Tax reform aftermath: New guidance for investors

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Since Congress passed the sweeping Tax Cuts and Jobs Act (the "Act") at the end of 2017, the IRS has issued substantial guidance interpreting portions of the Act. Much of this guidance favors investors by softening limitations and disallowances that the Act imposes.

This paper updates our paper of a year ago, "Tax reform accomplished: How does the legislation affect investors and businesses?" The update is intended to help investors apply the new guidance as they file their 2018 returns in April and begin their tax planning for 2019.

Investors should consult with their financial and other professional advisors to determine what actions, if any, make sense in their cases in light of the new guidance.

State and local taxes

The Act limits the deduction for state and local taxes (SALT) to $10,000 annually per tax return.

SALT deduction workarounds

- The SALT deduction limitation applies only to state and local taxes imposed on individuals. State and local taxes imposed on businesses remain fully deductible apart from the $10,000 limitation. For instance, property taxes imposed on business property are deductible from the business's income, even if the investor's non-business state taxes exceed $10,000. The portion of real property tax allocated to a home office is deductible in the same manner (assuming the investor does not use the simplified square footage method to calculate the home office deduction).

  Takeaway: Investors should scrutinize their 2018 state and local tax payments and home office allocation to determine if any taxes are business-related and, thus deductible on their 2018 return.

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- Immediately after the Act became law, many residents prepaid their 2018 property taxes in 2017, hoping to take a deduction before the $10,000 limitation took effect. The IRS allowed these deductions in 2017 only in cases where the prepaid taxes were assessed in 2017. Taxes assessed in 2018 were deductible in 2018, not in 2017. (Source: IR-2017-210. Dec. 27, 2017).

  Investors who prepaid property taxes but were unable to claim a deduction in 2017 should include the taxes in the calculation of 2018 state taxes paid. Most of these investors likely are over the $10,000 limit in 2018, so including these additional state taxes will not produce a federal tax benefit.

  Takeaway: Investors whose state and local tax liability declined to under $10,000 in 2018 (perhaps because they moved to a different state) should include disallowed 2017 prepaid property taxes in 2018 taxes paid.

- Some states sought to provide a deduction for taxes paid over the $10,000 limitation by providing a dollar-for-dollar state tax credit for contributions made to a state-run charity. The states suggested that the payment was deductible as a charitable contribution apart from the $10,000 SALT limitation.

  The IRS held that the charitable contribution deduction was not available because the investor receiving the dollar-for-dollar tax credit was not out-of-pocket any funds. Because there was no net donation, there was no charitable contribution for which a deduction could be claimed. IRS proposed amendments to regulations under Section 170 (August 23, 2018).

  The IRS provided two exceptions to the charitable contribution deduction disallowance. First, the disallowance does not apply where the state allows a dollar-for-dollar deduction (as opposed to a credit) equal to the contribution amount. Second, under a de minimis rule, the disallowance does not apply where the credit is less than 15% of the contributed amount.

  Takeaway: Investors who made charitable contributions to reduce their state tax obligation in 2018 should determine whether one of these exceptions applies to allow a deduction on their 2018 returns.

Mortgage interest

The Act eliminates the deduction for interest paid on home equity lines of credit (HELOCs), including interest paid on existing line of credit borrowings.

HELOC interest deduction workarounds

- The Act's prohibition notwithstanding, subsequent IRS guidance provides an exception to the HELOC interest disallowance where the HELOC loan proceeds are used to buy, build, or substantially improve the home that secures the HELOC loan. Thus, for example, interest paid on home equity loan proceeds used to build an addition to the home is deductible, while interest on the same loan used to pay personal living expenses, such as credit card debt or college tuition, is not. (Source: IR-2018-32. Feb. 21, 2018).

Investors should determine whether they invested HELOC loan proceeds to improve the home that secures the HELOC so that they may deduct the interest paid on their returns for 2018.

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Charitable contributions

Nominally, the Act did not restrict the rules for charitable contribution deductions. But the interplay of the charitable contribution rules with the Act's higher standard deduction and limitations on other itemized deductions provides investors with both opportunities and pitfalls when making charitable contributions.

