Year-End Tax Planning

As the end of the year is fast approaching, we should consider any last-minute strategies that might help reduce your 2019 tax bill. Last year was the first year to be impacted by the Tax Cuts and Jobs Act of 2017 (TCJA). While there was no significant new legislation in 2019 affecting individual taxes, situations do change from year to year, thus requiring a fresh look at how to approach year-end tax planning. The following are strategies that may benefit you and that we should discuss before December 31.

Bunching Deductions into 2019

As you may know, TCJA significantly increased the standard deduction for all taxpayers. This means that many individuals who previously received a tax benefit by itemizing deductions no longer do, because taking the standard deduction is more advantageous. For 2019, the standard deduction is $12,200 for single taxpayers, $24,400 for married taxpayers filing a joint return, $18,350 for taxpayers filing as head of household, and $12,400 for married taxpayers filing separately.

In addition, there is a $10,000 limitation ($5,000 in the case of married taxpayers filing separately) on the combined amount of state income taxes and property taxes that may be deducted when itemizing. Unfortunately, this $10,000 limitation applies to single as well as married taxpayers and is not indexed for inflation.

If the total of your itemized deductions in 2019 will be close to your standard deduction amount, alternating between bunching itemized deductions into 2019 and taking the standard deduction in 2020 (or vice versa) could provide a net-tax benefit over the two-year period. For example, if you give a certain amount to charities each year, and if it's financially feasible, you might consider doubling up this year on your contributions rather than spreading the contributions over a two-year period. If these amounts, along with your mortgage interest and medical expenses exceed your standard deduction, then you should double up on the expenses this year and take the standard deduction next year.

Similar opportunities may be available for bunching property tax payments and state income tax payments, subject to TCJA's $10,000 limitation on deductions for such payments. This strategy can be especially attractive for single taxpayers because the standard deduction is so much lower for single individuals. It's important to remember, however, that the deduction for property taxes applies only to property taxes that have been assessed. Thus, if the assessment for 2019 property taxes occurred in 2018 and the taxes are due in 2019, you can deduct in 2019 the taxes assessed for 2019 that you have paid as well as the property taxes assessed for 2020, assuming you also pay the 2020 taxes in 2019.

Finally, if any of your real estate or income taxes can be allocated to a trade or business, they are not subject to the $10,000 limitation.

Medical Expenses and Health Savings Accounts

For 2019, your medical expenses are only deductible as an itemized deduction to the extent they exceed 10 percent of your adjusted gross income. Depending on what your taxable income is expected to be in 2019 and 2020, and whether itemizing deductions would be advantageous for you in either year, you may want to accelerate any optional medical expenses into 2019 or defer them until 2020. The right approach depends on your income for each year, expected medical expenses, as well as your other itemized deductions.

However, health saving accounts (HSAs) present an attractive alternative. If you are eligible to set up such an account, you can deduct the amount you contribute to the account in computing adjusted gross income. Thus, the contributions are deductible whether you itemize deductions or not. Distributions from an HSA are tax free to the extent they are used to pay for qualified medical expenses (i.e., medical, dental, and vision expenses). For 2019, the annual contribution limits are $3,500 for an individual with self-only coverage and $7,000 for an individual with family coverage.

Mortgage Interest Deduction

If you sold your principal residence during the year and acquired a new principal residence, the deduction for any interest on your acquisition indebtedness (i.e., mortgage) could be limited. The TCJA limits the interest deduction on mortgages of more than $750,000 obtained after December 14, 2017. The deduction is limited to the portion of the interest allocable to $750,000 ($375,000 in the case of married taxpayers filing separately). For mortgages acquired before December 15, 2017, the limitation is the same as it was under prior law: $1,000,000 ($500,000 in the case of married taxpayers filing separately). However, as discussed below, if you operate a business from your home, an allocable portion of your mortgage interest is not subject to these limitations.

You can potentially deduct interest paid on home equity indebtedness, but only if you used the debt to buy, build, or substantially improve your home. Thus, for example, interest on a home equity loan used to build an addition to your existing home is typically deductible, while interest on the same loan used to pay personal living expenses, such as credit card debts, is not.

