Client Tax Letter

Smart tax, business and planning ideas **from your** Trusted Business Advisor℠

April /May/ June 2018

Patience is prudent

The Tax Cuts and Jobs Act (TCJA) of 2017, passed at year end, has been called the most extensive tax legislation in more than 30 years. It's certainly far reaching, covering individual income taxes, business income taxes, and estate taxes. The new law has many tax saving opportunities as well as possible pitfalls.

Trying to grasp everything in the TCJA can be overwhelming. Therefore, it's best not to panic; don't rush into tax motivated actions just because of gossip or opinions you hear. There's no need to act rashly this early in the year.

That said, it is important to understand what's in the TCJA and what it might mean to you. Consider this issue of *CPA Client Tax Letter* as a place to start. You'll find explanations of some key portions of the law as well as tax planning ideas.

One issue is not sufficient to cover the new law, so we'll keep you posted throughout the year as uncertainties are addressed and new strategies emerge. Of course, if you have questions about the TCJA and possible planning tactics, please call our office for a personalized response.

Know your true tax rate

It has been widely reported that the TCJA lowers federal income tax rates for many people. The highest tax rate, for example, has fallen from 39.6% to 37%. Many people who are in lower brackets also stand to benefit.

Example 1: Alice Young had $100,000 of taxable income in 2017. As a single filer, Alice was in the 28% tax bracket. If Alice has that same $100,000 in taxable income in 2018, she will be in a 24% bracket. Indeed, Alice could add as much as $57,500 in taxable income this year and maintain her lower 24% tax rate.

Not for everyone

However, there are some quirks in the new tax rates. Some people actually face higher rates.

Example 2: Brad Walker had $220,000 of taxable income in 2017, which put him in

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a 33% tax bracket. With the same income in 2018, Brad will face a 35% tax rate.

In addition, the federal tax rates such as 24% or 35% are just one factor in determining the true rate you'll pay by adding taxable income, or the true amount you'll save with a tax deduction. Many people owe state or even local income tax, which might be fully or partially deductible on a federal tax return or not deductible at all. Various other provisions of the tax code will also impact your marginal tax rate—the percent you'll owe or save by adding or reducing taxable income.

Knowing your true tax rate can help you make knowledgeable financial decisions, some of which are explained elsewhere in this issue. By starting with your 2017 tax return and incorporating your expectations as well as your plans for 2018, our office can help you determine the value of tax related actions.

Trusted advice

Retirement rules

- Participants in 401(k) and similar employer sponsored retirement plans can contribute up to $18,500 this year, or $24,500 if they've reached age 50.
- If your company's 401(k) plan offers a designated Roth account, contributions to the plan can be divided in any manner you choose between a pre-tax account and a designated Roth account, but the total can't exceed the $18,500 or $24,500 ceilings.
- Any employer match usually goes into the traditional 401(k), even if the contribution is to the Roth version, so income tax on the matching money is deferred.

Did you know?

In 1913, when the 16th Amendment instituted the federal income tax, the form and directions fit on four pages. The top tax rate was 7%. Since then, the peak rate has been as high as 94% in 1944 and as low as 28% from 1988–1990.

Source: Bradford Tax Institute

Rethinking retirement contributions

The TCJA generally lowered federal income tax rates, with some exceptions. Among the ways in which lower rates impact tax planning, they make unmatched contributions to traditional employer retirement plans less attractive.

Example 1: Chet Taylor has around $100,000 in taxable income a year. Chet contributed $12,000 to his company's traditional 401(k) in 2017, reducing his taxable income. He was in the 28% tax bracket last year, so his federal tax savings were $3,360 (28% of $12,000). An identical contribution this year will save Chet only $2,880, because the same income would put him in a lower 24% bracket.

Not everyone will be in this situation.

Example 2: Denise Sawyer has around $200,000 taxable income a year. Denise contributed $12,000 to her company's traditional 401(k) in 2017, reducing her taxable income. She was in the 33% tax bracket last year, so her federal tax savings were $3,960 (33% of $12,000). An identical contribution this year will save her $4,200 because the same income would put her in a higher 35% bracket.

Planning pointers

Considering the changes in tax rates, participants in employer sponsored retirement plans should review their contribution plans. If your company offers a match, be sure to contribute at least enough to get the full amount. Otherwise, you're giving up a portion of your compensation package.

Beyond that level, decide whether you wish to make unmatched tax-deferred contributions to your traditional 401(k) or similar plans. The value here is tax deferral and the ability to compound potential investment earnings without paying current income tax. Deferring tax at, say, 12%, 22%, or 24% in 2018 will be less desirable than similar deferrals were last year, when tax rates were 15%, 25%, or 28%.

