# 2018 YEAR-END TAX PLANNING FOR INDIVIDUALS

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*Nearly one year later, tax reform is still making headlines and we continue to learn more about its broad implications. Whether your previous tax filing posture was straightforward or complex, you will be impacted by the myriad of changes to the tax code. Now more than ever, it is imperative to thoughtfully consider year-end tax planning opportunities and ensure you are positioned to be in compliance with the new rules.*

2018 year-end tax planning begins with a projection of your estimated income, deductions and tax liabilities for 2018 and 2019. You should review actual amounts from 2017 to assist you with these projections. There may be opportunities to accelerate or defer income or deductions to optimize your total tax liability. This *Year-End Tax Planning for Individuals Letter (Tax Letter)* is written to help you do just that.

We have outlined the key topics impacting individual taxpayers in the below *Tax Letter*. Tax planning for individuals also requires consideration of the tax consequences from any businesses conducted directly or indirectly by individual owners.

Finally, this *Tax Letter* focuses on planning for federal income taxes, however, state taxes should also be considered. Please consult your advisor to discuss your personal state tax filing responsibilities.

## On Tax Reform

On December 22, 2017, President Trump signed sweeping federal tax reform into law. Tax reform has significantly changed the U.S. tax system for both individuals and businesses. Some of the most impactful measures from tax reform affecting individuals include:

- The suspension of most itemized deductions
- The near-doubling of the standard deduction
- The $10,000 cap on the state and local income and property tax deduction
- The suspension of personal exemptions
- The Section 199A deduction for pass-through business owners
- The increase of alternative minimum tax (AMT) exemptions for individuals
- The new individual income tax rates and brackets

## 2018 Versus 2019 Marginal Tax Rates

Whether you should defer or accelerate income and deductions between 2018 and 2019 depends to a great extent on your projected marginal (highest) tax rate for each year. With the compression of income tax rates starting in 2018, you should analyze your anticipated marginal tax rates for 2018 and 2019.

The highest marginal tax rate for 2018 is 37 percent, with an additional 3.8 percent tax on the net-investment income of high-income taxpayers.

# Shifting Income and Deductions into the Most Advantageous Year

You can shift taxable income between 2018 and 2019 by controlling the receipt of income and the payment of deductions. Generally, income should be received in the year with the lower marginal tax rate, while deductible expenses should be paid in the year with the higher marginal rate. If your top tax rate is the same in 2018 and 2019, deferring income into 2019 and accelerating deductions into 2018 will generally produce a tax deferral of up to one year. On the other hand, if you expect your tax rate to be higher in 2019, you may want to accelerate income into 2018 and defer deductions to 2019. Keep in mind, however, that the aforementioned tax reform repeals most itemized deductions.

Planning Suggestion: the time value of money should be considered when making a decision to defer income or accelerate deductions. Comparative computations should be made to determine and evaluate the net after-tax result of these financial actions.

## Controlling Income

Income can be accelerated into 2018, or deferred to 2019, by controlling the receipt of various types of income depending on your situation, such as:

For Business Owners

- Year-end interest or dividend payments from closely-held corporations
- Rents and fees for services (delay December billings to defer income)
- Commissions (close sales in January to defer income)

**Caution:** Income cannot be deferred to 2019 if you constructively receive it in 2018. Constructive receipt occurs when you have the right to receive payment or have received a check for payment, even though it has not been deposited. Income also cannot be deferred if you effectively receive the benefit of the income; for example, if you are allowed to pledge a deferred compensation account balance to obtain a loan.

Bonuses that are determined based on work performed in 2018 can be paid during 2018 or in 2019. Payment in 2018 secures the 2018 deduction for the business using either the cash or accrual basis of accounting. Payment in 2019 will delay the deduction for a cash basis business, therefore allowing some flexibility in the year of deduction.

For Investors

- Interest on short-term investments, such as Treasury bills (T-bills) and certain certificates of deposit that do not permit early withdrawal of the interest without a substantial penalty, is not taxable until maturity

**Example:** In November 2018, an investor buys a six-month T-bill. The interest is not taxable until 2019, assuming the T-bill is held to maturity.

## Interest on U.S. Series EE savings bonds

Other than not being taxable until the proceeds are received, interest on issued Series EE bonds may be exempt from tax if the proceeds of the bond are used to pay certain educational expenses for yourself or your dependents, and the requirements of "qualified United States savings bonds" are met.

Planning Suggestion: Consider investments that generate interest exempt from the regular income tax. You must, however, compare the tax-exempt yield with the after-tax yield on taxable securities to determine the most advantageous investment. In addition, some tax-exempt interest may be subject to AMT which could lower the after-tax yield.

Other ways to defer income include installment sales and tax-free exchanges of "like-kind" investment or business property. Following tax reform, such like-kind exchanges apply only to real property and do not apply to exchanges of personal or intangible property.

