2018 Year-End Tax Planning Tips

It's Never Too Early to Start Planning

As the end of another year approaches, it's time to start thinking about ideas which may help lower your tax bill. When discussing ideas and tips with your tax advisor, it's wise to remember a few things:

- This year's tax planning might be less exact than in past years, as everyone is still working on understanding the intricacies of the tax law enacted in December 2017;
- Year-end tax planning can go beyond just reducing this year's tax bill, it can include looking into future years as well;
- Planning for business, estate and gift taxes can be as important as planning for individual income taxes; and
- Start discussions *now* – you might need lead time to carry out any plan by year-end.

Individual Tax Planning

1. Timing of income and deductions. In most cases, income tax planning consists of maximizing the deductions available and minimizing the amount of income recognized in the current year. That strategy is reversed, however, when a person expects to be in a higher income tax bracket in the future. Below are common strategies used when considering income tax timing issues:

   a. *Alternate between itemized and standard deductions*. The 2017 tax law increases the standard deduction to $12,000 for individuals (from $6,350) and $24,000 for joint filers (from $12,700).[1] This will likely result in more taxpayers using the standard deduction rather than itemizing. This creates the opportunity to engage in multi-year planning by maximizing itemized deductions in a given tax year, so they exceed the standard deduction. Then the taxpayer uses the standard deduction in the alternate years.

   For example, many taxpayers like to make annual gifts to their favorite charities; however, with the new tax law, they may not be able to deduct the gifts if they do not itemize. A possible solution is a donor advised fund which allows the taxpayer to make a large charitable gift in a single year, without identifying future charitable recipients at the time of the donation. The taxpayer itemizes in the year of the donation to the donor advised fund. The taxpayer then recommends charities to receive distributions in that year, and in subsequent years. The taxpayer itemizes deductions in the year the donation is made, and may use the standard deduction in the subsequent years. Taxpayers can deduct cash donations up to 60% of AGI, an increase from the old rule which limited the deduction to 50% of AGI.[2]

   Also, the 2017 tax law caps the state and local tax (SALT) deduction at $10,000 in a single year.[3] For taxpayers living in states with low property taxes, consider paying two years' worth of property taxes (if allowed by the

[1] IRC §§ 1, 2, 32, 63.
[2] IRC § 170(b)(1)(G)(i).
[3] IRC § 164(b).

municipality) in the year in which the taxpayer is itemizing. Taxpayers then take the standard deduction in the alternate years. The $10,000 cap reduces the benefit of this strategy for taxpayers with high property taxes.

b. *IRA charitable rollovers*. If the taxpayer is at least 70½, a charitable rollover is another strategy to consider. A charitable rollover is a distribution from a taxpayer's Individual Retirement Account (IRA) made directly to charity. This distribution is excluded from the taxpayer's income, and the distribution satisfies the taxpayer's required minimum distribution for the year.[4] This is a tax-efficient way to make a charitable contribution, as excluding the charitable rollover from the owner's income is better than treating the distribution as it were first taxable, and then possibly deductible as a charitable gift (the AGI limits would apply and could reduce the deductible amount). The maximum amount that may be transferred is $100,000 annually to an eligible charity (a donor advised fund is not an eligible charity, but a private foundation may qualify).

c. *Medical expenses*. The floor for itemizing medical expenses is reduced from 10% to 7.5% of AGI, but only through 2018.[5] If a taxpayer is itemizing in 2018 rather than taking the standard deduction, carry out elective medical procedures and make large prescription drug purchases in 2018.

d. *Alimony*. After 2018, alimony payments are no longer deductible for the payor and taxable to payee.[6] If a taxpayer is currently going through divorce proceedings, finalize the divorce in 2018 to take advantage of the deduction (if the payor) or delay finalization until 2019 (if the payee).

2. Mortgage and home equity interest deduction. The mortgage interest deduction is now limited to $750,000 (prior mortgages of up to $1 million are grandfathered). Interest on home equity loans that are not used to buy, build or improve the residence is not deductible.[7] Consider refinancing to consolidate existing loans or downsizing to a smaller home with a smaller mortgage to retain the deductions.

