2018 Year-End Tax Planning for Individuals

Dear Clients and Friends,

As 2018 draws to a close, there is still time to reduce your 2018 tax bill and plan ahead for 2019. This letter highlights several potential tax-saving opportunities for you to consider. We would be happy to meet with you to discuss specific strategies.

Year-end planning for 2018 takes place against the backdrop of a new tax law – the Tax Cuts and Jobs Act – that made sweeping 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.

Here's a look at some of the more important elements of the new law that have an impact on individuals. Unless otherwise noted, the changes are effective for tax years beginning in 2018 through 2025.

- **Tax rates**: The new law imposes a new tax rate structure with seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate was reduced from 39.6% to 37% and applies to taxable income above $500,000 for single taxpayers, and $600,000 for married couples filing jointly. The rates applicable to net capital gains and qualified dividends were not changed. The "kiddie tax" rules were simplified. The net unearned income of a child subject to the rules will be taxed at the capital gain and ordinary income rates that apply to trusts and estates. Thus, the child's tax is unaffected by the parent's tax situation or the unearned income of any siblings.
- **Standard deduction**: The new law increases the standard deduction to $24,000 for joint filers, $18,000 for heads of household, and $12,000 for singles and married taxpayers filing separately. Given these increases, many taxpayers will no longer be itemizing deductions. These figures will be indexed for inflation after 2018.
- **Exemptions**: The new law suspends the deduction for personal exemptions. Thus, starting in 2018, taxpayers can no longer claim personal or dependency exemptions. While there is no longer a deduction, it is still important for you to give us your dependent information because there are other things we use this for including the child credit and the new "other dependent" credit.
- **New deduction for "qualified business income**": Starting in 2018, taxpayers maybe allowed a deduction equal to 20 percent of "qualified business income," otherwise known as "pass-through" income, i.e., income from partnerships, S corporations, LLCs, and sole proprietorships. The income must be from a trade or business within the U.S. Investment income does not qualify, nor do amounts received from an S corporation as reasonable compensation or from a partnership as a guaranteed payment for services provided to the trade or business. The deduction is not used in computing adjusted gross income, just taxable income. For taxpayers with taxable income above $157,500 ($315,000 for joint filers), (1) a limitation based on W-2 wages paid by the business and depreciable tangible property used in the business is phased in, and (2) income from the following trades or businesses is phased out of qualified business income: health, law, consulting, athletics, financial or brokerage services, or business for which the principal asset is the reputation or skill of one or more employees or owners.

- **Child and family tax credit**: The new law increases the credit for qualifying children (i.e., children under 17) to $2,000 from $1,000, and increases to $1,400 the refundable portion of the credit. It also introduces a new (nonrefundable) $500 credit for a taxpayer's dependents who are not qualifying children. The adjusted gross income level at which the credits begin to be phased out has been increased to $200,000 ($400,000 for joint filers).
- **State and local taxes**: The itemized deduction for state, local and property taxes is limited to a total of $10,000 starting in 2018.
- **Mortgage interest**: Under the new law, mortgage interest on loans used to acquire a principal residence and a second home is only deductible on debt up to $750,000 (down from $1 million), starting with loans taken out in 2018. And there is no longer any deduction for interest on home equity loans, regardless of when the debt was incurred.
- **Miscellaneous itemized deductions**: There is no longer a deduction for miscellaneous itemized deductions which were formerly deductible to the extent they exceeded 2 percent of adjusted gross income. This category included items such as tax preparation costs, investment expenses, union dues, and unreimbursed employee expenses.
- **Medical expenses**: Under the new law, for 2017 and 2018, medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income for all taxpayers. Previously, the AGI "floor" was 10% for most taxpayers.
- **Casualty and theft losses**: The itemized deduction for casualty and theft losses has been suspended except for losses incurred in a federally declared disaster.
- **Overall limitation on itemized deductions**: The new law suspends the overall limitation on itemized deductions that formerly applied to taxpayers whose adjusted gross income exceeded specified thresholds. The itemized deductions of such taxpayers were previously reduced by 3% of the amount by which AGI exceeded the applicable threshold, but the reduction could not exceed 80% of the total itemized deductions, and certain items were exempt from the limitation.
- **Moving expenses**: The deduction for job-related moving expenses has been eliminated, except for certain military personnel. The exclusion for moving expense reimbursements has also been suspended.
- **Alimony**: For post-2018 divorce decrees and separation agreements, alimony will not be deductible by the paying spouse and will not be taxable to the receiving spouse.
- **Health care "individual mandate**": Starting in 2019, there is no longer a penalty for individuals who fail to obtain minimum essential health coverage.
- **Estate and gift tax exemption**: Effective for decedents dying, and gifts made, in 2018, the estate and gift tax exemption has been increased to roughly $11.2 million ($22.4 million for married couples if portability is elected).
- **Alternative minimum tax (AMT) exemption**: The AMT has been retained for individuals by the new law but the exemption has been increased to $109,400 for joint filers ($54,700 for married taxpayers filing separately), and $70,300 for unmarried taxpayers. The exemption is phased out for taxpayers with alternative minimum taxable income over $1 million for joint filers, and over $500,000 for all others.

