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Year-End Tax Planning for Individuals

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2018 Year-End Personal Tax Planning

Dear Clients and Friends:

Greetings!

The following is our annual year-end tax planning letter. Feel free to share this letter with others that may find it of interest. If this letter was shared with you, and you would like to receive your own copy in the future, please connect with us at contact@dmj.com to be included in future mailings.

If you are a business owner, be sure that you also receive a copy of our year-end letter that focuses on business issues by emailing us at contact@dmj.com. The letter should be available by December 1 or so. For this year, also consider requesting this letter if you are reporting business income on your 1040 from a K-1 or other source. A new “Section 199A” deduction may be available to you.

One policy note. *Please return your engagement letter when it arrives in the mail. Our firm policy does not allow us to release your e-filed tax return until we have this signed document.*

The Tax Cuts and Jobs Act of 2017

On December 22, 2017, the President signed the Tax Cuts and Jobs Act of 2017 (“TCJA”), which marked the largest tax act since the Tax Reform Act of 1986. It brought about many, many personal changes, a few of which are mentioned here. All of these changes are in effect for 2018 filings, and expire on 12/31/2025 unless extended by future legislation.

- Reduce ordinary income tax rates.
- Roughly double the standard deduction.
- Limit the itemized deduction for taxes (state and local income or sales taxes and property taxes) to $10,000 for joint filers.
- Limits on interest on home equity debt.
- Repeal miscellaneous itemized deductions.
- Casualty losses are no longer deductible, except for a Presidential disaster declaration.
- Moving expenses are no longer deductible.
- Repeal the personal exemption.
- Increase and expand the child tax credit, and make it refundable for low incomer taxpayers.
- Reduce the impact of the alternative minimum tax (“AMT”).
- End Roth recharacterizations (you can still convert to a Roth, just not undo it later).
- Beginning in 2019, alimony paid may no longer be a tax deduction, and alimony received may no longer be taxable income. See us for details and if this applies to you.

Here is some other discussion of how the changes in the TCJA affect some specific tax areas.

- Itemized versus standard deductions. The doubling of the standard deduction combined with the limit on deduction for state and local taxes means that many more of our clients will face the standard deduction than ever before. This changes many historical concepts of tax planning, such as whether to prepay state taxes owed by year-end.
    - Also, clients may benefit from "bunching", meaning planning on itemizing every other year and compressing deductions into the itemizing year, while relying on the standard deduction in the off year.
- Charitable contributions.
    - For charitable commitments, use of a "donor-advised fund" will allow taxpayers to deduct multiple years' charitable contributions in the itemizing year, while spending amounts from the fund to meet charitable obligations in the standard deduction year.
    - The deduction bunching strategy means that for those taxpayers over age 70-1/2 with IRA balances, use of a charitable IRA distribution is more powerful than ever. Be careful with the requirements here and the result is a deduction allowed without having to itemize.
    - Increase the maximum cash charitable contributions to 60% of adjusted gross income ("AGI") (previously 50%).
- Home equity interest. Note that beginning in 2018, interest on up to $100,000 of home equity debt is no longer deductible ***UNLESS*** the debt was used for the purchase or improvement of a primary or second residence. As a result, if you have 2018 home equity interest, please be prepared to discuss with us how the money from this account was used.
- Medical deductions. For 2017 and 2018 only, these deductions need to exceed 7.5% of AGI before they increase itemized deductions. In 2019 and future years, the limit increases to 10%. So 2018 may be a good year to accelerate that medical procedure.
- Exemption. The TCJA completely repealed the 1040 exemption concept. That point is worth reiterating as it has been a fundamental rule in our tax system for decades.
- Child tax credit. While the repeal of the exemption might be painful for families, the child tax credit has been increased and improved in a way that probably more than offsets for the loss of the exemption.
    - The amount of the credit was increased from $1,000 to $2,000 per eligible child, which is generally a dependent child under age 17 at year-end.
    - The former credit began to phase-out at a relatively modest level of AGI - $110,000 joint and $75,000 single. Now the credit is fully in place at AGI up to $400,000 joint or $200,000 single.
    - Other dependents that do not meet this "child under age 17" rule now are eligible for a completely new second credit of $500 each. Examples could include parents and children in college. More guidance is needed here to be specific.
- Alternative minimum tax. While the AMT was not repealed, the AMT should be much less of a factor than in prior years because –
    - The types of deductions which triggered the AMT have been repealed or greatly limited (state and local taxes, miscellaneous itemized deductions, exemptions).
    - The exemption from the AMT was increased (discussed later).
    - Perhaps most importantly, the level of taxable income where the AMT phases out was increased to $1 million joint from $160,900 joint.

