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Year-End Tax and Financial Planning Ideas

2018 brought with it many changes to tax law, but that doesn't mean taxpayers need to rethink their year-end plans. For this year, many of the tried & true strategies still make sense.

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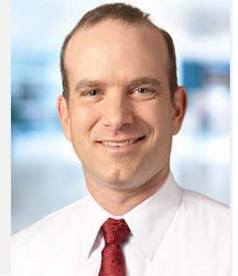

October 2018

The Tax Cuts & Jobs Act (TCJA) was passed in late December 2017, too late for most taxpayers to do any kind of significant year-end tax planning. Fortunately, the typical year-end strategy proved to be the right approach last year in most cases. With the lower marginal tax rates and the new caps on deductions that took effect in 2018, the default of moving income into this year while paying deductible expenses last year was likely a good approach.

But for those who didn't do any shifting of income or deductions last year – what will 2018 look like compared to 2017? It's safe to say that, assuming things are unchanged between the two years, taxable income for most people will increase due to the cuts in tax deductions. On the other hand, nearly all of that higher taxable income will now be taxed at lower marginal tax rates this year. In addition, the impact of the Alternative Minimum Tax has been greatly lessened, and many more families will be eligible for an even larger child tax credit this year.

So if taxable income is up but tax rates are down, does that mean taxpayers will pay less tax or more? One group that analyzed the impact of the TCJA, The Tax Policy Center, determined that for 2018, 80% of taxpayers will receive a tax cut this year, averaging about $2,100. On the other hand, about 5% would see a tax increase averaging about $2,800[1]. Those 5% tend to be those with income high enough to have avoided AMT in the past, who live in higher tax states or who own multiple properties.

Another thing to consider: In response to the lower tax rates for 2018, the IRS provided revised tables for employers to use when withholding taxes from employee's income. So while the total tax liability may be down this year, those subject to withholding likely had less tax taken out of their income for 2018. As a result, comparing a net tax refund (or balance due) for 2018 to 2017 may not give an accurate reading on the impact of the TCJA.

Despite all these changes, there is still room to consider additional tax planning strategies for 2018. Given the remote prospects of any kind of major changes for 2019, it's probably safe to assume next year's laws will be very similar to this year's. In that case, taxpayers who aren't facing a material change in their situation for 2019 are back to the usual strategy – defer income into next year and accelerate deductions into this year.

As always, though, tax planning is an individual process. The approach that is generally good for most may be the exact wrong thing in your own situation. Taxpayers whose income will fluctuate significantly between 2018 and 2019 – due to job change, retirement, sale of a business, etc. – might consider different year-end strategies. Remember also that tax planning is not done in a one-year vacuum. The decision to accelerate or defer income or deductions should be

[1] "Distributional Analysis of the Conference Agreement for the Tax Cuts and Jobs Act". *Tax Policy Center,* December 18, 2017. www.taxpolicycenter.org/publications/distributional-analysis-conference-agreement-tax-cuts-and-jobs-act/full

done with an eye towards the tax impact over both this and next year. Lastly, be sure to look at any changes to state income tax laws in the context of year-end tax planning.

The following list of year-end tax and financial planning strategies is a starting point to discuss with your Baird Financial Advisor along with your tax consultant. While investment decisions shouldn't be driven entirely by tax issues, there are instances where sound investment decisions can be made that will decrease an investor's overall tax liability.

PLANNING FOR CAPITAL GAINS & LOSSES

Deciding to sell a portfolio position should be primarily an investment decision rather than a tax decision. However, understanding the implications of that sale can help drive the timing of a transaction. Unfortunately, determining the tax impact of realizing a gain or loss can be very complicated thanks to multiple tax rates, as well as the 3.8% Net Investment Income tax. Unlike other aspects of the tax code, the tax rules for capital gains (as well as qualified dividends) are virtually unchanged for 2018, so it's really business as usual in this area.