3. Vacation or second homes. Taxpayers with a vacation or second home should consider renting that home out. The $10,000 SALT deduction limitation applies only to a personal residence, not rental property so the full amount of the real estate taxes may be deductible.

4. Harvest capital losses (or gains). High income taxpayers could be taxed at 23.8% in 2018 on long term capital gains (20% capital gains rate, plus the 3.8% net investment income tax (NII)). Some taxpayers might have already realized capital losses in 2018 that could be offset by selling investments to produce capital gains (or, if they've realized capital gains, can sell other assets that are underwater to realize offsetting losses). If the capital losses exceed capital gains, up to $3,000 of that excess can offset ordinary income now, with the remaining losses being carried over to deduct in future tax years. But beware of the "wash sale" rule: if a taxpayer sells stock or securities at a loss and (re)purchases substantially identical stock or security within 30 days before or after the sale, the wash sale rule denies the ability to take a capital loss.[8]

5. Avoid tax penalties by increasing withholding. The federal income tax is a pay-as-you-go system, which taxpayers must satisfy to avoid underpayment penalties either through withholding or by making estimated tax payments. In the wake of the new tax law, the IRS issued new withholding guidelines. Review these as soon as possible with your tax advisor.

[4] IRC § 408(d)(8).
[5] IRC § 213.
[6] IRC § 215.
[7] IRC § 163(h).
[8] IRC § 1091(a).

When a high-income individual receives an irregular increase in income – perhaps due to a payment of nonqualified deferred compensation – the taxpayer should pay attention to withholding. Taxpayers should contact their tax advisors as soon as possible to determine whether sufficient estimated taxes have been paid to avoid underpayment penalties. If it looks like penalties could apply, taxpayers should increase their tax withholding for the remainder of the year. Playing additional estimated taxes in the fourth quarter merely stops penalties from accruing, but it does not prevent penalties from being applied for the first three quarters. In contrast, withholding is treated as having been paid equally over the course of the tax year. Employees can file a new Form W-4 withholding certificate requesting increased withholding, and an employer has up to 30 days to give effect to the changes. After the additional amounts are withheld, the employee should make sure to submit a new Form W-4 to change the withholding back, if desired.

Another option is to take a distribution from an IRA and request that the IRA administrator withhold tax. The IRA owner can then return the full amount of the distribution to the IRA through a 60-day rollover (using outside money to cover the amount withheld for taxes). Note that there can be only one 60-day IRA rollover per 12-month period.[9]

6. Defer 2018 bonuses or 2019 compensation. An employee might be able to push the receipt of any anticipated 2018 bonus into the beginning of next year by asking the employer to delay payment. If the bonus is paid within the first 2½ months of 2019, it generally won't trigger any Section 409A concerns, but the devil is in the details in this area, so both parties should review the plan with their respective tax advisors.

   Some actions must be taken now to reduce income for next year, 2019. If an employer has a nonqualified deferred compensation plan that permits employee deferrals, employees must elect before the end of this year, 2018, to defer any income that would otherwise be paid in 2019.

7. Contribute to an IRA or 401(k). To the extent their budgets permit, taxpayers generally should contribute the maximum amount allowable to a Roth IRA, traditional IRA, or 401(k). Some of these contributions can be made as late as April 15, 2019.

   Deductible contributions to 401(k)s and traditional IRAs reduce taxable income today while contributions to Roth 401(k)s and Roth IRAs are not deductible. An added benefit is that after contributions are made, the growth inside a 401(k) or IRA is tax deferred. This means that the growth does not generate income that can trigger the 3.8% NII tax. Additionally, distributions avoid the 3.8% NII tax too. Distributions from Roth accounts are not taxable if certain conditions are met, and even taxable distributions from traditional IRAs and 401(k)s are specifically excluded from the NII tax. The catch is that they do increase modified adjusted gross income, making the imposition of the NII tax on other income more likely.