Planning Suggestion: If you made a 2018 sale that is eligible for installment reporting, you have until the due date of your 2018 return, including extensions, to decide if you do not want to use the installment method and, instead, report the entire gain in 2018

## Net Investment Income Tax

The Health Care and Education Reconciliation Act imposes an additional 3.8 percent tax (net investment income tax) on net investment income in excess of certain thresholds for taxable years beginning after December 31, 2012. The 3.8 percent tax is applicable to taxpayers with modified adjusted gross income for 2018 exceeding $250,000 for married couples and surviving spouses, $125,000 for married individuals filing separate returns, and $200,000 for single individuals and head of household filers. The tax is 3.8 percent of the lesser of your net investment income or the excess of your modified adjusted gross income over the applicable threshold amount stated above. This tax is also likely to apply to a significant portion of the net investment income of an estate or trust that is otherwise subject to income tax on such income. The suspension of most itemized deductions under tax reform eliminates the use of such itemized deductions against net investment income for tax years beginning in 2018 and ending before 2026.

Planning Suggestion: We strongly encourage you to consult your investment and tax advisors to maximize the after-tax returns if you believe your portfolio may not be currently aligned to account for increased tax exposure.

## For Employees

Year-end bonuses and deferred compensation

**Caution:** The Service will scrutinize deferrals of income between owner-employees and their closely-held corporations. Additionally, if you own more than 50 percent of a taxable (C) corporation or any stock of an S corporation that reports its income on an accrual method of accounting, the corporation can deduct a year-end bonus to you only when it is paid. Also, any deferred compensation arrangements must comply with the Section 409A rules discussed later in this letter. These rules may prevent a reduction of 2018 taxable income by deferral but elections can be made before December 31, 2018, that affect your 2019 taxable income.

**Planning Suggestion**: Determine if you would like to avoid 2019 taxation of your 2019 compensation and make the appropriate deferral election before the end of 2018.

**Additional Planning**: Evaluate existing deferred compensation arrangements and the stated distribution schedule. If distributions are not scheduled to begin within the next 12 months, consider a second deferral of five additional years.

The impact of the tax reform changes on your effective tax rate should be carefully evaluated before deferring income.

**Planning Suggestion**: If you are a shareholder in an S corporation, you might be able to reduce the Medicare and Social Security tax by reducing your salary. However, reasonable compensation must be paid to S corporation shareholders for services rendered to the S corporation.

## IRA distributions

If you are planning to make a charitable gift, individuals aged 70 ½ or older can donate money from their IRA account directly to a charitable organization without the gift counting as income. Qualified charitable distributions can also satisfy all or part of your required minimum distribution from your IRA.

## Educational expense exclusion

An exclusion for employer-provided education benefits for non-graduate and graduate courses up to $5,250 per year is available.

## Controlling Deductions

High-earning taxpayers will once again be able to take itemized deductions that were limited under Pease, however with the increased standard deduction, a taxpayer's amount of total deductions must generally be greater than $12,000 for single individuals and $24,000 for married couples filing jointly before they incur the benefit of itemizing deductions.

Deductions that may be accelerated into 2018 or deferred to 2019 include:

## Charitable contributions (cash or property)

You must obtain written substantiation from the charitable organization, in addition to a canceled check, for all charitable donations in excess of $250.

Charities are required to inform you of the amount of your net contribution where you receive goods or services in excess of $75 in exchange for your contribution.

If the value of contributed property exceeds $5,000, you must obtain a qualified written appraisal (prior to the due date of your tax return, including extensions), except for publicly-traded securities and non-publicly-traded stock of $10,000 or less.

**Planning Suggestion**: If you are considering contributing marketable securities to a charity and the securities have declined in value, sell the securities first and then donate the sales proceeds. You will obtain both a capital loss and a charitable contribution deduction.

**Caution:** If you are contemplating the repurchase of the security in the future, you need to consider the wash sale rules discussed.

On the other hand, if the marketable securities or other long-term capital gain property have appreciated in value, you should contribute the property in kind to the charity. By contributing the property in kind, you will avoid taxes on the appreciation and receive a charitable contribution deduction for the property's full fair market value.

Consider making a large contribution to a donor advised fund in one year to maximize your itemized deductions. You can then make distributions from the fund to multiple charities over several years. This will allow you to take the full charitable deduction in one year but spread out the contributions to multiple charities over time.

If you volunteer time to a charity, you cannot deduct the value of your time, but you can deduct your out-of-pocket expenses. If you use your automobile in connection with performing charitable work, including driving to and from the organization, you can deduct 14 cents per mile for 2018. You must keep a record of the miles.

The allowable deduction for donating an automobile (also, a boat and airplane) is significantly reduced. The deduction for a contribution made to a charity, in which the claimed value exceeds $500, will be dependent on the charity's use of the vehicle. In addition, greater substantiation requirements are also imposed on property contributions.