Contact us if you want to discuss how any of these changes affect your personal situation.

General tax environment

The IRS continues to send out computer-generated notices based on computer-based document-matching processes. Since IRS notices generated in this way are sometimes incorrect, you should consult with us about the appropriate response. Never ignore an IRS notice – it will not go away. Deal with it promptly to reduce any penalties and interest that may accrue.

Meanwhile, the IRS has made progress on its identity theft war, with less identity theft fraud seen for 2016 and 2017 tax filings than in prior years.

Disaster relief

If you were in an area affected by Hurricanes Florence or Matthew, or any other federally declared disaster area, and you suffered losses that were uninsured or in excess of insurance coverage, carefully assemble a list of your costs incurred and the insurance received. We can deduct the excess loss on either the 2018 or 2017 income tax return.

IRS adjusts tax provisions for inflation

The estate tax exemption was doubled as part of the TCJA. For 2018, the estate tax exemption is now $11.18 million (compared to $5.49 million in 2017). This doubling is part of the personal tax changes discussed earlier than expire on 12/31/2025. The exemption will increase by another $220,000 in 2019 to $11.4 million. Together, a married couple can pass a 2018 estate valued at $22.36 million to their heirs without paying federal estate tax because of the portability provision. It is estimated that now 99.8% of all estates will not owe the estate tax, but the need for proper planning is still present to make sure that this works as intended for you. This transfer amount is reduced during life by taxable gift tax transactions, so your total estate tax exemption could be less if taxable gifts have occurred in the past.

The annual gift tax exclusion increases to $15,000 per recipient in 2018 ($30,000 if married and using a gift-splitting election, or if each spouse uses separate funds). This is a $1,000 increase from $14,000 in 2017. By maximizing the use of these gifts annually, taxpayers can transfer significant wealth out of their estate without using any of their lifetime estate exemption.

Taxpayers who have a health savings account (HSA) under a high-deductible health plan (HDHP) have a contribution limit this year of $6,900 for a family, an increase of $150 from 2017. The single contribution limit is increased to $3,450, compared to $3,400 in 2017. Taxpayers are allowed an additional $1,000 contribution if you are age 55 or older. To be considered an HDHP, out-of-pocket maximums of $6,650 per individual ($6,550 in 2017) and $13,300 for a family ($13,100 in 2017) apply. Minimum deductibles are $1,350 per individual and $2,700 for a family ($1,300 and $2,600 in 2017, respectively).

Retirement plan rules

A good tax strategy is to participate in your employer's 401(k) plan. You may elect to contribute up to $18,500 for 2018 before taxes, and the additional catch-up contribution for employees who are age 50 and above is $6,000. Refer to your employer's plan to confirm that the catch-up contribution is permitted. These increased contribution limits also apply to 403(b) plans and most 457 plans. These under age 50 deferral amount was $18,000 in 2017.

Some 401(k) plans allow you to make an after-tax Roth contribution, which will not reduce your current taxable income. However, you generally will not owe tax when this contribution, plus any earnings, are withdrawn in retirement. Note that if you make the maximum retirement deferral possible, you are actually deferring more with a Roth 401(k) because, economically, you are actually contributing both the deferral and the tax on the deferral.

The IRA contribution limit has not increased since 2013. It is still $5,500, with an additional $1,000 catch-up contribution allowed for people 50 years of age or older. But in 2019, this base IRA contribution maximum will finally increase to $6,000. SIMPLE plan amounts also have not changed.