8. Roth IRA conversions. A taxpayer holding a traditional IRA could convert all or part of that account to a Roth IRA. This triggers current income tax, but the overall tax burden might be reduced in the long run. This is particularly true if the IRA owner can let the Roth IRA grow tax-deferred over many years, and if he or she will be in a higher income tax bracket when ultimately taking distributions.

   In the past, taxpayers who made a Roth IRA conversion could "undo" the conversion by moving the account back to a traditional IRA, known as recharacterizing the conversion. The 2017 tax act eliminated the ability to recharacterize Roth conversions.[10]

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[9] IRC § 408(d)(3)(B); IRS Announcement 2014-32 (Nov. 10, 2014).
[10] IRC § 408A(d)(6)(B)(iii).

Gift and Estate Tax Planning

Consider implementing gift and estate planning strategies to transfer wealth to younger generations while minimizing transfer taxes.

1. Annual exclusion gifts. The tried and true strategy of making maximum annual exclusion gifts still constitutes good planning. For 2018, a donor can give $15,000 per donee, or $30,000 per donee from a married couple. Taxpayers might want to consider giving income-producing assets to children in lower income tax brackets to reduce the overall tax burden to the family. Keep in mind that unearned income of children under 18 (or 24 if a full-time student) above $2,100 are taxed at trust rates.[11] In 2018, the top trust bracket of 37% applies to income over $12,500.

2. Lifetime gifts. The new tax law effectively doubles the gift, estate and generation skipping transfer (GST) tax exemptions to $11,180,000 (in 2018, adjusted for inflation annually).[12] However, the exemptions are scheduled to revert to approximately $6,000,000 in 2026. Taxpayers with large estates should consider using the increases in the gift and GST exemptions to make large gifts to dynasty trusts, creating funds that can endure for multiple generations and providing descendants with increased creditor protection, professional money management, and responsible spending patterns.

   For those with existing estate planning arrangements involving split dollar plans or installment sales, use the increased exemptions to repay the amounts owned and terminate the arrangements.

3. Planning for education. Combining education savings with gifts can accomplish multiple goals with one plan. Gifts to a Section 529 savings plan can use up to 5 years of a donor's annual exclusion gifts in a single year without creating a taxable gift ($75,000 in 2018). Assets in the 529 plan are not income taxed as they grow and can escape income tax forever if used for qualified higher education expenses or elementary or secondary school tuition. What's more, the value of the 529 plan is not included in the account owner's (e.g., Mom's) estate, even if she retains all the power over the account up to the day she dies.

   In addition to and separate from gifts to 529 plans, a donor can make direct payments of tuition to educational institutions – without any maximum limit – as these are not counted as gifts at all, not even chipping away at the $15,000 annual exclusion.[13]

Planning for Business Owners

1. Flow-through planning. The activities, income, and deductions of partnerships, S corporations, and sole proprietorships flow through to their owners and impact the owners' individual tax returns. In addition to planning related to incurring expenses or deferring income, the new tax law creates a new deduction for certain qualified business income ("QBI") from a pass-through business.[14] As we approach the end of the year, business owners can engage in planning to maximize their ability to benefit from the new deduction.

   a. *Planning with taxable income for purposes of the new pass-through tax deduction*. The new tax law allows owners of a flow-through business to deduct up to 20% of QBI earned from the business. The deduction is in effect for tax years 2018 through 2025. The deduction cannot exceed 20% of the taxpayer's "taxable income"

[11] IRC § 1(g).
[12] IRC §§ 2010, 2505, 2631.
[13] IRC § 2503(e)((2)(A).
[14] *See* Explaining the Section 199A Pass-Through Tax Deduction, Advanced Planning Bulletin, March 2018 for a complete discussion of the new QBI deduction.

and is subject to other limitations based on a taxpayer's taxable income. For example, in 2018, if a taxpayer has taxable income of over $415,000 (married, filing joint), then any QBI from a specified service trade or business engaged in by the taxpayer is not eligible for the deduction. Also, any QBI from a non-service business of the taxpayer would be subject to limits based on the amount of W-2 wages paid by the business and the cost of property owned by the business.

