The Reardon Group

Newsletter

TAX TIPS

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Mid-Year Tax Planning

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To Our Clients and Friends:

Over the past six months, we've digested the many tax law changes brought by the Tax Cuts and Jobs Act (TCJA). These changes bring a host of uncertainties as well as planning opportunities. From lower tax rates to a new deduction for pass-through income, the new tax law may mean more cash in your pocket. This letter presents some tax planning ideas under the TCJA for you to think about this summer while there's sufficient time left in 2018 to take tax-saving actions. Some of the ideas may apply to you, some to family members, and others to your business.

Individual Ideas

Take Advantage of Lower Tax Rates and Investment Gains

Under the TCJA, 2018 ordinary tax rates are generally lower than those for 2017. For example, the top rate has been reduced from 39.6% to 37%. (The remaining six rates are 10%, 12%, 22%, 24%, 32%, and 35%.) Also, the top rate now applies to joint filers whose taxable income is over $600,000 (as opposed to $470,700 for 2017). Some taxpayers who were taxed at 39.6% in 2017 may now find themselves in the 35% or 37% tax bracket.

In other good news, the TCJA didn't change the capital gains rate structure. Therefore, most categories of long-term capital gain are taxed at 0%, 15%, or 20%. The maximum 20% rate applies to joint filers with 2018 taxable income (including long-term gains) above $479,000. Higher-income individuals also can be hit with the 3.8% Net Investment Income Tax (NIIT). The bottom line is that taxpayers falling outside of the top ordinary tax bracket of 37% can be subject to the maximum capital gains rate of 20%.

As you evaluate investments held in your taxable brokerage firm accounts, consider the tax impact of selling appreciated securities (currently worth more than you paid for them) before the end of this year. For most taxpayers, the tax rate on long-term capital gains is still much lower than the rate on short-term gains. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling to qualify for the lower long-term gain tax rate.

Also, taxpayers who expect to be subject to a higher capital gain rate after 2018 should consider selling profitable long-term investments in 2018 to take advantage of this year's rate. The proceeds and tax savings could be used to help fund a traditional IRA (possibly deductible) or Roth IRA to postpone or eliminate future taxes.

New Standard Deduction versus Itemized Deductions

For 2018, joint filers can enjoy a standard deduction of $24,000 (versus $12,700 for 2017). The new standard deduction for heads of household is $18,000, and single taxpayers (including married taxpayers filing separately) can claim a standard deduction of $12,000. However, the TCJA suspends the deduction for personal exemptions.

If you typically claim the standard deduction (as opposed to itemizing deductions), chances are your tax bill will decrease for 2018. Although personal exemption deductions are no longer available, a larger standard deduction, combined with lower tax rates and an increased child tax credit (see later discussion), may result in less taxes.

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However, if you usually itemize deductions, the larger standard deduction may change this as the TCJA eliminates or limits many of the itemized deductions.

Note: Depending on your circumstances, we may need to adjust your estimated quarterly tax payments. This is a good time to check if you're on track to have the right amount of federal income tax withheld from your paychecks in 2018. You can correct any discrepancies by turning in a new Form W-4 (Employee's Withholding Allowance Certificate) to your employer.

Maximize Home Mortgage Interest Deductions

Before the TCJA, taxpayers could deduct interest paid on up to $1 million ($500,000 if married filing separately) of home acquisition debt (debt used to buy or substantially improve a first or second home). Also, taxpayers could deduct interest paid on up to $100,000 ($50,000 if married filing separately) of home equity debt, regardless of how the proceeds were used. The TCJA cuts those numbers back significantly.

For 2018–2025, the TCJA reduces the limit on home acquisition debt to $750,000. For married taxpayers filing separately, the debt limit is halved to $375,000. Also, the TCJA generally disallows home equity debt interest. However, the IRS recently advised homeowners that interest paid on home equity loans and lines of credit may be deductible if the funds are used to buy, build, or substantially improve the taxpayer's home that secures the loan. In other words, such loans will be treated as home acquisition debt subject to the new $750,000/$375,000 limits.

Thanks to a set of grandfather rules, the new limits don't apply to home acquisition debt that was taken out on or before 12/15/17 (or taken out on or before that date and refinanced later). This is good news for existing homeowners. However, if you have a home equity loan or line of credit, we will need to trace how the proceeds were used to determine if the interest is still deductible under the new law.

In addition, it may be beneficial to refinance your home using an interest-only mortgage. For example, if you refinance $1 million of pre-TCJA home acquisition debt with a new $1 million interest-only loan, you can continue to deduct all the interest under the grandfather rules. In contrast, if you gradually make principal payments on your $1 million of pre-TCJA home acquisition debt, you won't be able to treat any portion of an additional home loan taken in 2018–2025 as home acquisition debt because your existing loan will absorb the entire $750,000 TCJA limit.