You or your spouse must have earned income to contribute to either a traditional or a Roth IRA. Only taxpayers with modified AGI below $199,000 joint and $135,000 single are permitted to contribute to a Roth IRA. If a workplace retirement plan covers you or your spouse, modified AGI also controls your ability to deduct your contribution to a traditional IRA, which ends at $199,000 joint.

There is no AGI limit on your or your spouse's deduction if neither of you are covered by an employer plan. If your modified AGI falls within the phase-out range, a partial contribution/deduction is still allowed.

If you would like to contribute to a Roth IRA, but your income exceeds the threshold, consider making a non-deductible contribution to a traditional IRA for 2018 by April 15, 2019, and then later convert the regular IRA to a Roth IRA. Consult with your DMJ professional about the tax consequences of the conversion, especially if you have funds in other traditional IRAs, as this could dramatically change the tax impact.

Please do not forget that as of 2015, you may make only one IRA-to-IRA indirect rollover per year, which must be re-deposited within 60 days. This does not limit direct rollovers from trustee to trustee.

Any attempted rollover after the first one will be treated as a withdrawal and taxed at regular rates – with potentially a 10 percent early withdrawal penalty. The attempted rollover will be subject to regular IRA contribution limits, meaning that, if the amount of funds in the account exceeds your contribution limit, it will be subject to a 6 percent excise tax.

When you reach age 70-1/2, you are required to begin taking required minimum distributions (RMDs) from your IRAs and other retirement accounts. Roth IRAs are not subject to this rule. We can assist with the computation of the minimum amount needed to withdraw. For the first year only (if you turn age 70-1/2 in 2018), you have a grace period to take the initial 2018 year withdrawal until April 1, 2019. Often this is not a good idea, because a second withdrawal for 2019 would still need to be done by December 31, 2019, resulting in two taxable retirement withdrawals subject to income tax in one year, potentially at higher tax rates. Also, these rules mandate the minimum to withdraw annually after age 70-1/2 – there is no maximum for these taxpayers.

For RMDs from retirement accounts that are inherited (including Roth IRAs), a completely different set of rules apply, and most taxpayers cannot wait until age 70-1/2. Consult with us if you are unsure of what action is required.

Remember also that the provision that allowed an individual who is at least 70-1/2 years old to make a qualified charitable distribution of up to $100,000 from an IRA directly to a charity has been made permanent. This distribution to charity can satisfy all or part of your RMD requirement. This is generally a good idea for taxpayers who (1) are subject to the RMD rules, and (2) have charitable commitments to satisfy. It's also a good plan where the taxpayers cannot itemize deductions, or receive little benefit from doing so, due to high standard deductions, the house is paid for, etc. It is arguably a better idea to first use long-term significantly appreciated stock for your charitable giving if you can itemize (discussed later in this letter), but a charitable IRA distribution is also a good idea.

In addition to the SIMPLE IRA shown in the table below, self-employed individuals can have a Simplified Employee Pension (SEP) plan. They may contribute as much as 25 percent of their net earnings from self-employment, not including contributions to themselves. The contribution limit is $55,000 in 2018. The self-employed may set up a SEP plan as late as the due date, including extensions, of their 2018 income tax return.

An individual, or solo, 401(k) is another option for the self-employed. For 2018, a self-employed individual, as an employee, may defer up to $18,500 ($24,500 for age 50 or older) of annual compensation (an increase of $500 from 2017). Acting as the employer, the individual may contribute 25 percent of net profits, including the deferred $18,500, up to a maximum contribution of $55,000.