On the Roth side

If you decide to cut back on tax-deferred salary contributions, spending the increased current income won't help you plan for your future retirement. Other savings tactics may be appealing.

For instance, your employer might offer a designated Roth account in its 401(k) plan. These accounts offer no upfront tax benefit because they're funded with after-tax dollars. The advantage is all withdrawals, including distributions of investment income, will avoid income tax after age 59½, if you have had the Roth account for at least five years. (Other conditions can

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also qualify distributions from a Roth account for full tax avoidance.)

Generally, the lower your current tax bracket and the higher your expected tax bracket in retirement, the more attractive Roth contributions can be.

Example 3: Ed Roberts, age 30, expects his taxable income (after deductions) to be around $50,000 this year, putting him in the 22% tax bracket. Ed hopes to have a successful career, so he might face a higher tax rate on distributions in the future. Therefore, Ed contributes $6,000 ($500 a month) to his company's traditional 401(k) to get some current tax relief, and $6,000 to the Roth 401(k) for tax free distributions after age 59½.

Some advisers suggest going into retirement with funds in a regular taxable account, funds in a tax-deferred traditional retirement account, and funds in a potentially tax-free Roth account. Then, you may have considerable flexibility in choosing tax-efficient ways to draw down retirement cash flow.

Other options

What if Ed's employer's 401(k) plan does not offer designated Roth accounts? A possible solution for Ed would be to contribute to a Roth IRA instead. In 2018, he can contribute up to $5,500 ($6,500 for those 50 and older). Roth IRAs also offer completely tax-free distributions after five years and age 59½.

Example 4: Assume that Ed's employer will match up to $4,500 of his 401(k) this year and that Ed plans to save $12,000 for his retirement. Ed could contribute $5,500 to a Roth IRA and $6,500 to his traditional 401(k).

With higher incomes ($120,000 or more of modified adjusted gross income for single filers in 2018, $189,000 for couples filing jointly), Roth IRA contributions are limited or prohibited. People facing this barrier may able to fund a nondeductible traditional IRA, up to $5,500 or $6,500 this year, then convert those dollars to a Roth IRA with little or no tax at this year's tax rates. (IRA contributions for 2017, with slightly different income limits, are possible until April 17, 2018.)

Ultimately, the choice between traditional and Roth retirement accounts will largely depend on expectations of future tax rates. Deferring tax in a traditional plan this year and saving 24% in tax may not turn out to be a good deal if future withdrawals are taxed at 28%, 30%, or 35%. The fact that the TCJA rates are among the Act's provisions that are due to sunset in 2026, reverting to 2017 rates, may tilt the scales a bit towards the Roth side, where distributions eventually may escape tax altogether.

Regard Roth conversions carefully

The article "Rethinking Retirement Contributions" explains why the new TCJA devalues putting money into traditional tax-deferred plans and favors Roth versions. Does the same reasoning apply to conversions from Roth to traditional accounts? From a tax viewpoint, the answer may be yes, but other factors indicate you should be cautious about such moves.

Example 1: Fred and Glenda Polk would have had $220,000 in taxable income in 2017 without contributing to their employers' traditional 401(k) plans. However, they contributed a total of $40,000 to the plan, bringing their income down to $180,000. The couple was in the 28% bracket last year, so the income deferral saved a total of $11,200 in tax: 28% times $40,000.

Assume they kept their $11,200 of tax savings in the bank. If their employers have a 401(k) plan that offers designated Roth accounts, they could convert the $40,000 they contributed in 2017 to the Roth side if the plans allow such moves. Alternatively, depending on the plan terms and the Polks' circumstances, they might be able to rollover the $40,000 to a Roth IRA. Yet another possibility, the Polks might leave the $40,000 in their 401(k)s but convert $40,000 of pretax money in their traditional IRAs to Roth IRAs.

With any of these strategies, the couple would generate a $9,600 tax bill (24% of $40,000) on the Roth conversion, because their joint income falls into the 24% tax bracket in 2018, in this example. The Polks could pay that $9,600 from their $11,200 of tax savings in 2017 and wind up ahead by $1,600.

Therefore, people who move into a lower tax bracket this year might be able to come out ahead with Roth conversions of income that had been deferred at a higher tax rate. Going forward, the money transferred to the Roth side may generate tax free rather than taxable distributions.

