets stock fund at a loss and put the proceeds into an emerging markets fund from another company immediately, if you think such stocks will rebound.

Assuming you have held the devalued assets for more than 30 days, another strategy is to simply wait on the sidelines for at least 31 days after selling the assets for a loss, then buy back the stock or fund you've sold. You won't have a wash sale, so the capital loss will be effective.

One other plan is possible if you act before the end of November. You can "double up" by buying an equal amount of the securities you intend to sell at a loss. Then, wait 31 days to sell the original position by year-end for a capital loss in 2018. If the shares have bounced back by then, you probably won't regret buying more of them!

Year-end retirement tax planning

A major feature of the TCJA is the reduction of income tax rates owed by individuals. For example, married couples filing jointly for 2018 may have taxable income up to $77,400 and remain in the 12% bracket, up to $165,000 and stay in the 22% bracket, and up to $315,000 and stay in the 24% bracket. For single filers, the taxable income numbers are exactly 50% of those in the last sentence. Keep in mind that the numbers are for taxable income after all deductions have been taken.

In terms of retirement planning at year-end, one result is that low tax rates make tax deferral less attractive. Boosting your 401(k) contributions now may have less of a payoff than in previous years.

On the other hand, withdrawing from tax-deferred retirement accounts has become less difficult. That includes converting pre-tax dollars from a traditional, SEP, or SIMPLE IRA to a Roth IRA for potential tax-free distributions after five years, if you are at least age 59½.

No looking back

Roth IRA conversions have a catch, though. You no longer can reverse (recharacterize) a Roth IRA conversion back to a pre-tax IRA.

Example 1: Suppose Stephanie Jackson converts a $100,000 traditional IRA to a Roth IRA in November 2018. No matter what happens to that Roth IRA's value in the interim, Stephanie will report $100,000 of taxable income on her 2018 tax return.

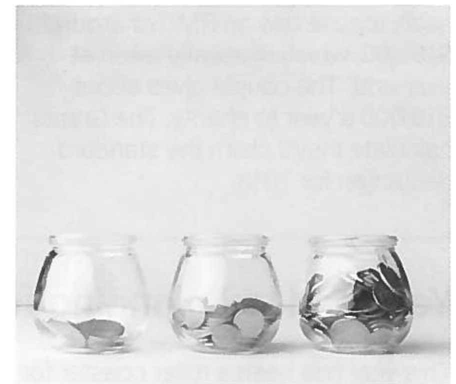
Therefore, the end of a calendar year can be the best time for a Roth IRA conversion. By then, you may have a good idea of your taxable income for the year, so you can make a tax-efficient partial conversion.

Example 2: Stephanie and her husband Tom calculate that they will have about $110,000 in taxable income on their joint return for 2018. Thus, one or both Jacksons could convert up to $55,000 and stay in the 22% tax bracket. Instead, they choose to have Stephanie convert $40,000 in late 2018. That will add $8,800 to their 2018 federal income tax bill (22% of $40,000), an amount they can comfortably pay from their cash reserves.

Planning ahead

An alternate approach is to set aside an amount to convert from a traditional to a Roth IRA each year.

Example 3: Chet and Doris Carson report from $200,000 to $250,000 of taxable income each year, placing them squarely in the 24% tax bracket. Between them, they have $600,000 in traditional IRAs. The Carsons plan



to convert $60,000 to a Roth IRA every year, generating a $14,400 annual federal income tax obligation. After 10 years, their traditional IRAs will be mostly or fully depleted, so the Carsons will owe little in the way of RMDs after age 70½. Roth IRA owners never have RMDs.

Roth IRA distributions are completely tax-free once the age 59½ and the five-year hurdles are cleared. Any Roth IRA conversion in 2018, no matter how late in the year, has a start date of January 1, 2018, so the five-year requirement after a year-end conversion will be met in just over four years.

Double trouble

Tax-deferred retirement accounts generally have RMDs after age 70½. Therefore, taxpayers in this age group should be sure to meet their annual requirement by year-end. Any shortfall can trigger a 50% penalty.

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In addition, each spouse must withdraw the RMD from his or her own account to avoid the penalty.

Example 4: Robert and Jan King each have a $20,000 RMD for 2018. Suppose Robert withdraws $40,000 from his IRA in 2018, but Jan does not take anything from her IRA.