Take Advantage of the New Child Tax Credit

Under pre-TCJA law, the child tax credit was $1,000 per qualifying child, but it was reduced for married couples filing jointly by $50 for every $1,000 (or part of $1,000) by which their Adjusted Gross Income (AGI) exceeded $110,000. (The threshold was $55,000 for married couples filing separately and $75,000 for unmarried taxpayers.)

Starting in 2018, the TCJA doubles the child tax credit to $2,000 per qualifying child under age 17. It also allows a new $500 credit (per dependent) for any of your dependents who aren't qualifying children under 17. There is no age limit for the $500 credit, but the tax tests for dependency must be met.

The TCJA also substantially increases the "phase-out" thresholds for the credit. Starting in 2018, the total credit amount allowed for a married couple filing jointly is reduced by $50 for every $1,000 (or part of $1,000) by which their AGI exceeds $400,000. The threshold is $200,000 for all other taxpayers. So, if you were previously prohibited from taking the credit because your AGI was too high, you may now be eligible to claim the credit.

Bunch Charitable Contributions through Donor-advised Funds

The TCJA temporarily increases the limit on cash contributions to public charities and certain private foundations from 50% to 60% of AGI. However, as we mentioned earlier, the standard deduction has almost doubled. Combined with the capping of the state and local tax deduction at $10,000 per year ($5,000 for a married taxpayer filing a separate return), changes to the home mortgage interest deduction, and the elimination of miscellaneous itemized deductions, it's likely that fewer taxpayers will be itemizing in 2018.

One way to combat this is to bunch or increase charitable contributions in alternating years. This may be accomplished by donating to donor-advised funds. Also known as charitable gift funds or philanthropic funds, donor-advised funds allow donors to make a charitable contribution to a specific public charity or community foundation that uses the assets to establish a separate fund. Taxpayers can claim the charitable tax deduction in the year they fund the donor-advised fund and schedule grants over the next two years or other multiyear periods. This strategy provides a tax deduction when the donor is at a higher marginal tax rate while actual payouts from the account can be deferred until later.

Revisit Your Qualified Tuition Plans

Although the details of Qualified Tuition Plans (QTPs) can vary widely, they generally allow parents and grandparents to set up college accounts for children and grandchildren before they reach college age. Once established, QTPs qualify for favorable federal (and often state) tax benefits, which can ease the financial burden of paying for college. QTPs may be particularly attractive to higher income parents and grandparents because there are no AGI-based limits on who can contribute to these plans.

Under pre-TCJA law, the earnings on funds in a QTP could be withdrawn tax-free only if used for qualified higher education at eligible schools. Eligible schools included colleges, universities, vocational schools, or other postsecondary schools eligible to participate in a student aid program of the Department of Education. Thanks to the TCJA, qualified higher education expenses now include tuition at an elementary or secondary public, private, or religious school, up to a $10,000 limit per tax year. So, you may want to revisit your QTPs if you have children or grandchildren who attend elementary or secondary schools.

Watch out for New Alimony Rules

Under the TCJA, certain future alimony payments will no longer be deductible by the payer. Also, alimony will no longer be considered income to the recipient. Therefore, for divorces and legal separations that are executed (that come into legal existence due to a court order) *after* 2018, the alimony-paying spouse won't be able to deduct the payments, and the alimony-receiving spouse doesn't include them in gross income or pay federal income tax on them.

It's important to emphasize that pre-TCJA rules apply to already-existing divorces and separations, as well as divorces and separations that are executed before 2019. However, under a special rule, if taxpayers have an existing (pre-2019) divorce or separation decree, and they have that agreement legally modified, then the new rules don't apply to that modified decree unless the modification expressly provides that the TCJA rules are to apply. There may be situations where applying the TCJA rules voluntarily is beneficial for the taxpayers, such as a change in the income levels of the alimony payer or the alimony recipient. If you're considering a divorce or separation (or modification of an existing divorce decree), please let us know so we can determine the tax consequences.

Consider Investing in Qualified Opportunity Zones

Tucked away in the TCJA is the creation of Qualified Opportunity Zones (QO Zones). These are low-income communities that meet certain requirements. Investing in QO Zones can result in two major tax breaks: (1) temporary deferral of gain from the sale of property and (2) permanent exclusion of post-acquisition capital gains on the disposition of investments in QO Zones held for ten years.

The IRS has already announced the designation of QO Zones in over 20 states and U.S. possessions. It will make future designations as submissions by states are received and certified. The IRS also plans to issue additional information on QO Zones in the future. If you're looking to defer taxable gains while revitalizing low-income communities, QO Zones may be the way to go.