We have compiled a list of actions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your particular situation, but you (or a family member) will likely benefit from many of them. We can narrow down the specific actions that you can take once we meet with you to tailor a particular plan. In the meantime, please review the following list and contact us at your earliest convenience so that we can advise you on which tax-saving moves to make:

• 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 a 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 be beneficial 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.

• 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 reduce 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.

• 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 70-½. (That start date also applies to company plans, but non-5% company owners who continue working may defer RMDs 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 70-½ 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 70-½ 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, which can result in tax savings.

• 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 if coverage is maintained. If you go on Medicare during the year, your HSA contribution is limited. If you contact us, we can help you calculate the maximum contribution.

• 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 2018 in order to maximize your casualty loss deduction this year.

Listed below are some last-minute tax tips to lower your 2018 tax bill.

- ***Check your withholding***. Employers adjusted workers' withholding earlier this year to reflect the federal tax overhaul, which reduces tax rates and doubles the standard deduction. However the new law also limits or scraps some popular tax breaks. If you continue to itemize and some of your large deductions have been eliminated, you may not be having enough withheld from your paychecks, which could lead to an unexpected tax bill next April. You are more vulnerable if you live in a high-tax state because the law now caps the deduction for state and local taxes at $10,000. To find out where you stand, go to the IRS withholding calculator. If you discover you're not having enough withheld, file a new W-4 with your employer. Because there are only a few pay periods left in the year, reducing the number of allowances you claim may not make a big difference in your withholding. Instead, go to line 6 on the W-4 and fill in the dollar amount you'd like to have withheld.

- ***Consider paying 2019 bills now***. In the past, many taxpayers paid their mortgage and state taxes due in January before December 31 so they didn't have to wait another year to take the deduction. But prepaying deductible expenses only makes sense if you itemize, and there's a good chance you won't have to go through that rigmarole when you file your 2018 tax return. The new tax law nearly doubles the standard deduction to $12,000 for single taxpayers and $24,000 for married couples who file jointly

- ***Reap the tax harvest***. The tax code allows you to sell investments that have fallen below your purchase price and use the resulting loss to offset capital gains in taxable accounts. That's a compelling reason to consider jettisoning your losing positions. Investments that you've held for a year or less are taxed as ordinary income, but investments you've held longer are taxed at the long-term capital gains rate, which ranges from 0% to 23.8%. After matching short-term losses against short-term gains, and long-term losses against long-term gains, any excess losses can be used to offset the opposite kind of gain. If you still wind up with an overall net capital loss, you can use up to $3,000 of that loss to offset ordinary income and roll the rest over to the following year. Note that once you sell an asset at a loss, you must wait 30 days before reinvesting in it or buying a substantially identical investment.

- ***Watch for capital gains distributions***. Mutual funds are required to pay out to their shareholders any gains realized from the sale of stocks or bonds during the year. If you own the fund in a taxable account, you must pay taxes on these distributions when you file your tax return, even if you reinvest them. "Given the 10-year run of the bull market in stocks, there will probably be somewhat higher capital gains distributions this year," says Joel Dickson, Vanguard's global head of investment research and development. If you get hit with a distribution, review your portfolio to see if you have any mutual funds, stocks or bonds that have declined in value since you purchased them. Selling them before year-end will provide losses to offset your gains. Mutual funds typically publish an estimate of their capital gains distributions in November or December, along with the date of the distribution. Estimates are on a per-share basis, so if you figure out how many shares you have, you can gauge the size of your distribution.

- ***Max out your pre-tax retirement savings***. As the year comes to a close, you may be able to squeeze a little more money from each paycheck for your retirement savings. You can contribute up to $18,500 to a 401(k), 403(b) or federal Thrift Savings Plan in 2018, plus $6,000 in catch-up contributions if you're 50 or older. Pretax contributions will lower your take-home pay and reduce your tax bill. If your employer offers a Roth 401(k), you can make contributions that won't lower your taxable income now but that can be withdrawn tax-free in retirement. If your employer offers both types of plans, you can direct new contributions to the Roth 401(k) rather than the pretax 401(k).