The Act roughly doubles the standard deduction to $24,000 for joint filers and to $12,000 for single filers, a simplification measure intended to free more people from the chore of recording and reporting their itemized expenses. The tax writers estimate that this increase in the standard deduction will reduce the number of investors who itemize from roughly one-third to fewer than 10%. (Source: Committee on Ways and Means, Tax Cuts and Jobs Act Section by Section Summary. November 2017).

Charitable contributions are deductible only if an investor itemizes deductions. If the prediction is correct, fewer investors will itemize, and thus more investors will lose the tax benefit of contributing to charity. Of course, individuals contribute to charities for reasons other than tax savings. But charitable organizations understandably are concerned that the Act will adversely affect the donations they receive.

Investors who claimed the standard deduction on their 2018 returns should consider "bundling" a number of years' charitable contributions in 2019. Investors who do this might consider establishing a donor advised fund to receive and later distribute the contributions.

Charitable contribution workarounds

- **Bundling contributions and donor advised funds:** Investors who otherwise take the standard deduction could consider "bundling" a number of years' charitable contributions into a single year. Bundling can allow investors in that year to exceed the standard deduction, itemize their deductions, and receive a tax benefit for the bundled contributions.

  Suppose an investor has $23,000 of itemized deductions, which includes a $1,000 donation to charity. The investor in this case will claim the standard deduction of $24,000. Because the investor does not itemize, the charitable contribution produces no tax benefit. Suppose instead the investor "bundles" five years' contributions in a single year, for a total contribution of $5,000. The itemized deductions in that year total $28,000, greater than the $24,000 standard deduction. The investor will itemize deductions, saving up to $1,480 in taxes (($28,000 - $24,000) x 37%). The investor would then claim the standard deduction (and make no charitable contributions) for the next four years.

  Investors considering "bundling" might not want to give five years' of contributions to charities all at once. Rather, they prefer to continue their practice of choosing a charity each year to receive a $,1000 donation. To meet this concern, the investor could establish a "donor advised fund" (DAF). Contributions to a DAF are deductible when made. However, the DAF is not required to distribute the proceeds to charities immediately. Instead, the DAF may dole out the funds in succeeding years to such charities in such amounts as the investor instructs at that time. (Of course, the investor does not receive a second deduction when the DAF distributes the funds.) To obtain an additional tax benefit, the investor could contribute appreciated assets to the DAF and avoid the recognition of capital gain.

  Takeaway: Investors who claimed the standard deduction on their 2018 return should consider "bundling" a number of years' charitable contributions in 2019. Investors who do this might consider establishing a donor advised fund to receive and later distribute the contributions.

- **IRA/charitable contribution rollover:** This method works only for investors over the age of 70-1/2. These investors are required to take annual distributions from their retirement accounts (required minimum distributions, or RMDs). Under legislation enacted prior to the Act and still in effect, an individual over the age of 70-1/2 may transfer up to $100,000 from an IRA directly to a charity and avoid tax on the IRA distribution. Moreover, the distribution to the charity counts toward satisfying the individual's RMD obligation. By transferring the withdrawn funds to a charity, the investor avoids paying tax on those funds, which provides a tax benefit equivalent to a deduction on the tax return. Thus, for someone over the age of 70-1/2, the first dollars contributed to charity should be distributions from an IRA.

To qualify under the IRA/charitable contribution rule, IRA assets must be transferred directly to a charity. Transfers to a DAF do not qualify. Thus, these two workaround methods may not be combined.

Takeaway: Investors over age 70-1/2 should consider using IRA funds to make charitable contributions in 2019.

Medical expenses

The Act temporarily broadens the deduction for medical expenses. Prior to the Act, medical expenses were deductible only to the extent they exceeded, in the aggregate, 10% of adjusted gross income (AGI). The Act reduces the 10% AGI threshold to 7.5% AGI for medical expenses incurred in 2017 and 2018. Beginning in 2019, the threshold rises back to 10% of AGI.

Takeaway: Investors who incurred medical expenses not covered by insurance in 2018 should check whether those payments, in the aggregate, exceeded 7.5% of their adjusted gross income.