Monitor State Response to Tax Reform

States react differently to changes to federal tax law. For example, some states automatically conform to federal tax law as soon as legislation is passed. Other states require their legislatures to adopt federal tax law as of a fixed date. This generally occurs on an annual basis. There are some states, however, that pick and choose which federal provisions to adopt. Because of this, your state income tax rules may be drastically different than the federal income tax rules. For example, you may be better off claiming the standard deduction for federal tax purposes but itemizing for state income tax purposes. We will need to monitor your state's response to the TCJA and help you minimize your state income tax bill.

Beware of the Alternative Minimum Tax

As tax reform efforts progressed late last year, there were high hopes that the individual Alternative Minimum Tax (AMT) would be repealed. Unfortunately, it still exists under the TCJA. The good news is that you are allowed a relatively generous AMT exemption, which is deducted in calculating your AMT income. The TCJA significantly increases the AMT exemptions for 2018–2025. The exemption is phased out when your AMT income surpasses the applicable threshold, but the TCJA greatly increases those thresholds for 2018–2025. This means that less people will be subject to the AMT rules.

Maximize Your Qualified Business Income Deduction

You may have heard a lot of talk in the news about a new deduction for "pass-through" income, but it's actually available for qualified business income from a sole proprietorship (including a farm), as well as from pass-through entities such as partnerships, LLCs, and S corporations. Under the TCJA, individuals may deduct up to 20% of their qualified business income; however, the deduction is subject to various rules and limitations.

Although there is some uncertainty surrounding this new deduction, there are some planning strategies we can consider. For example, there are ways to adjust your business's W-2 wages to maximize your qualified business income deduction. Also, it may be helpful to convert your independent contractors to employees, assuming the benefit of the deduction outweighs the increased payroll tax burden. Other planning strategies include investing in short-lived depreciable assets, restructuring the business, and leasing or selling property between businesses. We will work with you to determine which strategies produce the best outcome.

Business Ideas

Acquire Assets

Thanks to the TCJA, this is a great time to acquire business assets. Your business may be able to take advantage of very generous Section 179 deduction rules. Under these rules, businesses can elect to write off the entire cost of qualifying property rather than recovering it through depreciation. The maximum amount that can be expensed this year is $1 million (up from $510,000 for 2017). This amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $2.5 million (up from $2.03 million for 2017). But, there's more good news. The Section 179 deduction is now available for certain tangible personal property used predominantly to furnish lodging and certain improvements to nonresidential real property (roofs, HVAC, fire protection systems, alarm systems, and security systems).

Note: Watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction. This is because you can't claim a Section 179 write-off that would create or increase an overall business tax loss. Please contact us if you think this might be an issue for your business.

Above and beyond the Section 179 deduction, your business also can claim first-year bonus depreciation. The TCJA establishes a 100% first-year deduction for qualified property acquired and placed in service after 9/27/17 and before 1/1/23 (1/1/24 for certain property with longer production periods). Unlike under prior law, this provision applies to new and used property. The bonus percentage will phase down for years 2023 through 2026.

Note that 100% bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2018 tax year. Under the TCJA, the NOL generally can't be carried back to an earlier tax year. However, it can be carried forward indefinitely. Unfortunately, NOLs arising in tax years beginning after 2017 can't reduce taxable income by more than 80%.

Given these generous provisions, your asset acquisition plan is more important than ever. If you're planning on acquiring a business, we suggest you pursue an asset acquisition rather than a stock deal. Also, there may be reasons to elect out of bonus deprecation or use different expensing techniques in individual tax years. Monitoring each State's response to this tax reform provision may become a crucial factor in the decision making process.

Watch out for New Business Interest Expense Limit

Regardless of its form, every business will be subject to a net interest expense disallowance. Starting in 2018, net interest expense in excess of 30% of your business's adjusted taxable income will be disallowed. However, your business won't be subject to this rule if its average annual gross receipts for the prior three years is $25 million or less. Also, real property trades or businesses can choose to have the rule not apply if they elect the Alternative Depreciation System (ADS) for real property used in their trade or business. Since ADS is a slower way to depreciate property, real property trades or businesses will need to look at the trade-off between currently deducting their business interest expense and deferring depreciation expense. If you find yourself in this predicament, we can model out both scenarios to determine the best course of action.

Determine Eligibility for Credit for Employer-paid Family and Medical Leave

The TCJA establishes a new credit for employer-paid family and medical leave. The credit is for tax years beginning in 2018 and 2019 and is equal to 12.5% of the amount of wages paid to qualifying employees on family and medical leave. However, the employer must pay at least 50% of the wages normally paid to the employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percent by which the payment rate exceeds 50%. This could be a valuable incentive for your business.

Conclusion

As we said at the beginning, this letter is to get you thinking about tax planning moves for the rest of the year. This year is definitely unique given the numerous tax law changes brought by the TCJA. Even with uncertainty about some of the TCJA's provisions, there are things you can do to improve your or your business's situation. Please don't hesitate to contact us if you want more details or would like to schedule a tax planning session.

Jean, Shawn and the Staff of Weiss + Reardon & Company, P.C.

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