- ***Use your side hustle to boost retirement savings***. If you have self-employment or freelance income, open a solo 401(k) or a SEP. The 401(k) must be opened by December 31 and may have to at least be partially funded before the end of the year. You can contribute up to $18,500 ($24,500 if you're 50 or older) to a solo 401(k), minus any contributions you've made to a 9-to-5 employer's 401(k) for the year. You can also contribute up to about 20% of your net self-employment income to the plan. Contributions to the solo 401(k) can total $55,000 in 2018 (or $61,000 if 50 or older) but can't exceed your self-employed income for the year. Another option is to open a SEP account. SEP contributions are limited to about 20% of net self-employment income, up to $55,000. These plans can be established and funded at the time you file your tax return in 2019.

- ***Open a donor-advised fund***. Putting your money or other assets, such as stocks or personal property, in a donor-advised fund allows you to deduct the entire contribution in the year you make it and decide later how you want to dole out grants to charities of your choice. You can open a donor-advised fund at financial services firms such as Fidelity Charitable (minimum investment: $5,000) or Schwab Charitable ($5,000 minimum) or at community foundations. Contributing one lump sum this year may help lift your deductions above the amount of the new standard deduction and allow you to itemize.

- ***Max out charitable donations (and declutter).*** Donating clothes, kitchenware or furniture you no longer need can also boost your deductions while helping a worthy cause. You'll base your deduction on the "fair market value" (or what it might sell for at a thrift or consignment shop); you can use online tools such as TurboTax's ItsDeductible tool to estimate this value. You will need a written acknowledgment from the organization if you are claiming a contribution of $250 or more (consider snapping a photo of the donation for your records). For non-cash donations other than publicly traded stock valued at more than $5,000, you'll need a written appraisal.

- ***Transfer IRA money to charity***. Taxpayers who are 70½ or older can transfer up to $100,000 from a traditional IRA tax-free to charity each year, as long as they transfer the money to the charity directly. The "qualified charitable distribution" will count as your required minimum distribution without being added to your adjusted gross income, which can be a boon if you were going to take the new, higher standard deduction instead of itemizing (you can't deduct charitable transfers). The transfer could also help keep your income below the threshold at which you're subject to the Medicare high-income surcharge as well as hold down the percentage of your Social Security benefits subject to tax. Make a QCD well in advance of New Year's Eve because the money has to be out of the account and the check needs to be cashed by the charity by December 31.

- ***Consider a ROTH conversion***. Consider a conversion from a traditional IRA to a Roth IRA this year, up to the top end of your income tax bracket. You'll pay taxes on the conversion (minus any portion that represents nondeductible IRA contributions), but the money will grow tax-free in the Roth after that. Converting your entire traditional IRA balance can bump you up to a higher tax bracket though. Be careful about making a large conversion if you're within two years of signing up for Medicare—you'll have to pay extra for Medicare Part B if your adjusted gross income (plus tax-exempt interest income) is more than $85,000 if you're single or $170,000 if you're married filing jointly. Your last tax return on file determines your Medicare premiums, so a 2018 conversion could affect 2020 premiums. Also, the IRS changed the rules for 2018 and Roth IRA conversions cannot be undone as in prior years.

As a general reminder, there are several ways in which you can file an income tax return: married filing jointly, head of household, single, and married filing separately. A married couple, which includes same-sex marriages, may elect to file one return reporting their combined income, computing the tax liability using the tax tables or rate schedules for "Married Persons Filing Jointly." If a married couple files separate returns, in certain situations they can amend and file jointly, but they cannot amend a jointly filed return to file separately. A joint return may be filed even though one spouse has neither gross income nor deductions. If one spouse dies during the year, the surviving spouse may file a joint return for the year in which his or her spouse died. Certain married persons who do not elect to file a joint return may be entitled to use the lower head of household tax rates. Generally, in order to qualify as a head of household, you must not be a resident alien, you must satisfy certain marital status requirements, and you must maintain a household for a qualifying child or any other person who is your dependent.

These are just some of the year-end steps that can be taken to save taxes. Again, by contacting us, we can tailor a particular plan that will work best for you. The professionals at Friedman, Leavitt & Assoc., Inc. would be happy to meet with you at your convenience to discuss the strategies outlined above.

While we are getting very close to the end of the year, there is still time to implement these strategies to minimize your 2018 tax liability.

Thank you for your business. We have appreciated the opportunity to serve you in the past and we welcome the opportunity to serve you in the coming year. We would appreciated your referrals. If you know someone in need of our services, please mention our name to them. We are a growing firm and we would like more good clients like you.

We, at Friedman, Leavitt and Associates wish you all a good holiday season and a healthy, happy and rewarding new year.

Sincerely,

Friedman, Leavitt & Assoc., Inc.