Tax reform increased the adjusted gross income limitation for cash contributions to a public charity beginning in 2018 from 50 percent of adjusted gross income to 60 percent of adjusted gross income.

### Medical expenses

In addition to medical expenses for doctors, hospitals, prescription medications, and medical insurance premiums, you may be entitled to deduct certain related out-of-pocket expenses such as transportation, lodging (but not meals), and home healthcare expenses. If you use your car for trips to the doctor during 2018, you can deduct 18 cents per mile for travel during 2018. Payments for programs to help you stop smoking and prescription medications to alleviate nicotine withdrawal problems are deductible medical expenses. Uncompensated costs of weight-loss programs to treat diseases diagnosed by a physician, including obesity, are also deductible medical expenses.

In 2018, the deduction is limited to the extent your medical expenses exceed 7.5 percent of your adjusted gross income. In 2019, the limit will be increased to 10 percent.

Planning Suggestion: If you pay your medical expenses by credit card, the expense is deductible in the year the expense is charged, not when you pay the credit card company. It is important to remember that prepayments for medical services generally are not deductible until the year when the services are actually rendered. Because medical expenses are deductible in 2018 only to the extent they exceed 7.5 percent of AGI as discussed above, they should, where possible, be bunched in a year in which they would exceed this AGI limit.

Under certain conditions, if you provide more than half of an individual's support, such as a dependent parent, you can deduct the unreimbursed medical expenses you pay for that individual to the extent all medical expenses exceed the applicable AGI limit. Even if you cannot claim that individual as your dependent because his or her 2018 gross income is $4,150 or more, you are still entitled to the medical deduction. Please consult your advisor for details.

### Long-term care insurance and services

Premiums you pay on a qualified long-term care insurance policy are deductible as a medical expense. The maximum amount of your deduction is determined by your age.

Medical payments for qualified long-term care services prescribed by a licensed healthcare professional for a chronically ill individual are also deductible as medical expenses.

### Interest paid on qualified education loans

An "above-the-line" deduction (a deduction to arrive at AGI) is allowed for interest paid on qualified education loans. All student loan interest up to the $2,500 annual limit is deductible. However, in 2018 this deduction begins to phase out for single individuals with modified AGI of $65,000 and is completely phased out if AGI is $80,000 or more ($135,000 to $165,000 for joint returns).

**Caution:** Interest paid to a relative or to an entity (such as a corporation or trust) controlled by you or a relative does not qualify for the deduction.

### Retirement plan contributions

If your employer (including a tax-exempt organization) has a 401(k) plan or 403(b) plan consider making elective contributions up to the maximum amount of $18,500 ($24,500 if over age 50) in 2018, especially if you are unable to make contributions to an IRA. You should also consider making after-tax, nondeductible contributions to a 401(k) plan if the plan allows, as future earnings on those contributions will grow tax-deferred. A nondeductible contribution to a Roth IRA can also be considered.

Planning Suggestion: If you are a participant in an employer's qualified plan that allows employee contributions such as a 401(k) plan and are at least 50 years old, you can elect to make a deductible "catch-up" contribution of $6,000 to the plan (for a $24,500 maximum contribution). To make a "catch-up" contribution, your employer's plan must allow such contributions.

### IRA deductions

The total allowable annual deduction for IRAs in 2018 is $5,500, subject to certain AGI limitations if you are an "active participant" in a qualified retirement plan. A non-working spouse may also make an IRA contribution based upon the earned income of his or her spouse. A catch-up provision for individuals age 50 or older applies to increase the deductible limit by $1,000 for IRAs to a total deductible amount of $6,500.

Planning Suggestion: Consider making your full IRA contribution early in the year so that income earned on the contribution can accumulate tax-free for the entire year.

Planning Suggestion: If cash flow is a concern, consider the use of credit cards to make tax deductible year-end payments. Note however, interest paid to a credit card company is not deductible because it is personal interest.

### Capital Gains and Losses

Long-term capital gains have a lower tax rate, so investors may consider holding on to assets for over a year to qualify for those taxable rates.

**Note:** Capital gains may also be subject to the 3.8 percent net investment income tax discussed previously.

Capital losses are offset against capital gains. For joint filers, net capital losses of up to $3,000 ($1,500 for married individuals filing separately) can be deducted against ordinary income. Unused capital losses may be carried forward indefinitely and offset against capital gains and up to $3,000 ($1,500 for single filers) of ordinary income annually, in future years.

Planning Suggestion: Add up all capital gains and losses you have realized so far this year, plus anticipated year-end capital gain distributions from mutual funds (this amount should be presently available by calling your mutual fund's customer service number). Then review the unrealized gains and losses in your portfolio. Consider selling additional securities to generate gains or losses to maximize tax benefits.

**Caution:** Do not sell a security simply to generate a gain or loss to offset other realized gains or losses. The investment merits of selling any security must also be considered.

### Dividend Income

Qualified dividend income from domestic corporations and qualified foreign corporations is taxed at the same reduced rates as long-term capital gains for regular tax and AMT purposes.