One-way street

Nevertheless, there are reasons to be cautious about Roth conversions now. For instance, U.S. stocks are trading at lofty levels. Roth conversions could be highly taxed at today's equity values.

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Example 2: Heidi Morris has $300,000 in her traditional IRA, all of which is pre-tax. Investing heavily in stocks, Heidi has seen her contributions grow sharply over the years. With an estimated $100,000 in taxable income this year, Heidi calculates she can convert $50,000 of her traditional IRA to a Roth IRA in 2018 and still remain in the 24% tax bracket.

However, stocks could fall heavily, as they have in previous bear markets. The $50,000 that Heidi moves to a Roth IRA could drop to $40,000, $30,000, or even $25,000. Heidi would not want to owe tax on a $50,000 Roth conversion if she holds only $25,000 worth of assets in the account.

Under previous law, Heidi had a hedge against such pullbacks, at least for Roth IRA conversions. These conversions could be recharacterized (reversed) to her traditional IRA, in part or in full, until October 15 of the following calendar year. In our example, Heidi could have recharacterized after a market setback, avoided a tax bill, and subsequently re-converted at the lower value. (Timing restrictions applied.)

Such tactics are no longer possible because the TCJA has abolished recharacterizations of Roth IRA conversions. (Conversions to employer-sponsored Roth accounts could never be recharacterized.) Now moving pre-tax money to the Roth side is permanent, so the resulting tax bill is locked in.

In the new environment, it may make sense to take it slowly on Roth conversions in 2018. If stocks rise, boosting the value of your traditional retirement accounts that hold equities, you won't be sorry about the increase in your net worth; you can convert late in the year at today's lower tax rate. On the other hand, if periodic corrections occur, they could be an opportunity for executing a Roth conversion at a lower value and a lower tax cost.

Are state and local taxes reasons for relocation?

As many people are all too aware, some states and localities impose higher income and property taxes than others. Residents of high tax areas may have taken some solace by itemizing deductions on their tax returns and reducing federal income tax obligations by deducting the taxes paid.

Example: Jennifer Knight deducted $25,000 worth of state income tax and local property tax on her 2017 tax return. Assuming Jennifer was in a 25% tax bracket, she reduced her net outlay for those taxes with $6,250 in tax savings (her 25% tax rate times the $25,000 tax deductions).

In this scenario, Jennifer's actual tax cost was $18,750, not $25,000, because she cut her federal tax bill by $6,250.

New rules

Under the TCJA, there is still an itemized deduction for taxes paid, but it is now capped at $10,000 a year, starting in 2018. Some people refer to this as the SALT deduction for state and local taxes. It mainly covers property and income taxes, although taxpayers can choose to include sales tax instead of income tax towards the $10,000 cap. (The $10,000 limit is the same for single filers and couples filing jointly, so there is a true "marriage penalty" here.)

As might be expected, taxpayers and politicians in high tax states and localities have loudly protested the cutback in the deduction for taxes paid. Is this the final straw? The added burden that will drive people to move to areas where income and property tax (and perhaps estate tax) are less of a burden?

Relocation may make sense, but such a decision should be made with care. Calculate how much extra you'll be paying in tax now, considering the loss of the taxes paid deduction and all the other features of the TCJA. Don't forget to include the alternative minimum tax (AMT), which still impacts many individuals. People who owe the AMT get no tax benefit from deducting state or local

taxes. Our office can help with this computation.

Then, find out how much you'd owe after a move to a different area. Include income taxes and, assuming you'll be a homeowner, likely property tax. Find out if sales tax will be meaningful in the new area. Determine the state's estate tax exemption and estate tax rates, if you expect to leave assets to loved ones.

Typically, you'll discover that relocating is a puzzle with many different parts of varying sizes. Effectively paying more in state and local tax under the TCJA may be a key piece of that puzzle, but it's just one thing to consider before calling the movers.

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Positive prognosis for medical deductions

Many miscellaneous itemized deductions, including unreimbursed employee business expenses (see the *CPA Client Bulletin*, February 2018), no longer can be used to reduce your income, starting with 2018 tax returns. Some observers predicted a similar demise for medical and dental expenses. As it turned out, these deductions not only were retained, the tax benefit was enhanced.

Playing the percentages

Under the law in effect during 2017, unreimbursed medical and dental expenses could be deducted only to the extent they exceeded 10% of adjusted gross income (AGI).

Example: Ivan Larson had $100,000 of AGI in 2017 and $9,100 of unreimbursed medical or dental expenses. Because 10% of his AGI was $10,000, Ivan's outlays were under the threshold, so he wasn't expecting a tax deduction for them.

