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Midyear Tax Planning Letter

To Our Clients and Friends:

It's hard to believe that about 18 months have passed since President Trump signed into law the Tax Cuts and Jobs Act (TCJA)—the largest major tax reform in over three decades. As the IRS continues to release guidance on the new law, we discover tax planning opportunities that could put more cash in your pocket. Some of these opportunities may apply to you, some to family members, and others to your business. Here are some ideas to evaluate this summer while you have time to think.

Consider Adjusting Your Tax Withholding or Estimated Payments

Some taxpayers were surprised they owed taxes this year (or they received a substantially lower refund). In many cases, this was because they didn't adjust their tax withholding or estimated payments to account for tax law changes. For those accustomed to receiving refunds every year, an unexpected tax bill can be a real hardship. Fortunately, there's still time to make sure the right amount of federal income tax is being withheld from your paychecks for 2019.

IRS Form W-4 is used to tell your employer how much tax to withhold from each paycheck. If you owed taxes for 2018, you may want to decrease the number of allowances claimed on Form W-4. To help determine the number of allowances you should report, consider using the IRS's "Withholding Calculator" available at **www.irs.gov**. You will need your most recent pay stubs and a copy of your completed 2018 tax return. However, keep in mind that the calculator isn't perfect. If you want more precise results, we would be happy to put together a 2019 tax projection for you. Also, if you pay estimated tax payments throughout the year (you're self-employed, for example), we can take a closer look at your tax situation for 2019 to make sure you're not underpaying or overpaying.

Pay Attention to Filing Status

For married couples, filing a joint return usually produces the best tax results. However, if one spouse has substantial unreimbursed medical expenses, he or she may pay less tax by choosing a "married filing separately" status (assuming deductions are itemized by *both spouses* on their respective returns). That's because for 2019, only medical expenses that exceed 10% of adjusted gross income are deductible. By filing separately, the spouse generally lowers his or her adjusted gross income, which allows a larger deduction for medical expenses. However, in community property states (like Texas and California), income and expenses generally must be split equally unless they're attributable to separate funds.

Take Advantage of Lower Tax Rates on Investment Income

Income from an investment held for more than one year is generally taxed at preferential capital gains rates. Those rates are 0%, 15%, and 20% for most investments. (Higher-income individuals may be subject to an additional 3.8% net investment income tax.) The rate that applies is determined by your taxable income. For example, the 0% rate applies if your 2019 taxable income doesn't exceed $78,750 (for joint filers), $52,750 (for heads of household), or $39,375 (for other individuals). The 20% rate doesn't kick in until your taxable income exceeds $488,850 (for joint filers), $461,700 (for heads of household), or $434,550 (for other individuals).

If your taxable income hovers around these threshold amounts, there are ways to reduce your income to take advantage of a lower capital gains rate. For example, you could make deductible IRA contributions or reduce taxable wages by deferring bonuses or contributing to employer retirement plans. If possible, you should get your income low enough to qualify for the 0% rate.

If your income is too high to benefit from the 0% rate, try gifting investments (like appreciated stock or mutual fund shares) to children, grandchildren, or other loved ones. Chances are these individuals will be in the 0% or 15% capital gains tax bracket. If they later sell the investments, any gain will be taxed at the lower rates, as long as you and your loved one owned the investments for more than one year. This strategy has two risks, however. First, there are gift tax consequences if you transfer assets worth over $15,000 during 2019 to a single recipient. Second, all children under age 18 and most children age 18 or age 19–23 who are full-time students are subject to the “kiddie tax” rules. The kiddie tax limits the opportunity for parents to take advantage of the 0% capital gain rate by gifting appreciated property to their children, including college age children. Please contact us if you have any questions.

Find Ways to Defer Income

If you expect to be in the same or lower tax bracket in 2020, it might be beneficial to defer some taxable income until next year. For example, if you own a business and use the cash method of accounting, you can wait until the end of the year to send out some client invoices. That way, you won’t receive payments until early 2020. Also, you can postpone taxable income by accelerating some deductible expenses this year. This may be helpful if you’re affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (higher education tax credits, for example).

Invest in a Qualified Small Business Corporation

C corporations, including Qualified Small Business Corporations (QSBCs), received a huge tax cut under the TCJA—a flat 21% tax rate. (Under previous law, the top rate was 35%.) A QSBC is generally a domestic C corporation whose assets don’t exceed $50 million. In addition, 80% or more of the corporation’s assets must be used in the active conduct of a qualified business. There are other requirements as well, but we can fill in the details if you decide a QSBC might be right for you.

By far the biggest benefit of owning QSBC stock is the ability to shelter 100% of the gain from a stock sale. Another major benefit is the ability to roll over (defer) the gain on a stock sale to the extent you acquire replacement QSBC stock within 60 days of the original sale. You must have held the stock for more than six months to take advantage of this break. When combined with the new 21% tax rate, these benefits can make operating a business as a QSBC more tax-efficient than operating it as a pass-through entity (sole proprietorship, partnership, LLC, or S corporation).