Summary of 2017 Versus 2018 Amounts		
	2017	**2018**
Standard Deduction		
Single or married filing separately	$6,350	$12,000
Married filing jointly or surviving spouse	$12,700	$24,000
Head of household	$9,350	$18,000
Personal Exemption	$4,050	repealed
Health Savings Account Limitation		
Single	$3,400	$3,450
Family	$6,750	$6,900
Plus catch-up contribution for age 55 & over	$1,000	$1,000
401(k) Limitation	$18,000	$18,500
Plus catch-up contribution for age 50 & over, if permitted by employer plan	$6,000	$6,000
SIMPLE Plan Limitation (unchanged)	$12,500	$12,500
Plus catch-up contribution for age 50 & over, if permitted by employer plan	$3,000	$3,000
Estate Tax Exemption	$5,490,000	$11,180,000
Foreign Earned Income Exclusion	$102,100	$103,900

Make the most of long-term capital gains

- While avoiding or deferring tax may be your primary goal, to the extent there is income to report, the income of choice is long-term capital gain (more than one year holding period) thanks to the favorable tax rates available. Short-term capital gain is taxed at your ordinary income tax rate.

- If you hold a capital asset for more than one year before selling it, your capital gain is long-term. For most taxpayers, long-term capital gain is taxed at rates no higher than 15 percent. But taxpayers with income below certain limits have a long-term capital gains tax rate of 0 percent – see the chart below.
- Taxpayers whose income exceeds the thresholds set for the now-repealed 39.6 percent ordinary tax rate are subject to a 20 percent rate on capital gain. See the chart below.
- If the long-term capital gains rates of 0, 15, or 20 percent are not complicated enough, keep in mind that special rates of 25 percent can apply to certain real estate, and 28 percent to certain collectibles. Also, gains on the sale of certain C corporations held for more than five years can qualify for a 0 percent rate if certain tests are met. Talk to your tax advisor before you assume which long-term capital gains rate would apply. In any event, the 3.8% tax on Net Investment Income could also apply in addition to these capital gains rates.
- Remember that you can use capital losses, including worthless securities and bad debts, to offset capital gains. If capital losses exceed capital gains during the year, you can offset ordinary income by up to $3,000 of your losses. Then you can carry forward any capital losses in excess of a net of $3,000 into the next tax year.
- You should be careful not to violate the "wash sale" rule by buying an asset nearly identical to the one you sold at a loss within 30 days before or after the sale. Otherwise, the wash sale rule will prevent you from claiming the loss immediately. While wash sale losses are deferred, wash sale gains are fully taxable. It is important to discuss the meaning of "nearly" or "substantially" identical assets with your tax advisor.

Long-Term Capital Gains Rate Brackets				
	Single	**Joint**	**Head of Household**	**Trusts**
0% bracket	$0 – $38,600	$0 - $77,200	$0 - $51,700	$0 - $2,600
15% bracket begins	$38,601	$77,201	$51,701	$12,700
20% bracket begins	$425,801	$479,001	$452,401	$12,701

Note that the 3.8% tax on Net Investment Income may also apply. Also consider state income tax.

Charitable deductions

As most taxpayers are aware, federal tax law allows a deduction for contributions made to qualified IRS tax-exempt organizations. Before making such contributions, however, you should become familiar with some of the laws and limitations on contributions so you can maximize the tax benefit of the deduction.

The contribution must be made to a qualified IRS tax-exempt organization. The IRS maintains an online tool **(http://tinyurl.com/a72f74x)** that simplifies the search for organizations that meet the criteria.

It should be noted that churches are generally not on this list as they are automatically exempt. Also note that nonprofit status is granted by the state when the organization applies for its corporate charter as a nonprofit organization. Tax-exempt status is granted by the IRS upon application, after formative approval by the state.

The donor cannot exercise undue control over the contribution. For example, you cannot make a contribution to a church, specifying that the funds be used to pay the medical bills of a good friend. A contribution may be made to the church benevolent fund with an expressed preference that the funds be used to help your friend, but the request may not be a condition of the gift.

The contribution must be made by December 31 of that year. A check mailed with a December 31 postmark is acceptable. A credit card charge is deductible when charged, not when the credit card bill is paid. The organization cannot "hold the books open" for a few days after the end of the year and credit those contributions to the year just ended. Be sure so keep a receipt of all contributions of $250 or more.

