TAXTALK

2018 YEAR-END INCOME TAX PLANNING FOR U.S. INDIVIDUALS

The 2017 Tax Reform temporarily reduced the individual tax rates on virtually all levels of income, including reducing the highest federal income tax rate from 39.6 percent to 37 percent. These lower rates are not scheduled to expire until after 2025.

Despite the significant tax changes with federal tax reform, many individual taxpayers should still benefit from the traditional year-end tax planning strategies that include deferring "income" to a later year and accelerating "deductions" into the current year. **State tax issues are not addressed.**

The following are our 2018 year-end tax planning strategies:

Postponing Taxable Income May Save Taxes

Deferring Taxable Income

Generally, deferring taxable income from 2018 to 2019 may reduce your income taxes if your effective income tax rate for 2019 will be lower than your effective tax rate in 2018. For example, the deferral of income could cause your 2018 taxable income to fall below the thresholds for the highest tax bracket (i.e., U.S. $600,000 for joint returns and $500,000 if single).

In addition, if you have income that is subject to the 3.8 percent Net Investment Income Tax ("NIIT") and the income deferral reduces your modified adjusted gross income below the thresholds for the 3.8 percent NIIT (i.e., $250,000 for joint returns and $200,000 if single), you may avoid the additional 3.8 percent tax on investment income.

As indicated above, this article does not address state taxes. However, state taxes vary considerably depending on the state in which you are a resident for the year. For example, the individual state tax rates in the states of New York and California are relatively high as compared to Florida with no personal income tax for individuals. The difference in state tax rates may have a substantial impact of your individual effective tax rate on taxable income for the year. See State Tax section below.

If, after considering all factors, you conclude that deferring taxable income into 2019 will save you taxes, then consider the following strategies:

Deferring Self-Employment Income

Self-employed individuals using the cash method of accounting should delay 2018 year-end billings in order to defer income until 2019. From a business perspective, you may not want to defer billing if you believe this will increase your risk of not being paid.

Using Installment Sales

If you plan to sell certain appreciated property before the end of 2018, you may be able to defer the gain until later years by simply taking back a promissory note instead of all cash. By taking a promissory note, you may qualify for the "installment method" which allows you to pay tax on the gain only as you collect payments on the note. The benefits of the 'installment method" will only be beneficial if your income tax rate in 2019 and later will be less than the 2018 tax rates. As indicated above, you may also be able to avoid the 3.8 percent NIIT.

Taking Advantage of Deductions

Similar to deferring taxable income above, Taxpayers could benefit from accelerating deductible expenses into the current year. This strategy could be beneficial if you expect your tax rate to be higher in 2018 than in 2019 and/or the accelerated deductions cause your 2018 income to drop below certain income-sensitive thresholds allowing you to qualify for other tax savings. For example, as discussed below, individuals who report Qualified Business Income on their tax return will find it easier to qualify for the new 20% deduction with respect to that Qualified Business Income if their 2018 taxable income does not exceed $315,000 if filing a joint return ($157,000 if single).

The following are selected tax deductions that you might consider accelerating into 2018, and changes to those deductions as a result of U.S. Tax Reform.

New 20% Deduction for Certain Qualified Income (Section 199A)

This deduction may be the most discussed benefit to business owners. Otherwise known as the "20 percent deduction" this tax deduction potentially allows the owner of a business with qualified income to deduct 20% of their income for federal tax purposes. With the top individual tax rate of 37 percent, this deduction could give an individual taxpayer in the highest tax bracket a 29.6 percent effective tax rate on business income (37% -(20% x 37%). Almost 10 percent lower than 2017 top tax rate of 39.6 percent.

Section 199A was included in the 2017 U.S. Tax Reform Act that was signed into law on December 22, 2017. The Section provides a deduction to non-corporate taxpayers of up to 20 percent of the taxpayer's qualified business income (QBI) from qualified trades or businesses. This deduction is available for tax years beginning after 2017 through 2025.

Qualified trades or businesses include those operated through a sole proprietorship, partnership, S corporation, estates and trusts. However, qualified trades or businesses do not include a specified trade or business (SSTB). The section broadly defines a SSTB as a business in fields of law, heath, accounting, consulting, and similar business where the principal asset is the reputation or skill of one or more of its employees.

Note that the SSBT limitation does not apply if a taxpayer's taxable income is below $315,000 for a married couple filing a joint return and $157,000 for all other taxpayers:

The deduction is the lesser of:

(A) 20 percent of the taxpayer's QBI, plus 20 percent of the taxpayer's qualified rest estate investment trust (REIT) dividends and qualified publicly traded partnership income or

(B) 20 percent of the taxpayer's taxable income minus net capital gains.

The IRS released guidance in the fall of 2018 in order to avoid uncertainties and confusion in application of Section 199A. In this regard, you should consult with your tax advisors to analyze and maximize the 20 percent deduction.

Moving Expenses

Before Tax Reform, the deduction for qualified business-related "Moving Expenses" was an above-the-line deduction and an employer's reimbursement of an employee's qualified moving expenses was a tax-free fringe benefit. For tax years starting in 2018 through 2025, the new law requires employers to report any moving expenses it pays to employees as taxable wages to the employee and eliminates the employees' deduction for moving expenses.

Note that members of the Armed Forces who are on active duty and whose move was pursuant to a military order continues to be tax-free.

Alimony

Currently, an individual making qualified alimony payments is allowed an "above-the-line" deduction for the payments and the recipient of the payments must include the payments in income. Effective for divorce or separation agreements entered after December 31, 2018, the deduction for alimony or separate maintenance payments is repealed, and the alimony payments will no longer be taxable to the recipient.

State and Local Tax

From 2018 through 2025, the aggregate itemized deduction state and local real property taxes is now limited to $10,000. ($5,000 for married filing separately). As discussed above, your state of residence for the year will considerably impact the benefit of the state tax deduction. For example, the top individual tax rate in California for 2018 is 13.3 percent versus Arizona with 4.54 percent.

Home Mortgage Interest

Before Tax Reform, individuals were generally allowed an itemized deduction for home mortgage interest paid on up to $1,000,000 ($500,000 for married individuals filing separately) of home acquisition debt.

For Home Acquisition debt incurred after December 15, 2017 Tax Reform reduces the dollar cap for from $1,000,000 to $750,000 ($375,000 for married filing separately). However, from a tax planning perspective and subject to limited exceptions, if a taxpayer incurred Acquisition indebtedness on or before December 15, 2017, the refinancing of that indebtedness after December 15, 2017 will still be entitled to the $1,000,000 cap.

Miscellaneous Deductions

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

- Deductions for tax preparation fees
- Employment related educational expenses
- Hobby losses
- Investment expenses from pass-through entities
- Deduction for employee business expenses

Summary

The 2018 tax season will be the first year for U.S. Tax Reform. The rules for individuals are new and complex. However, there are planning opportunities that could generate tax savings. You should consult with your McCarney Group's advisor about these tax saving ideas.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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