Year-End Tax Planning for 2018

Year-end planning for 2018 takes place against the backdrop of a new law — the Tax Cuts and Jobs Act — that made major changes in the tax rules for individuals and businesses. For individuals, there are new, lower income tax rates, a substantially increased standard deduction, severely limited itemized deductions and no personal exemptions, an increased child tax credit, and a watered-down alternative minimum tax (AMT), among many other changes. For businesses, the corporate tax rate is cut to 21%, the corporate AMT is gone, there are new limits on business interest deductions, and there are significantly liberalized expensing and depreciation rules. In addition, there's a new deduction for non-corporate taxpayers with qualified business income from pass-through entities.

Despite this atmosphere of change, the time-tested approach of deferring income and accelerating deductions to minimize taxes still works for many taxpayers, along with the tactic of "bunching" expenses into this year or the next to get around deduction restrictions. For individuals, deferring income also may help minimize or avoid phaseouts of various tax breaks based on a taxpayer's adjusted gross income (AGI). As always, however, year-end tax planning doesn't occur in a vacuum. It must take account of each taxpayer's particular situation and planning goals, with the aim of minimizing taxes to the greatest extent possible. While most taxpayers will come out ahead by following the traditional approach, others with special circumstances may do better by accelerating income and deferring deductions.

This Special Report contains year-end planning tips that highlight the opportunities and challenges facing taxpayers under the new rules and provides two checklists of actions that can cut taxes for this year and in the years to come — one for individuals and one for businesses and business owners.

Checklist of Tax Planning Moves for Individuals

The following is a checklist of actions based on current tax rules that may help taxpayers save tax dollars if they act before year-end. Not all actions will apply in every taxpayer's particular situation, but individuals will likely benefit from many of them.

Higher-income earners must be wary of the 3.8% surtax on certain unearned income. The surtax is 3.8% of the lesser of: (1) net investment income (NII), or (2) the excess of modified adjusted gross income (MAGI) over a threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case). As year-end nears, a taxpayer's approach to minimizing or eliminating the 3.8% surtax will depend on his estimated MAGI and NII for the year. Some taxpayers should consider ways to minimize (e.g., through deferral) additional NII for the balance of the year, others should try to see if they can reduce MAGI other than NII, and other individuals will need to consider ways to minimize both NII and other types of MAGI.

The 0.9% additional Medicare tax also may require higher-income earners to take year-end actions. It applies to individuals for whom the sum of their wages received with respect to employment and their self-employment income is in excess of an unindexed threshold amount ($250,000 for joint filers, $125,000 for married couples filing separately, and $200,000 in any other case). Employers must withhold the additional Medicare tax from wages in excess of $200,000 regardless of filing status or other income. Self-employed persons must take it into account in figuring estimated tax. There could be situations where an employee may need to have more withheld toward the end of the year to cover the tax. For example, if an individual earns $200,000 from one employer during the first half of the year and a like amount from another employer during the balance of the year, he or she would owe the additional Medicare tax, but there would be no withholding by either employer for the additional Medicare tax since wages from each employer don't exceed $200,000.

Long-term capital gain from sales of assets held for over one year is taxed at 0%, 15%, or 20%, depending on the taxpayer's taxable income. The 0% rate generally applies to the excess of long-term capital gain over any short-term capital loss to the extent that it, when added to regular taxable income, is not more than the "maximum zero rate amount" (e.g., $77,200 for a married couple). If the 0% rate applies to long-term capital gains you took earlier this year — for example, you are a joint filer who made a profit of $5,000 on the sale of stock bought in 2009, and other taxable income for 2018 is $70,000 — then before year-end, try not to sell assets yielding a capital loss because the first $5,000 of such losses won't yield a benefit this year. And if you hold long-term appreciated-in-value assets, consider selling enough of them to generate long-term capital gains sheltered by the 0% rate.

Postpone income until 2019 and accelerate deductions into 2018 if doing so will enable you to claim larger deductions, credits, and other tax breaks for 2018 that are phased out over varying levels of adjusted gross income (AGI). These include deductible IRA contributions, child tax credits, higher education tax credits, and deductions for student loan interest. Postponing income also is desirable for those taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it may pay to actually accelerate income into 2018. For example, that may be the case where a person will have a more favorable filing status this year than next (e.g., head of household versus individual filing status), or expects to be in a higher tax bracket next year.

If you believe a Roth IRA is better than a traditional IRA, consider converting traditional-IRA money invested in beaten-down stocks (or mutual funds) into a Roth IRA if eligible to do so. Keep in mind, however, that such a conversion will increase your AGI for 2018, and possibly reduce tax breaks geared to AGI (or modified AGI).

It may be advantageous to try to arrange with your employer to defer, until early 2019, a bonus that may be coming your way. This could cut as well as defer your tax.