To maximize investment growth outside the estate, and to guard against a legislative change that lowers the exemption amount, investors should consider making large gifts as soon as practicable.

Federal estate tax

The Act doubles the lifetime exemptions for the estate and gift tax, and generation-skipping tax, to $11.4 million per person in 2019 ($22.8 million for a married couple). (Source: IRS Rev Proc 2018-18). The exemption amount is scheduled to return to $5.49 million (adjusted for inflation) per person in 2026. (The investor's state might have a lower exemption than the federal exemption for purposes of computing that state's death tax.)

Taking advantage of the higher exemption

- Gifts made while the exemption is high that do not exceed $11.4 million (adjusted for inflation) in the aggregate are not later included in the estate and subject to estate tax, even if the investor dies in a later year when the exemption is lower. (Source: IRS REG-106706-18. Nov 21, 2018). Not only does the gifted amount escape estate tax, but so do the growth and earnings between the dates of gifting and death.

Investors who incurred medical expenses not covered by insurance in 2018 should check whether those payments, in the aggregate, exceeded 7.5% of their adjusted gross incomes.

Takeaway: To maximize investment growth outside the estate, and to guard against a legislative change that lowers the exemption amount, investors should consider making large gifts as soon as practicable.

Entertainment expenses

The Act eliminates deductions for business entertainment expenses. When Congress passed the Act, it was unclear whether the disallowance applied to business meal expenses

Deduction of business meal expenses.

- Subsequent IRS guidance makes clear that the cost of food purchased for business reasons without an entertainment component (for example a restaurant dinner or a buffet offered at a client seminar) is not subject to the entertainment disallowance. Thus, the costs of standalone meals are deductible, subject to the 50% reduction in meal expense deductions that remains in effect from prior law.

  The cost of food purchased as part of or during an entertainment activity remains (50%) deductible if (i) the food and beverages are purchased separately from the entertainment, or (2) the cost of the food and beverages is stated separately from the cost of the entertainment on bills or receipts. (Source: IRS Notice 2018-76. Oct 3, 2018).

  For example, suppose an investor purchases a ticket to take a client to a baseball game. During the game, the investor buys the client a beer. Because the beer is purchased separately from the ticket, the investor may deduct the cost of the beer (but not the cost of the ticket). Suppose instead the investor takes the client to a luxury box, where food is provided without additional charge. In that case the food is part of the entertainment expense and not deductible, unless the investor receives a separate invoice for the food cost apart from the cost of the luxury box.

  Takeaway: Investors should scrutinize their business entertainment receipts from 2018 to determine if (i) the outlay is solely for the purchase of food, or (ii) the food is provided in connection with entertainment and the receipts break out the food cost separately from the entertainment expense.

Miscellaneous itemized deductions

The Act repeals the miscellaneous itemized deductions subject to the 2% floor. This repeal includes the deduction for investment fees and expenses available under prior law. Thus, an investor holding assets in a separately managed account (SMA) that produces $100,000 of income and imposes a $1,000 fee pays tax on $100,000, because the $1,000 fee that the investor pays directly is no longer deductible.

Receiving a benefit for investment expenses

- The new disallowance notwithstanding, fees that the investor incurs indirectly by way of a reduction in income inside the investment does provide a tax benefit. For instance, suppose instead of investing in an SMA, the investor purchases a mutual fund with the same earnings and fees. In that case, the $1,000 fee is netted against the $100,000 income inside the fund, and the net of $99,000 is distributed to the investor as a dividend. Thus, the SMA investor's taxable income is $100,000, while the mutual fund investor's taxable income is $99,000.

  This tax benefit does not mean that a mutual fund's structure is necessarily superior to an SMA's. Typically, the ability to harvest losses and manage taxes, in addition to lower fees, remains a significant advantage of SMAs.

  Takeaway: Investors should review with their advisors the form of investment that provides the greatest after-tax benefit in their situations.

Reduction in taxable income earned by pass-through entities

Business income earned by pass-through entities (e.g., partnerships, limited liability companies, S corporations, and sole proprietorships) flows through to the owners' tax returns. Prior to the Act, an owner paid tax on this income at ordinary income rates.