Home Office Expenses

When the TCJA eliminated the miscellaneous itemized expense deduction, it eliminated the ability of employees to deduct home office expenses. However, taxpayers with their own business can still file a Schedule C and take a home office expense deduction if part of the home is used for that business. State income taxes, property taxes, and home mortgage interest allocable to your business can also be deducted and such deductions are not subject to the limitations that apply to individual taxpayers who do not operate a Schedule C business from their home.

Revised Kiddie Tax Rules

One of the changes made by TCJA involves what is known as the "kiddie tax." The kiddie tax applies to a child's net unearned income (e.g., dividends, interest, and capital gain distributions) over $2,200. While such income used to be taxed at the parent's marginal income tax rate and took into consideration the unearned income of any siblings, TCJA simplified the calculation so that the child's unearned income is taxed at trust and estate tax rates. Although the trust and estate tax rates are similar to the individual tax rates, the tax brackets are much lower, meaning higher rates of tax apply to lower levels of income.

For 2019, the top marginal tax rate for a couple filing a joint return is 37% for taxable income over $612,350. For income subject to the estate and trust tax rates, the 37% tax rate begins at taxable income over $12,750. There is a way to save some taxes here, however, if your child is under the age of 18 at the end of 2019 and didn't have earned income that was more than half of the child's support, or a full-time student at least age 19 and under age 24 and the end of 2019 and didn't have earned income that was more than half of the child's support. For such children, you can elect to include the child's income on your tax return. However, we would need to evaluate whether adding such income to your tax return would subject you to the net investment income tax of 3.8 percent.

Child-Related Expenses and Credits

While the TCJA eliminated the personal and dependent exemption deductions that applied to tax years before 2018, it increased the child tax credit available for years after 2017 and increased the income level at which taxpayers are eligible for the credit. For 2019, if you file a joint return and your modified adjusted gross income (MAGI) is $400,000 or less, you are eligible for a $2,000 child tax credit for each qualifying child. If you are filing as single, head of household, or married filing separately, the MAGI limitation for claiming a child tax credit is $200,000 or less. For income above those levels, a pro rata credit may be available depending on total MAGI. Taxpayers with income below certain thresholds may be eligible for a refundable child tax credit.

Additionally, if you paid someone to take care of your child or a dependent so you can work or look for work, you may be entitled to a tax credit for up to 35 percent of the expenses paid. The amount of employment-related expenses used to calculate the credit is generally limited to $3,000 for one qualifying individual or $6,000 for two or more qualifying individuals. Various qualifications must be met in order to be eligible for the credit, but if you incurred such expenses, you may qualify. Additionally, if you paid someone to come to your home and care for a child or dependent, you may be a household employer subject to employment taxes.

If you incurred expenses to adopt a child, you may be eligible for a tax credit of up to $13,810 for some or all of those expenses. The determination of the tax year in which qualified adoption expenses are allowable as a credit depends on whether the expenses were paid before the year in which the adoption became final or whether they were paid during or after the year in which the adoption became final.

Education-Related Deductions and Credits

While the tuition and fees deduction that had previously been available expired at the end of 2017 along with the miscellaneous itemized deduction for work-related education expenses, other education-related tax deductions, credits, and exclusions from income may apply for amounts paid in 2019. Tax-free distributions from a qualified tuition program of up to $10,000 are now allowed for elementary or secondary school tuition. In addition, if your modified adjusted gross income level is below certain thresholds, the following are available for 2019:

- an exclusion from income for education savings bond interest;
- a deduction for student loan interest; and
- a lifetime learning credit of up to $2,000 for tuition and fees paid for the enrollment or attendance of yourself, your spouse, or your dependents for courses of instruction at an eligible educational institution.

Charitable Contribution Deductions

As a result of the increase in the standard deduction, some taxpayers are no longer getting a benefit from itemizing their deductions, such as charitable contributions, as they once were. However, as noted above, you can still help charities and get a tax benefit if you contribute enough to get over the standard deduction amount or bunch itemized deductions that would otherwise be spread over multiple years into one year.