Planning Suggestion: For taxpayers who are owners of closely-held corporations or a corporation that was converted to an S corporation, there may be some planning opportunities available. Your advisor can be consulted for further guidance.

## Sale of Principal Residence

For sales of a principal residence, up to $500,000 of gain on a joint return ($250,000 on a single or separate return) can be excluded. To be eligible for the exclusion, the residence must have been owned and occupied as your principal residence for at least two of the five years preceding the sale. The exclusion is available each time a principal residence is sold, but only once every two years.

Planning Suggestions: If you want to sell your principal residence but are unable to do so because of unfavorable market conditions, you can rent it for up to three years after the date you move out and still qualify for the exclusion. However, any gain attributable to prior depreciation claimed during the rental period will be taxed at a maximum 25 percent rate.

If you own appreciated rental property that you wish to sell in the future, you may consider moving into the property to convert it to your principal residence. You will need to live in the property for at least two of the five years preceding the sale of the property. As long as you haven't sold another principal residence for the two years prior to the sale, a portion of the gain is excluded. Any gain attributable to prior depreciation claimed will be taxed at a maximum 25 percent rate.

The sale of a principal residence does not qualify for the exclusion if during the five-year period prior to the sale, the property was acquired in a tax-free like-kind exchange.

## Roth IRAs and Education IRAs

### Roth IRAs

Taxpayers with income under certain income limits are permitted to make contributions to a Roth IRA. Unlike regular IRAs, where contributions are deductible and later distributions are taxable, contributions to Roth IRAs are not deductible and later "qualified" distributions are not taxable. Qualified distributions are distributions made five or more years after the Roth IRA is established, provided the distribution is made after the account owner is at least age 59½, has died or become disabled, or uses the money for a first-time home purchase, subject to a $10,000 lifetime cap. If the distribution is not qualified, a portion of the distribution may be included in gross income and may be subject to the 10 percent early withdrawal penalty. The penalty applies on the amount of the distribution that exceeds the taxpayer's contributions to the Roth IRA. Roth IRAs are not subject to the MRD rules that apply to regular IRAs when the owner reaches age 70½.

For 2018, taxpayers can contribute up to $5,500 to a Roth IRA (as long as you have compensation for the year at least equal to the contributed amount). Taxpayers age 50 or older can contribute an additional $1,000. Thus, the limit is $6,500 a year for people who will be age 50 (or older) in the applicable taxable year. The same contribution amounts apply for tax year 2019. However, the maximum contribution allowance must be reduced by any other contributions (deductible or nondeductible) the taxpayer makes to IRAs.

### Coverdell Education Savings Accounts (Education IRAs)

Distributions from an education IRA are not subject to tax to the extent the distributions do not exceed qualified education expenses. Qualified education expenses include elementary, secondary and higher education school expenses. In the year amounts are distributed from an education IRA, the beneficiary is also eligible for an American Opportunity Tax (Hope) Credit or Lifetime Learning Credit provided the same expenses are not used for each credit. Education IRAs can be rolled over, before the beneficiary reaches age 30, to benefit another person in the same family. If the beneficiary does not use the funds for qualified education expenses by age 30, the money must be withdrawn and will be subject to tax and penalty on the portion attributable to the earnings.

Planning Suggestion: Taxpayers who desire a larger nondeductible contribution to an education fund should consider a 529 account. Tax reform expanded the allowable expenses that may be paid from a 529 account to include up to $10,000 of expenses for tuition at an elementary or secondary public, private, or religious school in addition to qualified higher education expenses.

## Moving Expenses

Individuals were previously allowed to deduct qualified moving expenses paid or incurred in connection with starting work in a new location if specific distance and length of service requirements were met that were not reimbursed by an employer. For tax years 2018 through 2025, the new tax law requires employers to report any moving expenses it pays to vendors or employees as taxable wages to the employee and eliminates the employees' deduction for moving expenses.

Expenses related to a move that occurred in 2017 but were paid in 2018 remain tax-free. An exception also applies to military members on active duty who move pursuant to a military order related to a permanent change of station that continues to allow tax - free moving expenses.

## Interest Expense

### Personal Interest

Interest is not deductible on tax deficiencies, car loans, personal credit card balances, student loans (except for taxpayers eligible for the above-the-line deduction for interest paid on qualified education loans), or other personal debts.

### Home Mortgage Interest

A full regular tax deduction is allowed for interest on home acquisition debt used to acquire, construct, or improve a principal or secondary residence to the extent this debt does not exceed $750,000 for joint filers ($375,000 for single filers or married taxpayers filing separate returns). Home acquisition debt incurred on or before December 15, 2017, is grandfathered under the previous $1,000,000 limitation for joint filers ($500,000 for single filers or married taxpayers filing separate returns).

**Caution:** These debts must be secured by the principal or secondary residence such that your home is at risk if the loan is not repaid.