There are limitations on the amount of charitable contributions that you may deduct. For individuals, the limit is 60 percent of AGI (previously 50 percent) or 30 percent of AGI if the donation is capital gain property. Any excess may be carried over for up to five future years. Contributions may also be limited if the qualified organization is not considered by the IRS to be a 60 percent limit organization. This includes contributions to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations. Contributions made to these organizations are subject to a limit of 30 percent of AGI or 20 percent of AGI if the donation is capital gain. At the website listed above, the IRS indicates whether or not contributions to certain organizations are subject to these additional limitations.

Beyond the laws and limitations discussed above, some strategies may be employed to maximize the benefit of the deduction. If your itemized deductions are near the amount of the standard deduction, you may wish to bunch contributions in a year in which the standard deduction amount has been exceeded.

It is a good strategy to keep a running list of your charitable contributions so you can be prepared to speed up or delay any contributions to maximize your deductions. Along this same line, keeping tabs on your total income for the year, in case you will be subject to the phase-out provisions, will enable you to plan properly.

If you plan to contribute appreciated capital gain property, you will achieve the maximum benefit if the property is long-term – property held for more than 12 months.

- You can normally deduct the fair market value of the contribution rather than the cost basis. If held for 12 months or less, the deduction is limited to the basis in the property.
- Even if you want to keep the investment, consider gifting the qualifying property and using your charitable cash to instead purchase a replacement investment. You would be made whole, with a new 12-month long-term holding period to meet, but you have increased your investment basis in the meantime.

Don't give securities that have depreciated, as your deduction is limited to the lower fair market value. You would be better to sell the security, take your loss, and contribute the net cash to charity.

While those over age 70-1/2 can direct IRA withdrawals to charity, which can work well, arguably the gift of appreciated stock is an even better idea since you get a full deduction without reporting the appreciation as income. But with the expanded standard deduction in place, remember that you must be able to itemize for this plan to work.

Before making such a contribution, you should ascertain that the property does qualify for deduction of the fair market value and is, in fact, appreciated property.

This overview provides some of the laws and strategies for deriving the maximum tax benefit from charitable contributions. Before making significant contributions, you would be wise to consult with us to assure that you are maximizing the benefit.

Timing income and expenses can be important tax reduction strategy

As you consider your tax plan, determine whether you are likely to be subject to the alternative minimum tax (AMT). The AMT's function is to level taxes when income – adjusted for certain preference items – exceeds certain exemptions, but the tax rate applied to that income falls below the AMT rate.

Before deciding to accelerate or defer income and prepay or delay deductible expenses, you need to gauge the possible effect of the AMT on these tax-planning strategies. As noted earlier, this is less of a problem in 2018 than in the past, but it should not be ignored.

After analyzing your specific tax situation, if you anticipate that your income will be higher in 2019, you might benefit from accelerating income into 2018 and possibly postponing deductions, keeping the AMT threat in mind.

Alternative Minimum Tax				
AMT Income		**Rate**		
$1-$191,100*		26%		
Over $191,100*		28%		
	Single	**Head of Household**	**Married Filing Jointly and Surviving Spouses**	**Married Filing Separately**
AMT Exemption Amount	$70,300	$70,300	$109,400	$54,700
Exemption Phase-out Begins	$500,000	$500,000	$1,000,000	$500,000
*Note: Married taxpayers filing separate returns should substitute $95,500 for $191,100 in the rate table.				

On the other hand, if you think you may be in a lower tax bracket in 2019, look for ways to defer some of your 2018 income. For example, you could delay into 2019:

- Collecting rents
- Receiving payments for services
- Accepting a year-end bonus
- Collecting business debts

And if you itemize deductions, consider prepaying some of your 2019 tax-deductible expenses in 2018.

Individuals usually account for taxes using the cash method. As a cash method taxpayer, you can deduct expenses when you pay them or charge them to your credit card. Expenses paid by credit card are considered paid in the year they are incurred, so this may be a way to accelerate deductions if you do not have the cash to do so.