☐ Beginning in 2018, many taxpayers who claimed itemized deductions year after year will no longer be able to do so. That's because the basic standard deduction has been increased (to $24,000 for joint filers, $12,000 for singles, $18,000 for heads of household, and $12,000 for marrieds filing separately), and many itemized deductions have been cut back or abolished. No more than $10,000 of state and local taxes may be deducted; miscellaneous itemized deductions (e.g., tax preparation fees) and unreimbursed employee expenses are no longer deductible; and personal casualty and theft losses are deductible only if they're attributable to a federally declared disaster and only to the extent the $100-per-casualty and 10%-of-AGI limits are met. You can still itemize medical expenses to the extent they exceed 7.5% of your adjusted gross income, state and local taxes up to $10,000, your charitable contributions, plus interest deductions on a restricted amount of qualifying residence debt, but payments of those items won't save taxes if they don't cumulatively exceed the new, higher standard deduction.

Some taxpayers may be able to work around the new reality by applying a "bunching strategy" to pull or push discretionary medical expenses and charitable contributions into the year where they will do some tax good. For example, if a taxpayer knows he or she will be able to itemize deductions this year but not next year, the taxpayer will benefit by making two years' worth of charitable contributions this year, instead of spreading out donations over 2018 and 2019.

Some taxpayers may find it advantageous to apply a "bunching strategy" to pull or push discretionary medical expenses and charitable contributions into the year where they will do some tax good.

☐ Consider using a credit card to pay deductible expenses before the end of the year. Doing so will increase your 2018 deductions even if you don't pay your credit card bill until after the end of the year.

☐ If you expect to owe state and local income taxes when you file your return next year and you will be itemizing in 2018, consider asking your employer to increase withholding of state and local taxes (or pay estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2018. But remember that state and local tax deductions are limited to $10,000 per year, so this strategy is not a good one if to the extent it causes your 2018 state and local tax payments to exceed $10,000.

☐ Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retirement plan). RMDs from IRAs must begin by April 1 of the year following the year you reach age 70½. (That start date also applies to company plans, but non-5% company owners who continue working may defer RMDs from company plans until April 1 following the year they retire.) Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn. Thus, if you turn age 70½ in 2018, you can delay the first required distribution to 2019, but if you do, you will have to take a double distribution in 2019 — the amount required for 2018 plus the amount required for 2019. Think twice before delaying 2018 distributions to 2019, as bunching income into 2019 might push you into a higher tax bracket or have a detrimental impact on various income tax deductions that are reduced at higher income levels. However, it could be beneficial to take both distributions in 2019 if you will be in a substantially lower bracket that year.

☐ If you are age 70½ or older by the end of 2018, have traditional IRAs, and particularly if you can't itemize your deductions, consider making 2018 charitable donations via qualified charitable distributions from your IRAs. Such distributions are made directly to charities from your IRAs, and the amount of the contribution is neither included in your gross income nor deductible on Schedule A, Form 1040. But the amount of the qualified charitable distribution reduces the amount of your required minimum distribution, resulting in tax savings.

☐ If you were younger than age 70½ at the end of 2018, you anticipate that in the year you turn 70½ and/or in later years you will not itemize your deductions, and you don't have any traditional IRAs, establish and contribute as much as you can to one or more traditional IRAs in 2018. If the immediately previous sentence applies to you, except that you already have one or more traditional IRAs, make maximum contributions to one or more traditional IRAs in 2018. Then, when you reach age 70½, do the steps in the immediately preceding checklist item. Doing all of this will allow you to, in effect, convert nondeductible charitable contributions that you make in the year you turn 70½ and later years, into deductible-in-2018 IRA contributions and reductions of gross income from age 70½ and later year distributions from the IRAs.

☐ Take an eligible rollover distribution from a qualified retirement plan before the end of 2018 if you are facing a penalty for underpayment of estimated tax and having your employer increase your withholding is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2018. You can then timely roll over the gross amount of the distribution, i.e., the net amount you received plus the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2018, but the withheld tax will be applied pro rata over the full 2018 tax year to reduce previous underpayments of estimated tax.

☐ Consider increasing the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year.

☐ If you become eligible in December of 2018 to make health savings account (HSA) contributions, you can make a full year's worth of deductible HSA contributions for 2018.

☐ Make gifts sheltered by the annual gift tax exclusion before the end of the year if doing so may save gift and estate taxes. The exclusion applies to gifts of up to $15,000 made in 2018 to each of an unlimited number of individuals. You can't carry over unused exclusions from one year to the next. Such transfers may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

☐ If you were in an area affected by Hurricane Florence or any other federally declared disaster area, and you suffered uninsured or unreimbursed disaster-related losses, keep in mind you can choose to claim them on either the return for the year the loss occurred (in this instance, the 2018 return normally filed next year), or the return for the prior year (2017).