A residence includes a house, condominium, mobile home, house trailer, or boat containing sleeping space, commode, and cooking facilities. If you own more than two residences, you can annually elect which one will be your secondary residence.

### Investment Interest Expense

If you want to add to your investment portfolio through borrowing, consider borrowing from your stockbroker through a margin loan. The interest paid is investment interest expense and will be deductible to the extent of your net investment income (dividends, interest, etc.). Investment interest expense in excess of investment income may be carried forward indefinitely.

Planning Suggestion: Net long-term capital gain (long-term gains over short-term losses) and any qualified dividend income are not included as investment income for purposes of determining how much investment interest expense is deductible, unless you elect to subject the capital gain and dividend income to ordinary income rates.

You might consider switching your investments to those types of investments generating taxable investment income to absorb any excess investment interest expense.

Interest expense, to the extent that it is related to tax-exempt income, is not deductible. Interest expense relating to a passive activity, such as a limited partnership investment, is subject to the passive loss limitations on deductibility.

## Allocation Rules

Interest payments are generally allocated among the various categories - personal interest, home mortgage interest, investment interest, etc. - based on the ultimate use of the loan proceeds.

**Example:** An individual borrows $25,000 on margin and uses the proceeds to purchase an automobile for personal use. The interest expense is treated as personal interest.

The Service has issued complex regulations for determining how these allocations are made, which may require maintaining separate bank accounts or other records. Your advisor can help you maximize tax deductions for your interest payments.

## Miscellaneous Deductions

The 2017 tax reform suspended most miscellaneous itemized deductions for tax years 2018 through 2025, including:

- Deductions for employee business expenses
- Tax preparation fees
- Investment expenses, including investment management fees
- Employment related educational expenses
- Job search expenses
- Hobby losses
- Safe deposit box fees
- Investment expenses from pass-through entities

Previously, unreimbursed employee business expenses, investment expenses, personal tax advice and preparation fees, and most other miscellaneous itemized deductions, were deductible only if they exceed 2 percent of AGI.

## Business Meals and Entertainment

Beginning in 2018, the tax act eliminated the deduction for unreimbursed employee expenses. Therefore, it is important for employees to comply with their employer's documentation and other policies in order to receive reimbursement of expenses incurred for all business expenses including meals and entertainment.

If you own a business, the deduction for the cost of client entertainment is no longer allowed for 2018 and beyond as a result of tax reform. The IRS confirmed in Notice 2018-76 that businesses can generally continue to deduct 50 percent of the cost of business meals, including those incurred while meeting with or entertaining customers and clients.

Until proposed regulations are effective taxpayers may deduct an otherwise allowable business expense under Notice 2018-76 if:

- The expense is an ordinary and necessary expense under Section 162(a) paid or incurred during the taxable year in carrying on any trade or business.
- The expense is not lavish or extravagant under the circumstances.
- The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages.
- The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact.

In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

## Leased Automobiles

In prior years, the Service permitted salaried employees with unreimbursed business expenses as well as self-employed sole proprietors, partners, and S corporation shareholders to deduct only actual expenses incurred with respect to leased automobiles. Now, the Service allows taxpayers, beginning in the first year a leased automobile is placed in service, to use the standard mileage rate for business activity (54.5 cents per mile for travel during 2018).

**Planning Suggestion: Consider claiming the standard mileage rate for leased automobiles. There is less recordkeeping, and the standard mileage rate may result in a larger deduction.**

## Alimony Provision

For divorce or separation agreements entered into after December 31, 2018, the deduction for alimony or separate maintenance payments is repealed. When the divorce needs to be executed by for the alimony deduction depends on state law, individuals should consult their attorneys.

## State and Local Deduction

Tax reform introduced a $10,000 cap on the itemized deduction for state and local, sales, income or property taxes (SALT) for tax years beginning in 2018 and before 2026. While the limitation impacts all individual taxpayers, it will especially impact taxpayers who will file returns in states with high income and property taxes, including New York, New Jersey, Connecticut, California, Maryland, and Oregon, and married couples (regardless of whether they file jointly or separately).

The cap limits taxpayers' SALT deductions to $10,000 per return, and married taxpayers who file separately can only deduct up to $5,000 each, for itemized deductions. The cap does not apply to deductions resulting from a trade or business.

## Standard Deduction

A significant change for individuals resulting from tax reform was the near doubling of the standard deduction amounts. However, individual tax reform is temporary and is scheduled to sunset in 2026. Your advisor can assist you in adapting to the temporary changes based on your individual circumstances. Where individuals can strategically increase their itemized deductions, including by using their retirement plan contribution if they are charitably inclined, they should consider contributing.