Additionally, you can reap a larger tax benefit by donating appreciated assets, such as stock, to a charity. Generally, the higher the appreciated value of an asset, the bigger the potential value of the tax benefit. Donating appreciated assets not only entitles you to a charitable contribution deduction but you also avoid the capital gains tax that would otherwise be due if you sold the stock. For example, if you own stock with a fair market value of $1,000 that was purchased for $250 and your capital gains tax rate is 15 percent, the capital gains tax would be $113 ($750 gain x 15%). If you donate that stock instead of selling it, and are in the 24 percent tax bracket, you get an ordinary income deduction worth $240 ($1,000 FMV x 24%). You also save $150 in capital gains tax that you would otherwise pay if you sold the stock. Thus, the after-tax cost of the gift of appreciated stock is $647 ($1,000 - $240 - $113) compared to the after tax cost of a donation of $1,000 cash which would be $760 ($1,000 - $240). However, it's important to also keep in mind that tax deductions for appreciated property are limited to 50 percent of your adjusted gross income.

Finally, taxpayers 70 1/2 years old and older who own an individual retirement account (IRA) are required to take minimum distributions from that account each year and include those amounts in taxable income. If you are in this category, a special rule allows you to make a charitable contribution directly from your IRA to a charity. This has several benefits. First, since charitable contributions deductions are usually only available to individuals who itemize, individuals who take the standard deduction instead can benefit from this rule. Second, making the contribution directly to a charity counts towards your required minimum distribution but that amount is not included in income and thus reduces your taxable income and adjusted gross income (AGI). A lower AGI is advantageous because it increases your ability to take medical expense deductions that you might not otherwise be able to take. For example, medical expenses are only deductible to the extent those expenses exceed 10 percent of your AGI and a lower AGI means you can deduct more medical expenses. In addition, as AGI increases, more of your social security income is subject to tax. Finally, the 3.8 percent net investment income tax applies to the extent your AGI exceeds a certain level.

Rental Real Estate

If you own rental real estate, you may be eligible for a special tax break - TCJA's Section 199A deduction - which is based on a percentage of income earned by the rental real estate activity. In order to be eligible for the deduction, the activity must be considerable, regular, and continuous in scope. In determining whether your rental real estate activity meets those criteria, relevant factors include, but are not limited to, the following:

- the type of rented property (commercial real property versus residential property);
- the number of properties rented;
- you or your agent's day-to-day involvement;
- the types and significance of any ancillary services provided under the lease; and
- the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

Under a safe harbor issued by the IRS, a rental real estate activity will be treated as a business eligible for the special deduction if certain requirements are satisfied, such as:

- separate books and records are maintained to reflect the income and expenses for each rental real estate enterprise;
- for rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise (with slightly less stringent requirements for rental real estate enterprises that have been in existence for at least four years);
- contemporaneous records have been maintained, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii)

description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services; and

- certain compliance requirements are met.

If you think you may be eligible for this deduction, we should get together to nail down any last steps you may need to take to fall within the safe harbor. Alternatively, even if you don't meet the safe harbor requirements, you may still be eligible for this deduction.

In addition, if you rent out a vacation home that you also use for personal purposes, we should review the number of days it was used for business versus pleasure to see if there are ways to maximize tax savings with respect to that property.

Retirement Planning

By investing in a qualified retirement plan you'll not only receive a current tax deduction, thereby reducing current year income tax, but you can sock away money for your retirement years. If your employer has a 401(k) plan and you are under age 50, you can defer up to $19,000 of income into that plan. Catch-up contributions of $6,000 are allowed if you are 50 or over.

If you have a SIMPLE 401(k), the maximum pre-tax contribution for 2019 is $12,500. That amount increases to $15,500 if you are 50 or older.

If certain requirements are met, contributions to an individual retirement account (IRA) may be deductible. If you are under 50, the maximum contribution amount for 2019 is $6,000. If you are 50 or older but less than 70 1/2, the maximum contribution amount is $7,000. Contributions exceeding the maximum amount are subject to a 6 percent excise tax. Even if you are not eligible to deduct contributions, contributing after-tax money to an IRA may be advantageous because it will allow you to later convert that traditional IRA to a Roth IRA. Qualified withdrawals from a Roth IRA, including earnings, are free of tax, while earnings on a traditional IRA are taxable when withdrawn.