Subject to certain limitations, the Act provides a deduction equal to 20% of an owner's share of business income earned by a pass-through entity that does not provide personal services. Combined with the new 37% top individual tax rate, the deduction results in a top tax rate of 29.6%. The Act defines personal service businesses to include entities providing financial, brokerage, health, law, accounting, actuarial, or consulting services, but excludes engineering and architecture businesses.

Owners of a pass-through entity that provides personal services also may claim a deduction equal to 20% of their share of business income, but only if they report on their tax returns less than $315,000 of joint taxable income ($157,500 for single filers). The ability to claim the deduction is phased out for incomes between $315,000 and $415,000, so that owners of a personal service business who have taxable income over $415,000 may not claim the deduction at all.

Reducing income under the 20% deduction threshold

- The income limitation is based on the taxable income reported on an owner's joint tax return, not on the business' income. Thus the $315,000 limitation is increased by a spouse's income, and is reduced by personal deductions for such items as pension contributions, health savings accounts, self-employed taxes, self-employed health insurance, mortgage interest, charitable contributions, and state taxes (subject to the $10,000 limitation).

Investors should review with their advisors the form of investment that provides the greatest after-tax benefit in their situations.

  Owners whose taxable income exceeds $315,000 could consider taking steps to reduce their income below this amount. One way to reduce income is to establish a retirement plan funded with deductible contributions. Typically, a defined benefit pension plan permits the largest contributions and yields the greatest tax deduction.

  An owner of a business with no employees might find a pension plan particularly appealing. If the business employs additional workers, then the plan typically must provide contributions for those workers as well.

  If the business employs other workers, and the owner does not wish to make pension contributions for those workers, the owner could consider a 401(k) plan. A 401(k) plan does not require the owner to make contributions on behalf of other employees, but the owner's contribution amount typically is lower.

Business owners who do not have a pension or 401(k) plan should consider establishing a plan in 2019 if doing so would reduce their joint taxable income below $315,000, allowing them to deduct 20% of their business income beginning in 2019.

Of course, setting up a retirement plan does not help if the owner's allowable contributions are not sufficient to reduce taxable income below the income threshold. Moreover, the procedures for and consequences of establishing retirement plans are exceedingly complex. Business owners considering such an arrangement should consult with their financial advisors and employee benefits counsel before establishing a plan. Also, the owner should take into account the expense of preparing governing documents and annually maintaining such a plan, as these can be costly.

Takeaway: Business owners who do not have a pension or 401(k) plan should consider establishing a plan in 2019 if doing so would reduce their joint taxable income below $315,000, allowing them to deduct 20% of their business income beginning in 2019.

Using Roths for owners already under the 20% deduction threshold

- A business owner who already is below the income threshold could consider making contributions to a Roth account, and perhaps converting existing retirement accounts to Roths. Contributions to Roth accounts are not deductible, but the income later is withdrawn tax free. If the owner is eligible for the 20% business income deduction, then contributions to a traditional IRA or 401(k) produces a tax benefit at a maximum rate of 29.6% (see above). Distributions from the account will be taxed at a maximum current tax rate of 37%. Thus, the tax saved initially will be less that the tax later paid. In contrast, although contributions to a Roth produce no current tax benefit, the investor avoids tax on distributions at a 37% rate, a greater net tax savings.

  This analysis is subject to many variables, including whether the owner's tax rate will change upon retirement. Thus, an owner should consult with an advisor familiar with the advantages and disadvantages of Roth accounts before undertaking this arrangement.

  Takeaway: Owners already below the $315,000 taxable income threshold for claiming the 20% deduction on business income could consider making contributions to a Roth IRA or Roth 401(k). Contributions for 2018 typically may be made up to April 15, 2019.

This paper sets out a number of suggestions that investors may consider in filing their 2018 tax returns and undertaking tax planning for 2019 and beyond. Not all, or any, of these suggestions may be beneficial to a particular investor, as effective tax planning must take into account that investor's income, investment posture, and tax situation. Accordingly, investors should review these and any other tax planning suggestions with their financial and tax advisors before filing their 2018 tax returns and before undertaking potential tax planning opportunities for 2019 and beyond.

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