The 2018 standard deduction is:

| Filing Status | Amount |
|---|---|
| Single | $12,000 |
| Married filing joint return and qualifying surviving spouse with dependent child | $24,000 |
| Married filing separate return | $12,000 |
| Head of household | $18,000 |

An additional $1,300 standard deduction may be claimed by a married taxpayer who is at least 65 years old or blind for tax year 2018. In 2018, a total additional deduction of $2,600 ($1,600 by a single taxpayer) standard deduction can be claimed if the taxpayer is at least 65 years old and blind.

**Planning Suggestion: A taxpayer benefits from itemizing deductions only if the deductions exceed the standard deduction. If your itemized deductions fluctuate from year to year, consider bunching your itemized deductions in one year and claiming the standard deduction in other years.**

## Personal Exemptions

The deduction for personal exemptions is suspended through 2025; however, the $100 and $300 exemptions for complex and simple trusts, respectively, were retained.

The $4,150 exemption for qualified disability trusts was also retained but is to be adjusted for inflation in future years.

# Passive Activities, Rental and Vacation Homes

Losses from passive activities (which, as discussed below, generally include the rental of real estate) are deductible only against passive income. Passive losses cannot be used to reduce non-passive income, such as compensation, dividends, or interest. Unused passive losses are carried over to future years and can be used to offset future passive income. Any remaining loss is deductible when the activity, which gave rise to the passive loss, is disposed of in a transaction in which gain or loss is recognized.

A passive activity is one in which the taxpayer does not materially participate. Material participation is involvement in operations on a regular, continuous, and substantial basis. You are considered to materially participate in an activity if, for example:

- You participate in the activity for more than 500 hours in the taxable year.
- Your participation for the taxable year was substantially all of the participation in the activity.
- You participated for more than 100 hours during the taxable year, and you participated at least as much as any other individual for that year.

In determining material participation, a spouse's participation can be taken into account. Limited partners are presumed not to materially participate in the partnership's activity.

Rental activities are generally considered passive.

If you think you may be affected by the passive loss rules, you should consider speaking with your advisor. In certain cases with proper planning, the adverse effect of these rules may be minimized.

## Vacation Homes

Expenses of a rental property are deductible, even if they exceed gross rents and produce a loss. However, the current deduction of such a loss may be restricted due to the passive activity rules discussed above. A vacation home is treated as rental property if personal use during the year does not exceed the greater of:

- 14 days, or
- 10 percent of the number of days the home is rented at a fair rental value.

If personal use exceeds these limits, the property is considered to be a residence. In that event, the deductibility of expenses is limited, although property taxes, mortgage interest, and casualty losses can generally be deducted currently.

**Planning Suggestion: If you rent your home for less than 15 days during the year, the total rental income you receive is not subject to income tax.**

## Disposition of Leasehold Improvements

When a lessor disposes of leasehold improvements upon termination of a lease, the lessor can generally write off the adjusted basis of those improvements.

<u>Planning Suggestion</u>: If you have leases terminating early in 2019 where there is substantial remaining basis in the leasehold improvements, it may make sense to provide the lessees with an incentive to leave before the end of 2018 so that you can write off the remaining basis in the applicable leasehold improvements before the end of 2018.

## Section 199A

Tax reform lowered the corporate tax rate to a flat rate of 21 percent. In turn, under the new law (under Section 199A), for taxable years beginning after December 31, 2017, taxpayers other than C corporations with taxable income (before computing the Qualified Business Income (QBI)) at or below the threshold amount, are entitled to a deduction equal to the lesser of:

1. The combined QBI amount of the taxpayer, or

2. An amount equal to 20 percent of the excess, if any, of the taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for such taxable year.

The combined QBI amount is generally equal to the sum of (A) 20 percent of the taxpayer's QBI with respect to each qualified trade or business plus (B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership (PTP) income of the taxpayer for the taxable year. The Section 199A deduction may reduce a pass-through owner's maximum individual effective tax rate from 37 percent to 29.6 percent. It is critical to begin evaluating the extent the pass-through owner will be eligible for this deduction.

## Alternative Minimum Tax

A taxpayer must pay either the regular income tax or the AMT, whichever is higher. The AMT tax system is parallel to the regular tax, but it treats some items of income and deduction differently.

The established exemption amounts for 2018 are $70,300 for unmarried individuals and individuals claiming the head of household status, $109,400 for married individuals filing jointly and surviving spouses, and $54,700 for married individuals filing separately. These exemption amounts are significantly higher than in prior years (in 2017 the amounts were $54,300 for unmarried individuals and individuals claiming head of household status, $84,500 for married individuals filing jointly and surviving spouses, and $42,250 for married individuals filing separately). Further, with the introduction of the SALT deduction cap and end of miscellaneous itemized deduction for 2018 through 2025, the likelihood that an individual taxpayer will be subject to AMT is low.

With increased AMT exemptions for individuals, such taxpayers are likely to use more of the R&D credits passing through to them from their businesses.

The exemption for estates and trusts was unchanged by tax reform at $24,600.