If you already have a traditional IRA, we should evaluate whether it is appropriate to convert it to a Roth IRA this year. You'll have to pay tax on the amount converted as ordinary income, but subsequent earnings will be free of tax and the decrease in tax rates that are effective this year makes such a conversion less costly than it would have been in previous years. Of course, this option only makes sense if the tax rates when the money is withdrawn from the Roth IRA are anticipated to be higher than the tax rates when the traditional IRA is converted. And if you have a traditional 401(k), 403(b), or 457 plan that includes after-tax contributions, you can generally rollover these after-tax amounts to a Roth IRA with no tax consequences. A rollover of a SIMPLE 401(k) into a Roth IRA may also be available. As with all tax rules, there are qualifications that apply to these rollovers that we should discuss before any actions are taken.

Finally, if you make qualified retirement savings contributions during 2019 you can claim a retirement savings credit of up to $1,000 (single or head of household) or $2,000 (joint filers) if your adjusted gross income does not exceed $64,000 (married filing jointly), $48,000 (head of household), or $32,000 (all other taxpayers).

Reevaluating Your Stock Portfolio

Year end is a good time to review your stock portfolio to see if you might want to divest yourself of stocks that have lost value since you originally bought them. We should evaluate whether you might benefit from selling off appreciated stocks, particularly those that would generate a short-term capital gain, and using the resulting gain to limit your exposure to a long-term capital loss on stocks you may want to dump, since the deduction of long-term capital gains is limited. And any net capital gain you may reap will be taxed at the substantially reduced capital gain tax rate.

The tax rate for net capital gain is generally no higher than 15 percent for most taxpayers. Some or all of your net capital gain may be taxed at 0 percent if your income is not above $39,375 (single), $78,750 (joint), or $52,750 (head of household). However, a 20 percent tax rate on net capital gain does apply to the extent that your ordinary taxable income is over $434,550 (single), $488,850 (joint), $244,425 (married filing separately), or $461,700 (head of household). Additionally, the following types of capital gains have different tax rate structures: (1) the taxable part of a gain from selling certain qualified small business stock is taxed at a maximum 28 percent rate; (2) the net capital gain from selling collectibles (such as coins or art) is taxed at a maximum 28 percent rate; and (3) the portion of certain unrecaptured gain from selling real property is taxed at a maximum 25 percent rate. If you have been involved in any such transactions during the year, we should review your options for reducing the tax on those transactions.

Substantial Increases in Deductions or Nontaxable Income Could Result in AMT Exposure

While fewer taxpayers are subject to the alternative minimum tax (AMT) as a result of the TCJA increasing exemption amounts and raising the exemption phaseout levels, the AMT is not completely dead. Certain adjustments to your taxable income, or certain exclusions from gross income, for regular tax purposes are not allowed for AMT purposes and will increase your AMT income (AMTI), thus potentially subjecting you to the AMT. Typical items which may reduce regular income but are not allowed for AMTI purposes include the standard deduction, the state and local income tax deduction, and the deduction for property taxes. In addition, the exercise of incentive stock options can result in AMT income, whereas such income is not recognized for regular tax purposes. Thus, if you have exercised any incentive stock options or have had a substantial increase in certain deductions in 2019, but have not previously been subject to the AMT, there is the possibility that you could be subject to the AMT for 2019.

If you work from home, one strategy for avoiding the AMT is to allocate part of your mortgage interest or property taxes to your Schedule C business. To the extent you can claim items on your Schedule C, they aren't added back in calculating AMTI.

While all taxpayers are eligible for an exemption from the AMT, the amount of the exemption depends on your filing status. For 2019, the exemption amounts for individuals, other than those subject to the kiddie tax, are (1) $111,700 in the case of a joint return or a surviving spouse; (2) $71,700 in the case of an individual who is unmarried and not a surviving spouse; and (3) $55,850 in the case of a married individual filing a separate return. However, these exemptions are phased out by an amount equal to 25 percent of the amount by which your alternative minimum taxable income (AMTI) exceeds: (1) $1,020,600 in the case of married individuals filing a joint return and surviving spouses and (2) $510,300 in the case of all other individuals.