Invest in a Qualified Opportunity Fund

Added by the TCJA, Qualified Opportunity Funds (QOFs) are entities that invest in certain low-income communities (known as *qualified opportunity zones*). They provide unique planning opportunities for investors who have gains to defer. To become a qualified opportunity zone, a community must be nominated by a state or U.S. possession and certified by the Treasury Department as qualifying for this program. To see a list of current qualified opportunity zones, see **www.cdfifund.gov/Pages/Opportunity-Zones.aspx**.

There are two major tax benefits of investing in qualified opportunity zones. The first one is an election to temporarily defer gain from the sale of property if such gain is reinvested in a QOF. The second benefit is an election to permanently exclude from income post-acquisition capital gains on the disposition of QOF investments held for ten years. QOFs are a hot topic right now, so please contact us if you’re interested in these types of investments.

Re-evaluate Your Deduction Strategy

It's best to itemize your deductions if you have significant personal expenses. However, don't rule out the standard deduction. For 2019, joint filers can enjoy a standard deduction of $24,400. The standard deduction for heads of household is $18,350, and single taxpayers (including married taxpayers filing separately) can claim a standard deduction of $12,200.

Unfortunately, the TCJA suspended or limited many of the itemized deductions. For example, the deduction for state and local taxes is limited to $10,000 ($5,000 if married filing separately). To combat this, several states enacted programs that provide state tax credits to individuals who contribute to charitable funds. As expected, the IRS issued regulations that require taxpayers to reduce their charitable contribution deduction by the amount of any state or local tax credit received. Fortunately, the IRS also released guidance that generally allows taxpayers to treat payments disallowed as charitable contribution deductions under the regulations as state or local taxes. This guidance applies retroactively to the 2018 tax year, so there may be an opportunity to amend your return and claim a refund. We will contact you if this new guidance benefits you.

The TCJA also temporarily increased the limit on cash contributions to public charities and certain private foundations from 50% to 60% of adjusted gross income. However, with the increased standard deduction and limits on itemized deductions, it's likely that fewer taxpayers will be able to deduct charitable contributions for 2019.

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. If you have questions or want more information on donor-advised funds, please give us a call. We welcome the opportunity to help you put together a charitable giving plan that suits your goals.

Set up a Qualified Tuition Plan

Although the details of Qualified Tuition Plans (QTPs) can vary widely, they generally allow parents and grandparents to set up college savings 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 income-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, this is the perfect time to set up a QTP if you have children or grandchildren who attend elementary or secondary schools.

Planning for Small Businesses

If you own a business, consider the following strategies to minimize your tax bill for 2019.

Maximize Your Qualified Business Income Deduction. Thanks to the TCJA, business owners may deduct up to 20% of their qualified business income from sole proprietorships and pass-through entities (such as partnerships, LLCs, and S corporations). The deduction, however, is subject to various rules and limitations based on your taxable income, the type of business you operate, and your business's W-2 wages and property. The good news is that there are certain planning strategies that can be considered now to maximize your deduction.

Since the deduction may be limited by your business's W-2 wages, it may be helpful to increase year-end bonuses or convert independent contractors to employees (assuming the benefit of the qualified business income deduction outweighs the increased payroll tax burden). Also, if your deduction is limited because your taxable income is too high, consider reducing your income by (1) contributing to an employer retirement plan, (2) making deductible IRA contributions, (3) contributing to a health savings account, (4) deferring business income or accelerating business expenses, or (5) using donor-advised funds to effectively deduct charitable donations for several years within a single tax year.

If you own rental real estate, your activities may qualify for the deduction. Under guidance issued by the IRS, rental real estate is eligible for the deduction if you keep separate books and records for the activity; perform 250 or more hours of rental services per year; and maintain reports, logs, or similar documents that show the hours of all services performed, a description of all services performed, the dates on which the services were performed, and who performed the services. If you don't meet these requirements, it's still possible that your rental activities qualify for the deduction. We would have to perform a more in-depth analysis to make sure the activities rise to the level of a trade or business.

Acquire Assets. 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 for 2019 is $1.02 million. This amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $2.55 million.

Above and beyond the Section 179 deduction, your business also can claim first-year bonus depreciation. The TCJA established 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.

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. We can help with that.

Employ Your Kid. If you're self-employed, you might want to consider hiring your child as an employee. Doing so shifts income (which isn't subject to the kiddie tax) from you to your child, who normally is in a lower tax bracket or may avoid tax entirely due to the standard deduction. There also can be payroll tax savings since wages paid by sole proprietors to their children age 17 and younger are exempt from Social Security, Medicare, and federal unemployment taxes.

Employing your children has the added benefit of providing them with earned income, which enables them to contribute to an IRA. Children with IRAs, particularly Roth IRAs, have a great start on retirement savings since the compounded growth of the funds can be significant. Remember a couple of things when employing your child. First, the wages paid must be reasonable given the child's age and work skills. Second, if the child is in college or entering soon, too much earned income can have a detrimental impact on the student's need-based financial aid eligibility.

Please Contact Us

As we said at the beginning, this letter is to get you thinking about tax planning moves for the rest of the year. Even though the IRS continues to publish guidance on the TCJA, there are things you can do now to improve your tax situation. Please don’t hesitate to contact us if you want more details or would like to schedule a tax planning session.

Best regards,

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