A full discussion of the AMT is beyond the scope of this letter. AMT considerations are exceedingly complex and require careful planning. Please consult your advisor prior to year-end to discuss how the AMT might affect you.

# Stock Options

## Incentive Stock Options

An incentive stock option (ISO) is an option issued to an employee that allows all increases in value to be subject to long-term capital gain treatment if the taxpayer disposes of the option shares more than two years after the date the option is granted and more than one year after the date the option shares are purchased. Also, the employee must continue to be an employee until at least three months before the option is exercised. If these rules are not met, a portion of the gains from ISOs are ordinary income subject to federal tax rates as high as 37 percent.

However, there is a hidden cost to obtaining long-term capital gain treatment from an ISO. The "spread" (the difference between the fair market value of the shares on the purchase date and the option price paid for the shares) must be added into the taxpayer's AMT calculation for the year the options are exercised. Any AMT attributable to the ISO spread generally is allowed as an AMT credit carryforward to offset regular taxes owed in future years. Thus, any AMT attributable to the ISO is effectively a prepayment of tax, not additional tax.

Planning Suggestion: If you are planning to exercise ISOs before December 31, 2018, that trigger AMT, consider deferring the exercise until early in 2019. Any AMT on such exercise would likely not be due until April 15, 2020, after the required one-year holding period for the stock has been met. At that time the option shares can be sold at long-term capital gains rates, with a portion of the proceeds used to pay the 2019 AMT liability.

Additional Planning: Consider a plan to exercise options each year up to the level that generates AMT. Tax reform increased the amount of preference items you can have before owing AMT tax.

If you have exercised an ISO in 2018 and the value of the stock has decreased, consider a sale before the end of 2018. This action should reduce the AMT effect. The sale must be made to a non-family member (or to an entity not considered to be related to the taxpayer under applicable rules) and the stock cannot be repurchased (even through an exercise of a different option or new compensatory award) for at least 30 days.

## Nonqualified Stock Options

When a taxpayer exercises a non-qualified stock option (NQSO) that does not have a readily ascertainable fair market value at the time of issuance (generally the case where the option or the option stock is not publicly traded), the spread (the difference between the stock's fair market value and option price) is taxed as compensation income. When the taxpayer sells the NQSO stock, any subsequent appreciation is taxed as long- or short-term capital gain depending upon the stock's holding period. Because the spread is taxed as ordinary income, taxpayers in the highest marginal federal tax bracket are taxed at 37 percent.

Planning Suggestion: If a taxpayer expects to be subject to AMT for 2018 and no AMT credit carryforward is expected, the taxpayer should consider increased ordinary taxable income to at least the AMT level by exercising NQSOs. The accelerated ordinary income from the NQSO is effectively taxed at the AMT marginal rate of 28 percent as opposed to 37 percent. In addition, all future appreciation is capital gain. When making this decision, the potential tax savings should be compared with the opportunity cost of accelerating the income taking into account the time value of money.

## Children's Taxes (Kiddie Tax)

Beginning in 2018, unearned income of a child under age 18 is taxed at ordinary income and preferential rates applied to trusts and estates. Earned (compensation) income received by a child under age 18 is taxed at the rates applied to single filers.

The kiddie tax applies to full-time students who have not attained the age of 24 by the end of the taxable year and non-full-time students who have not attained the age of 19 by the end of the taxable year, but in either case, only if the child's earned income does not exceed one-half of the amount of the child's support.

A child with earned income may claim a standard deduction up to $12,000 for 2018 and may be eligible for the $5,500 deductible IRA contribution. Therefore, the child may earn $17,500 without paying federal income tax. The child should also consider a contribution to a nondeductible Roth IRA.

Planning Suggestion: If you own a business, consider hiring and paying a salary to your child. This income will be taxed at the child's rates, and the payment will be deductible by your business. This technique can be used to fund a college education. Of course, the child must perform services to earn the compensation, and the compensation must be reasonable for the services provided.

If the child is 18 or over, this compensation will be subject to social security tax. It will also be subject to federal unemployment insurance tax if the child is 21 or older. The child's compensation could also be subject to state and local income and payroll taxes.

For 2018, a child under age 18 is not required to file a tax return if the child only has interest and dividend income up to $1,050, has not made estimated payments, has total gross income less than $10,500, and is not subject to backup withholding. However, the parents must include the child's income exceeding $2,100 on his/her tax return.

**Caution:** A child under 18 who has capital gains or earned income must file his or her own tax return. Estimated taxes may have to be paid during the year if withholding taxes are not sufficient to cover the child's tax liability.

Planning Suggestion: Consider making gifts of growth stock or Series EE bonds (which can defer taxation of the interest until maturity) to a child under age 18 (or 24, if appropriate). These investments can be converted to investments producing current income after the child reaches 18 (or 24, if appropriate). The resulting income will be taxed at the child's rates rather than the parents' top rate. Further, parents in the higher tax brackets should consider making gifts of income-producing property to a child who is 18 (or 24, if appropriate) or older to take advantage of the child's lower tax bracket (see "Year-End Gifts"

**Reminder:** Your income tax return must report social security numbers for all children whom you claim as dependents. A social security number can be obtained by filing an application on Form SS-5 with your local Social Security Administration office.