Planning for the 3.8 Percent Net Investment Income Tax

A 3.8 percent tax applies to certain net investment income of individuals with income above a threshold amount. The threshold amounts are $250,000 (married filing jointly and qualifying widow(er) with dependent child), $200,000 (single and head of household), and $125,000 (married filing separately). In general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, and income from businesses involved in trading of financial instruments or commodities. Thus, while the top tax rate for qualified dividend income is generally 20 percent, the top rate on such income increases to 23.8 percent for a taxpayer subject to the net investment income tax (NIIT).

If it appears you may be subject to the NIIT, the following actions may help avoid the tax and we should discuss whether any of these options make sense in light of your financial situation.

- Donate or gift appreciated property. As discussed above, by donating appreciated property to a charity, you can avoid recognizing the appreciation for income tax purposes and for net investment income tax purposes. Or you may gift the property so that the donee can sell it and report the income. In this case, you'll want to gift the property to individuals that have income below the $200,000 (single) or $250,000 (couples) thresholds.

- Replace stocks with state and local bonds. Interest on tax-exempt state and local bonds are exempt from the NIIT. In addition, because such interest income is not included in adjusted gross income, it can help keep you below the threshold for which the NIIT applies.

- If you are in the real estate business, we should review the criteria for being classified as a real estate professional in addition to the criteria necessary for meeting the safe harbor requirements mentioned above for obtaining the qualified business income deduction. If you meet the requirements for being a real estate professional, your rental income is considered nonpassive and thus escapes the NIIT.

- If you intend to sell any appreciated assets, consider whether the sale can be structured as an installment sale so the gain recognition is spread over several years.
- Since capital losses can offset capital gains for NIIT purposes, consider whether it makes sense to sell any losing stocks, but keeping in mind the transaction costs associated with selling stocks.
- If you have appreciated real property to dispose of and are not considered a real estate professional, a like-kind exchange may be more advantageous. By deferring the gain recognition, you can avoid recognizing income subject to the NIIT.

Because the NIIT does not apply to a trade or business unless (1) the trade or business is a passive activity with respect to the taxpayer, or (2) the trade or business consists of trading financial instruments or commodities, we may want to look at ways in which a venture you are involved with could qualify as a trade or business. However, such classification could have Form 1099 reporting implications whereas personal payments are not reportable if your activity is not considered a trade or business.

Additional Medicare Tax

An additional Medicare tax of 0.9 percent is imposed on wages, compensation, and self-employment income in excess of a threshold amount. The threshold amounts are $250,000 (joint return or surviving spouse), $125,000 (married individual filing a separate return), and $200,000 (all others). However, the threshold amount is reduced (but not below zero) by the amount of the taxpayer's wages. Thus, a single individual who has $145,000 in self-employment income and $130,000 of wages is subject to the .9 percent additional tax on $75,000 of self-employment income ($145,000 - $70,000 (the $200,000 threshold - $130,000 in wages)). No tax deduction is allowed for the additional Medicare tax.

For married couples, employers do not take a spouse's self-employment income or wages into account when calculating Medicare tax withholding for an employee. If you and your spouse will exceed the $250,000 threshold in 2019 and have not made enough tax payments to cover the additional .9 percent tax, you can file Form W-4 with the IRS before year end to have an additional amount deducted from your paycheck to cover the additional .9 percent tax. Otherwise, underpayment of tax penalties may apply.

Timing Income and Deductions

If there is going to be a dramatic swing in your taxable income or your life circumstances between 2019 and 2020, it may make sense to either: (1) accelerate income into 2019 and defer deductions into 2020, or (2) accelerate deductions into 2019 and defer income into 2020.

- **Accelerating Income into 2019.** Options for accelerating income include: (1) harvesting gains from your investment portfolio, keeping in mind the 3.8 percent NIIT; (2) converting a retirement account into a Roth IRA and recognizing the conversion income this year; (3) taking IRA distributions this year rather than next year; (4) if you are self-employed and have clients that owe you money, try to get them to pay before year end; and (5) settling any outstanding lawsuits or insurance claims that will generate income this year.