In this situation, the IRS has collected the amount owed by the Kings. That makes no difference. Jan will still face a $10,000 penalty: 50% of her $20,000 RMD shortfall.

Year-end business tax planning

Under the TCJA, equipment expensing permitted by Section 179 of the tax code was expanded. In 2018, your business can take a first-year deduction of up to $1 million worth of equipment purchases. You might buy, say, $400,000 worth of equipment and deduct $400,000 from your company's profits this year. Without the Section 179 tax break, that $400,000 tax deduction would be spread over multiple years.

New and used equipment that is bought or leased can qualify for first-year expensing. The equipment must be placed in service by December 31 to earn a 2018 deduction. For this purpose, the date you pay for the equipment doesn't matter.

Section 179 is meant to benefit smaller companies, not giant corporations. Therefore, this tax break phases out, dollar for dollar, at $2.5 million of outlays in 2018.

Example 1: ABC Corp. buys $2.8 million of equipment in 2018. That's $300,000 over the $2.5 million limit for expensing this year. Consequently, ABC's Section 179 deduction is reduced by $300,000, from the $1 million ceiling, to $700,000. After taking a $700,000 deduction under Section 179, the remaining $2.1 million of ABC's equipment purchases must be depreciated under other tax code rules.

Bonus depreciation

The TCJA also expanded the use of "bonus" depreciation: first-year deductions for equipment expenditures that don't qualify for Section 179 expensing. Prior law allowed for 50% bonus depreciation, but that has been increased to 100% deductions in the year of acquisition.

Certain equipment is excluded from bonus depreciation, but most of the items you use in your business probably will qualify. Indeed, bonus depreciation now applies to some used equipment, as well, whereas only new equipment qualified in the past. Again, exceptions apply, but 100% tax deductions probably will be available for items that have not been used by your company in the past and have not been acquired from a related party.

Acting by year-end may lock in substantial depreciation deductions for this year. You even may be able to use bonus depreciation deductions that exceed business income to reduce your personal income tax bill for 2018.

Sport-utility vehicles

For more than a decade, large passenger autos defined as *sport-utility vehicles* have faced a $25,000 cap in regard to Section 179 expensing.

Example 2: Jerry Miller bought an SUV for $60,000 in 2017 and used it 100% for business. Jerry was entitled to a $25,000 deduction under Section 179. The remaining $35,000 qualified for 50% bonus depreciation, so Jerry's 2017 deduction was $42,500. The other $17,500 had to be depreciated over a longer time.

The new law appears to improve the tax treatment of SUVs.

Example 3: Suppose Jerry Miller's partner, Nancy Owens, buys a $70,000 SUV in 2018 and uses it solely for business. She'll still face a $25,000 limit on Section 179 expensing, but the other $45,000 can qualify for 100% bonus depreciation in 2018, generating a full $70,000 deduction for this year.

Certain conditions will affect the amount of the deduction, including the extent of business use. For any vehicle that you use fully or partially for business, keep a careful log to support any tax benefits you claim.

Changing times

For business owners, this first year-end tax planning opportunity under the TCJA of 2017 may be a time to reconsider how the company is structured. Broadly, your choice is between operating as a regular C corporation or as a flow-through entity, such as an S corporation or a limited liability company.

The new tax law lowered the corporate income tax, which has been set at a relatively attractive flat 21% rate. However, C corporations

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still impose two levels of tax: the corporate income tax plus personal tax paid by company owners. Dividends are not tax deductible, so business owners effectively pay double tax on dividends received.

Flow-through entities may qualify for a newly enacted 20% deduction on qualified business income (QBI).

Example 4: Carol Lawson owns 100% of CL Inc., which is an S corporation engaged in manufacturing. In 2018, she expects her company to pass through about $100,000 of income to her. Thanks to a 20% ($20,000) QBI deduction, only $80,000 of that $100,000 will count as income on Carol's personal tax return.

The QBI deduction tilts the scale towards choosing a pass-through entity. However, a successful small company might pass through large amounts of money to owners, and there are rules that limit the amount of QBI for certain high-income taxpayers. Also note that even a 20% QBI deduction for someone in the top 37% personal income tax bracket would effectively leave that income taxed at 29.6% (80% of 37%), higher than the corporate income tax rate.

Our office can review your specific situation and help you compare the tax treatment you'd face with different business entities. In some cases, a small business that distributes most or all of its income to shareholders as dividends may do well to avoid the double taxation that C corporations generate.

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