- For 2018, married taxpayers with taxable income below $77,200 (singles below $38,600) can realize tax-free long-term capital gains (assets held more than one year). While that doesn't mean low-income taxpayers can have an unlimited amount of tax-free gains, it does provide a planning opportunity for those taxpayers. Taxpayers who find themselves below those levels for 2018 should consider realizing some tax-free gains this year. However, they should be sure to work with a tax advisor as there are rules limiting the overall benefit.
- Once taxpayers exceed those income levels, long-term gains will be subject to a 15% tax rate.
- Taxpayers reaching the highest ordinary tax bracket are subject to a 20% tax rate on their long-term capital gains. This rate applies for couples with taxable income over $479,000 and singles over $425,800 in 2018.
- Lastly, couples with Modified Adjusted Gross Income (MAGI) above $250,000 for 2018 ($200,000 for singles) will also owe a 3.8% tax on their investment income over those thresholds. Because MAGI is always greater than taxable income, taxpayers could be subject to this tax even though their taxable income ends up below this threshold. Also, the threshold for this tax is not subject to inflation adjustments, so taxpayers whose income was just below the threshold in 2017 may find they're over it for 2018.

Being aware of these breakpoints can help taxpayers better understand the cost of their investment decisions. For example, for those whose income is expected to drop in 2019 due to retirement, realizing a gain in 2018 may end up costing more in taxes than it would by deferring it to the next year when they could be subject to a lower tax rate. A lower tax rate on the gain also means an investor can withstand a drop in the value of an investment and still have more sales proceeds on an after-tax basis.

On the other hand, the investment risk associated with that deferral can't be ignored. Investors thinking of realizing a gain late in the year may be willing to accept the investment risk for a bit longer in order to defer the gain into January 2018. Investors facing that same decision earlier in the year may not be so willing to accept that risk for a longer time.

Other considerations to keep in mind when it comes to managing gains and losses at year-end include:

- Investors should review net long-term and short-term gains and losses for the year to see if there may be an opportunity to sell a losing investment to offset gains from other sales. Since short-term gains (assets held one year or less) are taxed at the ordinary income tax rate, it's important to plan to offset those first, which may require realizing only short-term losses.
- Conversely, investors may look at realizing gains before year-end to absorb any losses realized earlier in the year. Short-term losses first offset short-term gains, and long-term losses first offset long-term gains. If there are net losses in one category, those losses can offset net gains in the other category. If total losses exceed total gains for the year, up to $3,000 of the remaining loss can be used to offset other income that year. Losses in excess of this are carried over to the next year to offset gains in that year. These excess losses can be carried forward indefinitely. There were no changes to these rules as part of the TCJA.

- Another thing to consider when trying to zero-out capital gains for the year: mutual fund distributions. When mutual fund investors sell their fund shares, it forces the fund managers to sell positions to generate cash. The positive run in the stock market these last few years means many funds could be forced to realize significant gains to generate that cash, and those gains must be passed through to the remaining investors. Investors that continued to hold those funds will likely receive larger capital gain distributions than were expected.
- Lastly, avoid the urge to recognize gains in order to "use up" losses realized during the year, only to immediately repurchase the item sold at a gain because it still makes sense to own. Those losses can instead be carried forward to the next year and be used to offset a gain on something you no longer wish to own. Using up losses this year can result in taxable gains in the future that can't be offset.

OTHER INVESTMENT PLANNING STRATEGIES

- While the TCJA contained significant changes to the treatment of mortgage interest, the deduction for investment interest was left unchanged. In order to fully deduct any investment interest expense paid during the year, an equal or larger amount of interest income and short-term capital gains must be recognized during the year. Investment interest is deductible only against those types of investment income, although excess interest expense may be carried over indefinitely to offset future investment income.
    - Investors have the option of foregoing the lower tax rates on qualified dividends and long-term gains in order to treat those items as investment income for purposes of this deduction. Making this election essentially means taking a lower tax benefit for deducting that interest expense this year rather than carrying the deduction forward for perhaps a larger benefit in the future. Those considering this election should consult with a tax advisor who can prepare projections under both scenarios.
- Beware of the wash sale rules while divesting of investments at a loss. These rules prevent investors from deducting a capital loss from the sale of an item if they buy a "substantially identical" position during a 61-day period, including the 30 days before the sale and continuing for 30 days after the sale. The wash sale rules don't apply to any sales for a gain, nor do they apply to gifts of appreciated stock to charity. While a loss under the wash sale rules is usually only deferred rather than permanently lost, taxpayers would likely prefer receiving the full tax benefit of any realized losses sooner rather than later.
    - Selling a security for a loss in a taxable account and then repurchasing it in an IRA (or other retirement account) will still result in a wash sale. In this scenario, the loss on the sale is permanently lost. Therefore, investors must be aware of their entire portfolio when it comes to avoiding a wash sale.
    - Investment firms are required to account for wash sales when the exact same position is bought and sold in the same account. However, wash sales involving positions that are not exactly the same but that are still "substantially identical" (such as selling a stock and then buying a call option on the same stock) or when they occur over multiple accounts are not required to be tracked by those firms. Taxpayers will need to watch for those potential wash sales themselves.
- In order to claim a loss for a "worthless stock," an investor must be able to prove the stock had value at the end of 2017 but did not at the end of 2018. If it's uncertain whether the stock is truly worthless by the end of the year, owners should sell the stock for whatever value they can in order to claim a capital loss. A bankruptcy filing by the company does not, on its own, mean a stock is worthless.