If you claim a dependent care credit, you must report the service provider's social security or employer identification number on your tax return. You should use IRS Form W-10 to obtain this number from the provider.

## Adoption Expenses

Up to $13,810 for 2018 of eligible adoption expenses are allowed to be claimed as a nonrefundable credit. The credit limitation is the same for special-needs children (children that cannot or should not be returned to the home of the birth parents because of specific factors, or who could not otherwise be adopted because of certain conditions). The credit is per adoption, not per year.

Thus, if a person adopts two children in 2018 and incurs $30,000 of qualified expenses, the credit limitation is $27,620. In 2018, the adoption credit is phased out for higher income individuals with modified AGI between $207,140 and $247,140. Unused adoption credit can be carried forward for up to five years.

## Nanny Tax Reporting

During 2018, if you paid $2,100 or more to a person 18 or over for household services, you are required to report his or her social security and federal unemployment taxes on your personal tax return. These amounts are reported on Schedule H.

These employment taxes must be paid by the due date of the return, April 15, 2019, without extensions. Inasmuch as these taxes are part of your tax liability, your estimated taxes or withholding must be sufficient to cover them.

Planning Suggestion: As the $2,100 amount applies to each household employee, if possible, try to keep payments to each person below $2,100 per year. In 2018, you can also give your household employee up to $260 per month for expenses to commute by public transportation without this amount counting toward the $2,100 threshold or being included in the employee's gross income.

**Caution:** Payments to household employees may also be subject to state unemployment and other state taxes.

## Estate and Gift Taxes

Tax reform increased the applicable estate and gift exemption for individual taxpayers and doubled the generation-skipping transfer tax exemption amounts to $11,180,000 ($22,360,000 for married couples), for tax years beginning after December 31, 2017, and before January 1, 2026. These amounts will be adjusted for inflation each year. Further, inflation will be measured using the Chained-Consumer Price Index (CPI), a lower rate of inflation. Chained-CPI is estimated once in February and is finalized the following February.

Planning Suggestion: Affluent families should consider developing a lifetime gifting strategy to use some or all of their increased exemptions prior to December 31, 2025. The spousal limited access trust is an oft-used, time tested strategy that can help such taxpayers to do so.

## Year-end and Other Gifts; Portability

The end of the year is the traditional time for making gifts. For 2018 you may give up to $15,000 to a person without incurring any federal gift tax liability. The $15,000 annual limit applies to each donee. Thus, you may make $15,000 gifts to as many people as you like. If you are married, you and your spouse can give a combined $30,000 to each donee, if your spouse consents to splitting the gift or if you give community property. To qualify for this annual exclusion, the property must be given outright to the donee or put into a trust that meets certain conditions.

In addition to the annual exclusion, the lifetime exemption (made available in the form of a credit against tax based on an exemption-equivalent amount) allows each person to transfer $11,180,000 for 2018 by gift without incurring any gift tax liability (reduced by the amount of any lifetime exemption that may have been used in a prior year). Using this credit now will keep future appreciation on the transferred property out of your estate. However, using the lifetime credit against 2018 gifts reduces the credit available for future years.

A widow or widower may have an increased lifetime exemption if the deceased spouse died after 2010 with an unused exemption amount and an estate tax return was filed. Please note that an estate tax return must be filed on a timely basis for the surviving spouse to obtain the increased exemption. This is true even if an estate tax return was otherwise not required to be filed because the value of the gross estate was less than the threshold required for filing an estate tax return. A full discussion of the portability of the lifetime exemption between spouses is beyond the scope of this letter. Please consult with your advisor for a more complete explanation of the portability rules.

In addition to gifts subject to the annual exclusion and the lifetime credit, direct payments of tuition made on another person's behalf to a university or other qualified educational organization are also excluded from gift tax, as are direct payments of medical expenses to a medical care provider.

Planning Suggestion: You should consider using appreciated property in making gifts. If the recipients are in lower income tax brackets than you, income from the transferred property, including any gain on sale, will be taxed at lower rates.

Additional Suggestion: It is generally unwise to give property that has declined in value. Rather, you should consider selling the property and realize the tax benefits of the loss.

All outright gifts to a spouse (who is a United States citizen) are free of federal gift tax. However, for 2018, only the first $152,000 of gifts to a non-United States citizen spouse are excluded from the total amount of taxable gifts for the year. You should coordinate your year-end gift giving with your overall estate planning. Your advisor can assist you with these matters.

## Conclusion

Like an annual physical examination is important for maintaining good health, an annual financial examination that includes year-end tax planning can enhance your financial well-being. Your advisor is available to help you achieve your tax and financial objectives.