Surprisingly, the TCJA lowered the threshold to 7.5% of AGI, effective for 2017 and 2018. For Ivan, that was $7,500 of expenses (7.5% of his $100,000 AGI), so his deduction for last year was $1,600 (his $9,100 of costs minus the $7,500 threshold).

Under the TCJA, the threshold will move back to 10% of AGI next year. Therefore, you may want to accelerate elective medical expenses such as prescription sunglasses and tooth implants into 2018.

If you plan to incur such expenses this year, before they may be absolutely necessary, you should be confident that your total of unreimbursed medical and dental costs will exceed

7.5% of AGI in 2018. You also should believe that you won't be taking the standard deduction: $12,000 this year for Ivan, a single taxpayer.

Unless you'll itemize deductions *and* your total of unreimbursed medical and dental costs will top 7.5% of AGI, accelerating elective outlays into 2018 will be a wasted effort. You'll be better off waiting until 2019 to make such payments when they might be tax deductible under the law that will be in effect then.

Home equity hassle

A key component of the TCJA is the expansion of the standard deduction. The numbers for 2018 are $24,000 (married couples filing jointly), $18,000 (heads of household), and $12,000 (all others). These amounts are almost double the respective standard deductions in 2017. However, personal exemptions were eliminated.

As a give-and-take, the new tax law trims some itemized deductions. Taxpayers can either itemize or use the standard deduction, so some shift to the standard deduction is likely.

Down with debt deductions

Among the trimmed itemized deductions are those for mortgage interest. The new law caps deductions to interest on $750,000 worth of debt used to buy, build, or substantially improve a main or second home. For loans incurred before December 15, 2017, the old rules remain in place, so interest on up to $1 million of such debt is still deductible.

These rule changes affect only newer home loans in the $750,000–$1 million range. Of broader impact, interest on any home equity loans or lines of credit cannot be deducted, starting in 2018. Previously, interest on home equity debt up to $100,000 generally could be deducted. (All of these home loan interest tax changes are scheduled to end after 2025, reverting to 2017 law.)

Therefore, home equity debt now looks like many other types of loans: the interest is nondeductible. Should you keep the one you have? That depends on your situation. If you wish to reduce your debt load, paying down home equity debt has become more attractive. Prepaying a nondeductible loan at, say, 5% is the equivalent of earning 5% on your money, after tax, with no market risk.

Another option is to update your existing home debt. A so-called cash out refinance might provide you with spending money, although the full interest deduction may not be available. Our office can help you crunch the numbers to see if the expense involved would make it worthwhile, and how it will impact the after-tax cost of residence related debt.

Yet another alternative is to use a personal loan to pay off the home equity debt. An unsecured personal loan might be preferable to a loan or line of credit that places your home at risk.

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New tax deduction for pass-through entities

Many small businesses are pass-through entities, including S corporations, partnerships, sole proprietorships, LLCs, and LLPs. The label indicates that all business earnings are passed through to the owners' personal income tax returns. Thus, they avoid the corporate income tax.

The TCJA contains a new tax benefit for pass-throughs. This provision is complex, but it is relatively straightforward for taxpayers with taxable income below $157,500 in 2018, or $315,000 on a joint return. Such business owners may qualify for a tax deduction that equals 20% of their qualified business income (QBI).

Example: Melanie Foster runs her business as an LLC. In 2018, her QBI (the net of her company's domestic business taxable income, gain, deduction, and loss) is $140,000. On the joint tax return that Melanie files with her husband, the taxable income is $235,000. This taxable income is before the QBI deduction.

Here, Melanie can deduct $28,000 (20% of $140,000) from their taxable income. Note that this deduction doesn't reduce the Fosters' adjusted gross income, which can impact many areas on their tax return.

Over the limits

For taxpayers over $157,500 or $315,000 in taxable income, other factors come into play, which can reduce the QBI deduction. Moreover, some service businesses, such as medical practices and law firms, don't merit the Q (for qualified) in QBI if their income is over certain limits. Our office can illustrate the value of the deduction for your pass-through business income.

Tax calendar

APRIL 2018

April 17

Individuals. File a 2017 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, "Application for Automatic Extension of Time To File U.S. Individual Income Tax Return." Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2018 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2018 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of $2,000 or more in 2017 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2016 or 2017 to household employees. Also, report any income tax you withheld for your household employees.

Corporations. File a 2017 calendar-year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

Corporations. Deposit the first installment of estimated income tax for 2018.

MAY 2018

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2018. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

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