TAX RATES, BRACKETS & FILING STATUS

The top tax bracket for 2018 is now 37%, lower than the top rate for 2017 of 39.6%. In fact, most income levels will be taxed at a lower marginal rate in 2018 than they were in 2017 under the TCJA.

- Taxpayers should review federal withholding and estimated income tax payments in order to avoid underpayment penalties. In the case where a taxpayer's 2018 tax liability may have increased from 2017, they don't necessarily have to pay that increased tax to the IRS before the end of the year. To avoid a penalty for 2018, total tax

payments must equal the lesser of (1) 90% of the current year tax liability or (2) 100% of last year's liability (110% if 2017 Adjusted Gross Income (AGI) was more than $150,000).

  - Taxpayers whose income in 2018 is lower than it was last year may instead prefer to remit just 90% of their projected 2018 tax liability before the end of the year, leaving the remainder to pay with their tax return. In order to provide some cushion for unforeseen events, it may be better to target 93-95% of the projected liability.

- Some taxpayers may be in the habit of always making estimated payments for the year based on the prior year's tax liability. Given the increased possibility of a lower tax cost for 2018, taxpayers should verify they aren't paying too much with their estimated payments for this year. Those who are overpaying can always reduce their 4th quarter payment to account for the change in tax this year.
  - There is generally no incentive to make federal tax payments any earlier than necessary. Other than paying enough to avoid an underpayment penalty, the best cash management strategy is to defer as much of the federal tax liability until the due date for the tax return, while still avoiding an underpayment penalty. Keep in mind that requesting an extension of time to file a tax return doesn't extend the time for paying the tax.
- Couples who were married in 2018 will be filing joint tax returns for the first time. The tax impact of this change in filing status could vary significantly depending on the couple's income level.
  - When there is a significant difference in income between the two spouses, filing jointly may result in a net tax savings over what they each paid as single individuals.
  - When each spouse has similar levels of income, however, the "marriage penalty" could result in an increased tax liability over what they paid as single taxpayers. Newly married couples should be prepared for this potential tax increase. The TCJA took steps to significantly reduce the impact of this penalty, although at higher income levels it does still apply.
  - Couples getting married in 2019 should consider the timing of their deductions in order to maximize the tax benefit over the two-year period. Those expenses should be paid in the year the couple will be subject to the highest marginal tax rate.
- The Kiddie Tax generally applies to children under age 18, or under age 24 if they are a full-time student. As a result, parents will find it difficult to shift investment income from themselves to their children for a tax savings. For 2018, the first $1,050 of unearned income (such as interest, dividends and capital gains – basically anything other than wages or self-employment income) is exempt from tax. The next $1,050 is taxed at the child's tax rate, but any income over $2,100 is now taxed at the trust tax rates as a result of the TCJA. The tax brackets for trusts are very condensed compared to individuals, with a trust (and now a child) reaching the top rate of 37% at just $12,500 of income. The top capital gain tax rate of 20% applies once the child's income exceeds just $12,700 (compared to $479,000 for a married parent).
  - These new tax rates under the Kiddie Tax mean parents and grandparents have to be very careful when realizing income – especially capital gains – in a child's account. It's very possible a child will pay more tax on a capital gain than their parent would.

ITEMIZED DEDUCTION PLANNING

The most talked-about changes in the TCJA were the new limitation on deductions – including the cap on state taxes and the elimination of home equity interest and the entire category of miscellaneous deductions. Because of these changes, many taxpayers likely tried to accelerate those deductions into 2017. When combined with the larger standard deduction, the percentage of taxpayers who will itemize for 2018 is estimated to fall from a historical norm of 30% to just 10%.