- **Deferring Deductions into 2020.** If you anticipate a substantial increase in taxable income next year, it may be advantageous to push deductions into 2020 by: (1) postponing year-end charitable contributions, property tax payments, and medical and dental expense payments, to the extent deductions are available for such payments, until next year; and (2) postponing the sale of any loss-generating property.

- **Deferring Income into 2020.** If it looks like you may have a significant decrease in income next year, either from a reduction in income or an increase in deductions, it may make sense to defer income into 2020 or later years. Some options for deferring income include: (1) if you are due a year-end bonus, having your employer pay the bonus in January 2020; (2) if you are considering selling assets that will generate a gain, postponing the sale until 2020; (3) if you are considering exercising stock options, delaying the exercise of those options; (4) if you are planning on selling appreciated property, consider an installment sale with larger payments being received in 2020; and (5) consider parking investments in deferred annuities.

- **Accelerating Deductions into 2019.** If you expect a decrease in income next year, accelerating deductions into the current year can offset the higher income this year. Some options include: (1) prepaying property taxes in December, keeping in mind the $10,000 limitation on deducting state income and property taxes and the fact that the property taxes must have been assessed in order to be deductible; (2) if you owe state income taxes, making up any shortfall in December rather than waiting until your state income tax return is due (and similarly keeping in mind the $10,000 limitation); (3) making your January mortgage payment in December; (4) making any large charitable contributions in 2019, rather than 2020; (5) selling some or all loss stocks; and (6) if you qualify for a health savings account, setting one up and making the maximum contribution allowable.

Foreign Bank Account Reporting

The IRS has become increasingly aggressive at tracking down individuals who have not reported foreign bank accounts. If you have an interest in a foreign bank account, it must be disclosed; failure to do so carries stiff penalties. You must file a Report of Foreign Bank and Financial Accounts (FBAR) if: (1) you are a U.S. resident or a person doing business in the United States; (2) you had one or more financial accounts that exceeded $10,000 during the calendar year; (3) the financial account was in a foreign country; and (4) you had a financial interest in the account or signatory or other authority over the foreign financial account. If you are unclear about the requirements or think they could possibly apply to you, please let me know at your earliest convenience.

Other Considerations

Here are some additional items to consider:

Flexible Spending Accounts. Generally, you will lose any amounts remaining in a health flexible spending account at the end of the year unless your employer allows you to use the account until March 15, 2020, in which case you'll have until then. You should check with your employer to see if the employer gives employees the optional grace period to March 15.

Life Events. Life events can significantly impact your taxes. For example, if you are using head of household or surviving spouse filing status for 2019, but will change to a filing tax status of single for 2020, your tax rate will go up. Thus, accelerating income into 2019 and pushing deductions into 2020 may also yield tax savings.

Individual Healthcare Penalty. For 2019, the tax penalty on individuals who fail to carry health insurance, which was enacted as part of the Affordable Care Act, has been eliminated.

Moving Expense Reimbursement. If you received a reimbursement from your employer for moving expenses incurred in 2019, the reimbursement is taxable income. While taxpayers could previously deduct employment-relating moving expenses, this deduction is no longer available for moves taking place in years 2018-2025, unless you are a member of the U.S. Armed Forces on active duty and move pursuant to a military order to a permanent change of station.

Casualty and Theft Losses. If you incurred a casualty loss in a presidentially declared disaster area in 2019, it may be deductible. Any other casualty loss, along with all theft losses, are not deductible.

Section 199A Passthrough Tax Break. Enacted as part of TCJA, the Section 199A tax break allows a 20 percent deduction for qualified business income from sole proprietorships, S corporations, partnerships, and LLCs taxed as partnerships. If you qualify for the deduction, which is available to both itemizers and nonitemizers, it is taken on your individual tax returns as a reduction to taxable income. The new tax break is subject to some complicated restrictions and limitations, but the rules that apply to individuals with taxable income at or below $160,700 ($321,400 for joint filers; $160,725 for married individuals filing separately) are simpler and more permissive than the ones that apply above those thresholds.

Please call me at your convenience so we can set up an appointment and to estimate your tax liability for the year and determine whether any estimated tax payments may be due before year end.

Sincerely,

Michael David Daniels

http://www.michaelddaniels.com