2019 Year-End Tax Considerations [Part III]

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In our last two pieces we discussed the TCJA from the **"Good"** and the **"Bad"** aspects. Now we delve into the **"Ugly" --** how we apply these disparate rule changes resulting from the TCJA in our year-end planning.

Straight income tax planning (without the complexity of layering alternative minimum tax rules over normal income tax rules) has traditionally been fairly simple and direct.

- The mantra has always been *"it is better to pay tax later, to enjoy the benefit of use of the money in the interim."* Accordingly, you would typically--
    - Defer income
    - Accelerate deductions and credits
    - Always maximize contributions to qualified retirement plans to defer income and enjoy tax-free appreciation within the plans, paying tax only on withdrawal in retirement when you are in a lower tax bracket.
    - Always prefer the tax flow through treatment of an S corporation or LLC over the double taxation of a C corporation [corporate tax on profits and individual tax on dividends].
    - Always prefer long term capital gains to ordinary earned income because the tax rates are almost 50% lower and the capital gains are subject to the 3.8% Medicare surtax.
    - Always contribute as much as you can to charity each year (up to 50% (now 60%) of AGI), to maximize your charitable deduction.

Unfortunately [unless you earn a living as a tax planner, as does your humble author], these tried and true approaches in large part no longer apply. No magical formula ensures success in this new tax regime. Your situation must be reviewed and planned for each tax year. Here are some considerations:

- **Decide Whether to Itemize Your Deductions or Take the Standard Deduction**
    - Because the standard deduction for a married couple filing jointly in 2019 is $24,400, many people who itemized in previous years may be opting for the simplicity and certainty of the standard deduction. Some of the points discussed below will have an impact on this decision.

  - [TIP] You may not have enough deductions every year to justify itemizing, so bunch your deductions for discretionary things such as elective medical procedures, charitable contributions, pre-paying taxes, mortgage payments and deductible expenses for privately owned businesses. Load up one year to maximize deductions and itemize that year. Take the standard deduction the following year(s).
- **Consider Donor Advised Funds**
  - In years you would like to itemize, combine several years' of deductions into a single contribution to a donor advised fund at a local community foundation.
  - [TIP] Consider donating assets other than cash, such as appreciated securities, because the deduction is based on the current value of the asset, not the cost basis. This facilitates your avoiding the capital gains tax on sale of the security outright, but gets you the full gift amount. This is an over-simplification of complex rules, so please consult with your tax professional.
  - [TIP] If you are over 70 ½, consider donating your RMD (up to $100,000) to your donor advised fund as a qualified charitable distribution ("QCD"), even if you are not itemizing. The transfer is not taxable to the Taxpayer, so there is no charitable deduction. If you sell for a gain individually, you will also be subject to the 3.8% Medicare surtax.
- **Avoid the Penalty on Estimated Tax**
  - To avoid the nasty underpayment penalty you must make payments on a pro-rata basis throughout the year equating to—
    - 90% of your current year's tax liability or
    - 100% (110% if your AGI is over $150,000) of your prior year tax liability.
  - [TIP] If you are under-withheld, consider increasing your W-4 federal tax withholding, which is considered ratably paid throughout the year, versus estimated tax payments which are credited on the date of payment. Estimated taxes should take into account the 3.8% Medicare surtax and the 0.9% Medicare tax.
- **Tax Loss Harvesting**
  - Recognizing capital losses can lower capital gains taxes, which are enhanced by mutual fund capital gain distributions at year-end [below].
  - [TIP] Avoid the wash sale rule prohibiting the claiming of a loss from a security sale if you buy a substantially identical one within 30 days before or after the sale you are claiming losses for. The 31-day window runs before and after the trade date for the sale, not the settlement date.
- **Watch Out for Year-end Mutual Fund Distributions**
  - If you sell a position in a fund that has performed well you expect to generate a capital gain. If you then purchase a replacement fund that then declares its own distribution, you compound your tax issues. The fund value immediately drops by the amount of the distribution, so the recent purchaser basically swaps the receipt of ordinary dividend income for invested capital in the replacement fund.

    - [TIP] Even if a fund loses value, it could still make a large distribution in a year. The need to distribute is based on activity within the fund, not whether the trading price of the entire fund itself went up or down in the marketplace. Plan accordingly.
- **Manage Required Minimum Distributions ("RMDs")**
    - You must begin taking annual RMDs from your retirement accounts the year you turn 70 ½ . In that first year you may defer your first RMD until April 1 of the following year, but you would then have to take a total of two distributions in the second year.
    - [TIP] If you are charitably inclined, consider using a qualified charitable distribution ("QCD"). A QCD allows you to contribute up to $100,000 in RMD (or any IRA distribution) to the charity of your choice without having to treat the distribution as a taxable distribution. The ability to exclude the QCD from your income is in lieu of taking a charitable deduction for your contribution. The distribution must flow directly from the IRA custodian to the charity, without you in the middle of the flow of funds.
- **Small Business Owners and Self-Employed Individuals**
    - Small business owners or self-employed individuals can defer significant taxes by using defined contribution and defined benefit plans.
    - [TIP] Simplified Employee Pension (SEP) IRAs. allow
        - Tax deductible contributions up to the lesser of 25% of compensation or $56,000 (in 2019).
        - Contributions may be made until the extended due date of your 2019 tax return (as late as October 2020).
    - Defined benefit plans may provide a maximum annual retirement benefit as much as $225,000 or 100% of a participant's compensation over a consecutive three-year period. Tax deferral is available the year the plan is established.
    - The impact of §199A of the TCJA and the tax deduction of 20% of qualified income of pass-through entities is a complex, but profitable, planning exercise that we will address in future pieces.
    - We will also examine the generous benefits in TCJA for real estate investors in a subsequent piece.

Remember, It is not what you make that matters… it is what you keep!!