- One of the common year-end strategies in the past was to accelerate state income and property tax payments into the current year to realize their tax benefit sooner. With the state tax deduction now capped at $10,000, there may not be a benefit to do that. In that case, taxpayers may be better delaying the payment of these amounts as long as possible in order to maintain access to their cash.
    - Many states offer tax incentives related to the payment of property taxes, such as a credit based on the total property taxes paid in a year. Before choosing to delay (or even accelerate) payments into a different tax year, be sure to review how the state will treat that payment.
    - While state income and property taxes are still non-deductible under the Alternative Minimum Tax, the other changes made to that system have significantly reduced the number of people who will owe AMT in 2018. While the AMT can't be ignored, it's very unlikely that it should influence the timing of state tax payments.
- Another change in the TCJA expanded the deductibility of medical expenses, but the change is short-lived. For 2017 and 2018 only, medical expenses will be deductible to the extent they exceed 7.5% of AGI. After 2018, that increases to 10%. That means that, all things being equal, medical expenses will be easier to deduct in 2018 than in 2019.
    - Therefore, taxpayers should look to accelerate medical expenses from 2019 into 2018. This includes things like refilling prescriptions, ordering new glasses or contacts, any elective procedures, dentist visits, etc.
- The expected increase in the use of the standard deduction means renewed focus on another common planning technique – the idea of "bunching" the payment of certain itemized deductions in order to maximize their tax benefit. By using the standard deduction, otherwise-deductible expenses end up not providing any tax value. Instead, by accelerating or deferring the payment of certain expenses between tax years, a taxpayer can alternate between itemizing and claiming the standard deduction, thereby maintaining as much tax benefit for those expenses as possible.
    - For example, consider a taxpayer who consistently falls just short of exceeding the standard deduction each year. By moving deductible expenses from one year into the other they can actually itemize in one year and then claim the standard deduction the other. The total out-of-pocket expense over the two year period is the same, but the tax benefit of those expenses is maximized.
    - Most deductible expenses, such as taxes and mortgage interest, aren't flexible enough to be moved from one year to the next. However, charitable contributions lend themselves perfectly to this strategy. Taxpayers considering a bunching strategy must decide if 2018 will be a year in which they itemize or take the standard deduction, and then plan the timing of their charitable gifts accordingly. See the following section for more suggestions on charitable giving.
- Another change for 2018 is the repeal of the limitation on itemized deductions for high-income taxpayers, also known as the Pease limitation. This limitation applied to couples with adjusted gross income over $313,800 in 2017 (singles over $261,500). That rule has been eliminated for 2018-2025, so taxpayers over those thresholds will no longer lose their deductions as their income goes up.
- The personal exemption amount has been temporarily reduced to $0 for those same years. So while there is no longer a $4,050 deduction for dependents like in 2017, identifying those dependents is still important because of things like the child tax credit and other tax benefits. The child tax credit has been around for many years, but the TCJA expanded the size and scope of the credit:
    - The credit amount increased from $1,000 to $2,000 for children under age 17.
    - A separate $500 credit is available for dependents that don't qualify for the $2,000 credit.
    - The total credit begins to be phased out for couples with income over $400,000 and singles over $200,000, up from $110,000 and $75,000 in 2017.

CHARITABLE GIVING STRATEGIES

While some taxpayers will no longer receive a tax benefit for their charitable gifts (due mainly to the new larger standard deduction), that's not the case for all taxpayers. As such, it's important to structure charitable giving in a way that provides the largest benefit to both the charity and the donor. The bunching technique (see the Itemized Deduction Planning section above) is a great way to maximize these benefits, along with these other considerations:

- In order to deduct a charitable gift this year, it must be considered a completed gift by December 31, 2018. To meet that deadline, a check must be mailed or a credit card charged by the end of the year. The TCJA expanded the deductibility of cash gifts by allowing them to offset up to 60% of AGI (up from 50% in 2017).
- As in past years, utilizing appreciated property for contributions rather than cash can be a great tax savings tool. Those gifts will generate a deduction for the full value of the property without triggering a taxable gain.
    - When making charitable gifts, be sure not to gift securities that have a loss. By giving a position with a loss, the deduction is limited to the market value at the time of the gift, and neither the taxpayer nor the charity will receive any tax benefit for the built-in loss. Rather than donating something that has a loss, taxpayers are better off selling it first to realize the loss, which can then be deducted, and then donating the sales proceeds to the charity.
    - Also be sure to donate only those items that would be considered "long-term" assets. Donating an asset that is considered a "short-term" holding will limit the donor's tax deduction to their cost basis.
- Charitably-inclined taxpayers whose income is unusually large in 2018 (due to a sale of a business, stock option exercise, deferred compensation payment, etc.) may want to consider a donor advised fund. These funds allow taxpayers to make a gift in the current year, but then defer the distributions to charities until sometime in the future. With this type of gift, the tax benefit is realized immediately without having to commit to a specific charity until later. The gift to the fund is irrevocable, but these vehicles can be a great way to maximize the tax benefit of a donation.
- Taxpayers who are subject to the Required Minimum Distribution rules on retirement plans and want to make charitable gifts should consider Qualified Charitable Distribution technique, or QCD. A QCD is a distribution from an IRA that is transferred directly to a charity. The withdrawal from the IRA isn't included in taxable income, although the donation is also not deductible. That may be fine with the donor, especially if they're only claiming the standard deduction anyway. The QCD is also a way to minimize a taxpayer's AGI, which can allow them to qualify for other tax benefits, as well as avoid higher Medicare premiums. Among the rules to keep in mind for these distributions are:
    - Taxpayers must be at least age 70½ at the time of the payment to the charity. Just reaching that age later in the calendar year is not sufficient.
    - The payment to the charity will count towards the taxpayer's Required Minimum Distribution for the year.
    - Direct transfers to charity can only come from an IRA. A QCD is not allowed from a SEP or Simple IRA, or from an employer plan.
    - Distributions are capped at $100,000 per IRA owner.
    - Transfers must be made to a public charity – private foundations, donor advised funds, charitable trusts and other recipients are not eligible.
    - Lastly, keep in mind that donating appreciated property in some cases will lead to a better overall tax result than the QCD technique. The deduction for gifting the stock will still offset the IRA withdrawal, but the capital gain on the stock is also avoided, providing a double tax benefit.

RETIREMENT PLANNING

- The 2018 contribution limits to most forms of retirement plans have in some cases increased a bit over 2017:
  - 401(k), 403(b) and 457 plans - $18,500 (up from $18,000)
  - Traditional and Roth IRAs - $5,500
  - SIMPLE IRAs - $12,500
  - SEP IRAs - $55,000 (up from $54,000)
- Taxpayers should be sure to maximize contributions to their employer-sponsored retirement plan as well as to an IRA, either Traditional or Roth (if eligible). Contributing to an employer plan does not prevent someone from also contributing to an IRA, although it may limit (or even eliminate) any tax deduction for a Traditional IRA contribution, as explained below.
  - Those covered by an employer-sponsored retirement plan are subject to income limits that affect the ability to deduct contributions to a Traditional IRA. For 2018, married couples with income over $101,000 and singles over $63,000 will begin to lose the benefit of the IRA deduction. The deduction is fully phased out once income reaches $121,000 for couples, $73,000 for singles. However, being over that threshold does not prevent someone from making a non-deductible contribution (as long as they have earned income equal to or greater than the contribution amount).
  - For 2018, full contributions to a Roth IRA are only allowed for joint taxpayers with AGI below $189,000 (single taxpayers below $120,000), with contributions phased out at $199,000 ($135,000 for singles).
- Taxpayers age 50 or older are usually eligible for a "catch up" contribution – an additional contribution amount over the base limitation. Those who turned 50 in 2018 should be aware of this increased IRA or employer plan contribution amount. The catch up amounts for 2018 are $1,000 for IRAs, $6,000 for 401(k), 403(b) and 457 plans, and $3,000 for SIMPLE IRAs, all of which are the same as 2017.
- Taxpayers should consider the potential benefit of converting a Traditional IRA to a Roth IRA prior to year-end. The conversion amount will be fully taxable in the year of conversion (other than any previous non-deductible contributions to the account) but future growth in the account can be withdrawn tax-free.
  - The TCJA included an important change to the rules on Roth conversions, however. Now, once a taxpayer completes a conversion, they are no longer able to recharacterize that conversion back to a Traditional IRA. In other words, taxpayers can't "change their mind" on the conversion. Because of this, the old strategy of doing a large conversion now and then recharacterizing some of it back once other income and deductions are more certain is not available.
- Once an IRA owner reaches age 70½, they become subject to the Required Minimum Distribution (RMD) rules. Those IRA owners must take a distribution from their IRA by December 31, 2018, with the amount based on the January 1, 2018 value of the account. IRA owners who turned 70½ during 2018 are able to defer their first RMD until April 1, 2019, but then must take a second RMD for 2019 by the end of next year. Missing the deadline for taking any RMD will result in a penalty equal to 50% of the undistributed amount.
  - The RMD rules apply to Traditional IRAs and, in most cases, to employer retirement plans. Roth IRAs, however, are exempt from these rules. Upon death of the owner, any non-spouse beneficiary must also begin taking RMDs, including from a Roth IRA.