In addition to charitable contributions discussed earlier, you should decide whether it would be beneficial for you to prepay the following expenses:

- **State and local income taxes** – You may prepay any state and local income taxes normally due on January 15, 2019, if you do not expect to be subject to the AMT in 2018. However be mindful of another limitation – the $10,000 cap on this deduction beginning in 2018.
- **Real estate taxes** – You can prepay in 2018 any real estate tax due early in 2019. But you should keep in mind how the AMT could affect both years when preparing to pay real estate taxes on your residence or other personal real estate, and again the $10,000 cap. However, real estate tax on rental property is deductible and can be safely prepaid even if you are subject to the AMT.
- **Mortgage interest** – Your ability to deduct prepaid interest has limits. But, to the extent your January mortgage payment reflects interest accrued as of December 31, 2018, a payment before year end will secure the interest deduction in 2018. However, note that this technique really only works once. Deducting a 13th monthly payment in 2018 leaves you only 11 payments to deduct in 2019, thus you are forced to continue to prepay the next January payment just to keep 12 months of deductions in future years.
- **Margin interest** – If you bought securities on margin, any interest accrued as of December 31, 2018, will be deductible in 2018 only if you actually pay the interest by December 31 (subject to the investment interest limitation rules).
- **Miscellaneous itemized deductions** – The deductions that are limited to 2% of AGI are repealed beginning in 2018.

Stay on top of your tax payments

If you expect to be subject to an underpayment penalty for failure to pay your 2018 tax liability on a timely basis, consider increasing your withholding between now and the end of the year to reduce or eliminate the penalty. Increasing your final estimated tax deposit due January 15, 2019, may reduce the amount of the penalty, but is unlikely to eliminate it entirely.

Withholding, even if done on the last day of the tax year, is deemed withheld ratably throughout the tax year. For federal taxes, underpayment penalties can be avoided when total withholdings and estimated tax payments exceed the 2017 tax liability, or in the case of higher-income taxpayers, 110 percent of 2017 tax. For NC tax, the rule is the same except you can replace “110 percent of 2017 tax” with “100 percent.”

North Carolina Taxes

For NC residents, here are a few state issues to consider.

Your NC personal income tax rate for 2018 will be 5.499%, unchanged from 2017. The basic mechanics of the computation of taxable income will be similar to 2017. Looking forward, the tax rate beginning 1/1/2019 drops to 5.25%, but no structural changes in the computation of taxable income are on the horizon at this time.

Conclusion

The U.S. Tax Code is incredibly complex and can change rapidly, even though it may sometimes seem to be moving along at a snail's pace. This complexity has given rise to more calls for simplification, such as in the Tax Cuts and Jobs Act of 2017. This Act made the Code simpler in some ways, but more complicated in others.

Although a majority of taxpayers have their taxes prepared by a professional, people are turning in larger numbers to self-prepared returns. Since the online program does the calculations, it seems to be an economical approach to preparing and filing taxes.

However, the program is no substitute for a qualified tax professional such as a CPA. Programs can calculate tax liability, but they cannot substitute for professional advice and guidance.

With such complexity in the tax code, a CPA is better able to keep abreast of the changes and can prepare taxes in a manner that determines a taxpayer's minimum legal tax liability. But minimizing tax liability started last week, last month, last year. Tax planning is a constant in today's complex world.

In closing, DMJ is committed to improving our connection with each client. We encourage you to stay in contact and learn more about our services and relevant news by following us at:

twitter.com/dmjandco

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Receive monthly email updates and relevant tax news by joining our mailing list by contacting contact@dmj.com

Learn more at **www.dmj.com**

Thank you!

2018 marks the 69th year of DMJ's service to its clients. We remain humbled by the support and faith that this represents from you, our trusted client. What began as a simple one-room office in Greensboro, North Carolina in 1949 has grown to more than 75 professionals in the Triad, Triangle, and Sandhills. We serve clients throughout the state and beyond.

While our offices are physically located in North Carolina, we assist clients with tax reporting matters in practically every jurisdiction in the country, as well as many foreign countries. Where we do not have the first-hand contacts and experience, we rely on associate firms through our CPAmerica association, both nationwide and worldwide. We bring you the access, knowledge, and experience of much larger firms while providing you with the customized service and familiar faces you know and trust.

Sincerely,

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