Because taxable income plays a large role in both determining eligibility for the QBI deduction and the limitations on the amount deductible, lowering taxable income can have a big impact. For service businesses or businesses with few employees or property, it could be critical for taxable income to be below threshold amounts to be able to benefit from the deduction. For other business owners, it may be more important to have taxable income high so that the overall limit of 20% of taxable income doesn't apply to the deductible amount. Note that reductions to gross income that alter QBI will affect the calculation of the QBI deduction.

For these purposes, "taxable income" is defined as gross income minus permissible deductions, including itemized deductions if the standard deduction isn't taken. Making changes to any of the items that make up taxable income could significantly impact the benefit of the pass-through tax deduction for a taxpayer.

Ways to influence taxable income before the end of the year

Gross income	**Defer income** **Qualified plan contributions** **Depreciation elections**
Permissible deductions	**Self-employed health insurance** **HSAs** **Self-employed SEP, SIMPLE, and qualified plans**
Standard v. itemized deductions	**Charitable contributions** **Medical expenses** **Mortgage interest**

b. *Free up suspended partnership losses*. The ability to use partnership losses can be limited for several reasons, such as the lack of tax basis in the partnership interest, or because of the passive loss rules of Section 469. The unused losses are "suspended" until they can be used. Suspended losses can be freed up either when the reason they were suspended no longer exists (*e.g.*, the basis increases) or when the interest in the partnership is fully terminated.[15]

2. Accelerated deductions for acquired property. The new tax law allows businesses to fast-track depreciation deductions, which can lower a flow-through business owner's overall tax burden.

   a. *Bonus depreciation.* Buying qualified property allows a business to take a 100% depreciation deduction. The qualified property must be placed into service between September 27, 2017 and December 31, 2022.

   b. *Section 179*. The maximum that can be expensed under Code Section 179 is increased to $1 million and it does not phase out until the cost of qualifying property acquired in a year exceeds $2.5 million.

3. Benefit planning for entities. Owners of businesses that are not C corporations are unable to use many of the common tax-free employee benefits that companies provide to employees. There are, however, some strategies available to business owners that should be considered before the end of the year.

[15] IRC § 469(g).

a. *Qualified retirement plans*. The individual contribution limit for an IRA is $5,500 (plus catch-up if over 50), but employers can contribute up to $55,000 (2018 figure) on a pre-tax basis for employees under a qualified defined contribution plan. There are many qualified plan options that an owner-employee could use to maximize pre-tax contributions for retirement funding. Typical plan options for small business owners or self-employed individuals include SEP and SIMPLE IRAs and qualified plans (both defined benefit and defined contribution plans). While a SIMPLE plan must be established by October 1 of a calendar year, other plans have until December 31 to be set up.[16]

b. *Consider obtaining long-term care insurance*. Self-employed individuals can pay for long-term care (LTC) insurance premiums for themselves and their spouse and deduct up to the "eligible long-term care premium amount."[17] This amount is often not as large as the actual premium paid, but self-employed taxpayers can deduct the eligible LTC premium amount without having to exceed the 7.5% AGI threshold that applies to individuals purchasing LTC insurance without the involvement of a trade or business.

   What's more, if the employer is a C Corporation and provides the LTC insurance benefit to an owner-employee due to *employee* status, or if any employer provides LTC insurance coverage to a non-owner employee, the premium paid – rather than the eligible LTC premium amount – is generally deductible for the business and altogether excluded from the employee's income.

Conclusion

Effective income and estate tax planning requires that taxpayers consult with their tax advisors throughout the year. It is particularly important and useful, however, to review all planning as the end of the year nears. With the changes tax law changes effective in 2018, the need for a review is doubly important.

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[16] A SEP IRA can be established as late as the extended due date for filing the business' 2018 tax return and contributions for 2018 can still be reflected on the 2018 tax return.
[17] IRC § 213(d).