OTHER FINANCIAL PLANNING CONSIDERATIONS

- The annual gift tax exclusion amount increased to $15,000 for 2018 (up from $14,000 in 2017). Taxpayers trying to minimize a future estate tax liability can begin by making annual gifts to family members.

- The TCJA nearly doubled the estate tax exemption amount $11.18 million for 2018, up from an expected amount of $5.6 million. This amount will continue to increase with inflation each year going forward. Making large gifts under this provision should be done only after a thorough review of the overall estate plan, but should be strongly considered by those who are likely to pay an estate tax.
  - The TCJA made no changes to the portability rules, meaning a married couple has a combined $22.36 million exemption. There were also no changes to the rules that adjust the cost basis of assets owned by a decedent to their fair market value on the date of death.
  - This increased exemption is temporary, however, as it's scheduled to fall back to $5.6 million (adjusted for inflation) in 2026. This creates planning complexity for those with an estate between the two amounts. Those individuals may be able to delay making any lifetime gifts for now, but as 2026 approaches, it may be appropriate to take advantage of the larger exemption before it expires.
- Taxpayers may consider funding a 529 plan to help pay for future education expenses. One advantage of gifting to a 529 plan is that 5 years' worth of gifts can be made in one year. With the annual gift exclusion at $15,000 for 2018, a taxpayer can gift up to $75,000 at one time to a 529 plan – double that if the gift comes from a couple. Taxpayers considering making 5 years' worth of gifts at once should wait until early 2019 to do so. That will allow them to still contribute $15,000 to the 529 for 2018 before doing the 2019 through 2023 gifts next year.
- Funding a Coverdell Education Savings Account can also provide tax-free income for education expenses. Taxpayers can contribute up to $2,000 per year per beneficiary under 18 years old. These accounts can be used to fund both college and K-12 expenses. Contributions are limited to married couples with Modified AGI below $220,000 ($110,000 for singles).
  - After the TCJA, 529 plan assets can now be used to fund K-12 expenses. Withdrawals for these purposes are limited to $10,000 per beneficiary, and can only be used for tuition costs, but this new flexibility may cause donors to reconsider contributing to a Coverdell in the future.

STAYING UP-TO-DATE

This may be a good time to address other financial concerns that don't necessarily relate to year-end.

- Identity theft and data security continue to be important issues. Use the end of the year to consider the following:
  - Change your online passwords, using something that isn't easily guessed.
  - Review your credit report, which be obtained for free at annualcreditreport.com.
  - Consider enrolling in a credit monitoring service. If you fear your credit may be at risk, consider establishing a credit freeze or fraud alert for you, your spouse and dependents.
- Investors should review their investment asset allocation with their Baird Financial Advisor to determine if it's still appropriate given their goals and time horizon. Market volatility can also trigger a need to rebalance a portfolio periodically back to a target allocation.
- Individuals should compile a list of where all pertinent financial documents can be found in the event they become incapacitated. Include account numbers, contact names and phone numbers, as well as important facts on all family members. This sheet should be kept in a safe location, but be accessible by the appropriate person if the need arises.
- Estate documents should be reviewed to ensure they're still appropriate, especially if there has been any change in marital status, any births or deaths in the family, a significant change in personal net worth, or relocation to a new state during the year.
- Review any beneficiary designations on insurance policies, retirement plans, etc. to ensure they are still appropriate.