☐ If you were in an area affected by Hurricane Florence or any other federally declared disaster area, you may want to settle an insurance or damage claim in order to maximize your casualty loss deduction this year.

Checklist of Planning Moves for Businesses and Business Owners

☐ For tax years beginning after 2017, taxpayers other than corporations may be entitled to a deduction of up to 20% of their qualified business income. For 2018, if taxable income exceeds $315,000 for a married couple filing jointly, or $157,500 for all other taxpayers, the deduction may be limited based on whether the taxpayer is engaged in a service-type trade or business (such as law, accounting, health, or consulting), the amount of W-2 wages paid by the trade or business, and/or the unadjusted basis of qualified property (such as machinery and equipment) held by the trade or business. The limitations are phased in for joint filers with taxable income between $315,000 and $415,000 and for all other taxpayers with taxable income between $157,500 and $207,500.

Taxpayers may be able to achieve significant savings by deferring income or accelerating deductions so as to come under the dollar thresholds (or be subject to a smaller phaseout of the deduction) for 2018. Depending on their business model, taxpayers also may be able to increase the new deduction by increasing W-2 wages before year-end. The rules are quite complex, so don't make a move in this area without consulting your tax adviser.

☐ More "small businesses" are able to use the cash (as opposed to accrual) method of accounting in 2018 and later years than were allowed to do so in earlier years. To qualify as a "small business" a taxpayer must, among other things, satisfy a gross receipts test. Effective for tax years beginning after December 31, 2017, the gross-receipts test is satisfied if, during a three-year testing period, average annual gross receipts don't exceed $25 million (the dollar amount used to be $5 million). Cash method taxpayers may find it a lot easier to shift income, for example, by holding off billings till next year or by accelerating expenses, paying bills early or by making certain prepayments.

More "small businesses" are able to use the cash (as opposed to accrual) method of accounting in 2018 and later years than were allowed to do so in earlier years.

Property acquired and placed in service in the last days of 2018, rather than at the beginning of 2019, can result in a full expensing deduction for 2018.

- Businesses should consider making expenditures that qualify for the liberalized business property expensing option. For tax years beginning in 2018, the expensing limit is $1,000,000, and the investment ceiling limit is $2,500,000. Expensing is generally available for most depreciable property (other than buildings), and off-the-shelf computer software. For property placed in service in tax years beginning after Dec. 31, 2017, expensing also is available for qualified improvement property (generally, any interior improvement to a building's interior, but not for enlargement of a building, elevators or escalators, or the internal structural framework), for roofs, and for HVAC, fire protection, alarm, and security systems. The generous dollar ceilings that apply this year mean that many small and medium sized businesses that make timely purchases will be able to currently deduct most if not all their outlays for machinery and equipment. What's more, the expensing deduction is not prorated for the time that the asset is in service during the year. The fact that the expensing deduction may be claimed in full (if you are otherwise eligible to take it) regardless of how long the property is held during the year can be a potent tool for year-end tax planning. Thus, property acquired and placed in service in the last days of 2018, rather than at the beginning of 2019, can result in a full expensing deduction for 2018.

- Businesses also can claim a 100% bonus first-year depreciation deduction for machinery and equipment — bought used (with some exceptions) or new — if purchased and placed in service this year. The 100% write-off is permitted without any proration based on the length of time that an asset is in service during the tax year. As a result, the 100% bonus first-year write-off is available even if qualifying assets are in service for only a few days in 2018.

- Businesses may be able to take advantage of the de minimis safe harbor election (also known as the book-tax conformity election) to expense the costs of lower-cost assets and materials and supplies, assuming the costs don't have to be capitalized under the Code Sec. 263A uniform capitalization (UNICAP) rules. To qualify for the election, the cost of a unit of property can't exceed $5,000 if the taxpayer has an applicable financial statement (AFS; e.g., a certified audited financial statement along with an independent CPA's report). If there's no AFS, the cost of a unit of property can't exceed $2,500. Where the UNICAP rules aren't an issue, consider purchasing such qualifying items before the end of 2018.

- A corporation (other than a "large" corporation) that anticipates a small net operating loss (NOL) for 2018 (and substantial net income in 2019) may find it worthwhile to accelerate just enough of its 2019 income (or to defer just enough of its 2018 deductions) to create a small amount of net income for 2018. This will permit the corporation to base its 2019 estimated tax installments on the relatively small amount of income shown on its 2018 return, rather than having to pay estimated taxes based on 100% of its much larger 2019 taxable income.

- To reduce 2018 taxable income, consider deferring a debt-cancellation event until 2019.

- To reduce 2018 taxable income, consider disposing of a passive activity in 2018 if doing so will allow you to deduct suspended passive activity losses.