Viewpoint

ANDREW H. FRIEDMAN & JEFFREY B. BUSH, THE WASHINGTON UPDATE | MARCH 2019

Tax Reform Aftermath: New Guidance for Taxpayers

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 taxpayers by softening limitations and disallowances that the Act imposes. This Viewpoint is intended to help taxpayers understand the new guidance as they file their 2018 returns in April and begin their tax planning for 2019. Taxpayers 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

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

Taxpayers should scrutinize their 2018 state and local tax payments and home office allocation to determine if any property or sales taxes are business-related and thus deductible on their 2018 return.

Prepaid property taxes: 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 not deductible in 2017. *IR-2017-210 (Dec. 27, 2017).*

Residents who prepaid property taxes but were unable to claim a deduction in 2017 should discuss with their tax advisor whether they may include the taxes in the calculation of 2018 state taxes paid. Most of these taxpayers likely are over the $10,000 limit in 2018, so including these additional state taxes will not produce a federal tax benefit in any event.

Taxpayers whose state and local tax liability is under $10,000 in 2018 (perhaps because they moved to a different state) should discuss with their tax advisor whether they may include disallowed 2017 prepaid property taxes in 2018 taxes paid.

Contributions to state-run charities: 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 on the federal return as a charitable contribution apart from the $10,000 SALT limitation.

The IRS held that the charitable contribution deduction was not available because the taxpayer 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. Thus, a taxpayer must reduce the charitable contribution by the amount of the credit received. *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.

Taxpayers 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 appears to eliminate the deduction for interest paid on home equity loans and lines of credit (HELOCs), including interest paid on existing line of credit borrowings.

HELOC interest deduction workarounds: IRS guidance clarified that the HELOC interest disallowance does not apply 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. *IR 2018-32 (Feb. 21, 2018).*

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

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 taxpayers 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 (slightly higher for older taxpayers), 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 taxpayers who itemize from roughly one-third to fewer than 10%. *Committee on Ways and Means, Tax Cuts and Jobs Act Section by Section Summary (November 2017).*

Charitable contributions are deductible only if a taxpayer itemizes deductions. If the prediction is correct, fewer taxpayers will itemize, and thus more taxpayers 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.

Charitable contribution workarounds

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

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

Taxpayers considering "bundling" might not want to give the five years' additional contributions to charities all at once. Rather, they may prefer to continue their practice of choosing a charity each year to receive a $1,000 donation. To meet this concern, the taxpayer 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 taxpayer instructs at that time. (Of course, the taxpayer does not receive a second deduction when the DAF distributes the funds.) To obtain an additional tax benefit, the taxpayer could contribute appreciated assets to the DAF and avoid the recognition of capital gain.

Taxpayers who claimed the standard deduction on their 2018 return should consider "bundling" a number of years' charitable contributions in 2019. Taxpayers 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 individuals over the age of 70½. These individuals 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 70½ 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 taxpayer 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 70½, 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.

Taxpayers over age 70½ 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.

Taxpayers 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.

Federal estate and gift tax

The Act doubles the lifetime exemption for the estate and gift tax from $5 million to $10 million, adjusted for inflation. For 2019, taking inflation into account, the exemption is $11.4 million per person ($22.8 million for a married couple). *IRS Rev Proc 2018-57.* The exemption is scheduled to return to $5 million (adjusted for inflation) per person in 2026. (The taxpayer's state might have a lower exemption than the federal exemption for purposes of computing that state's estate tax.)

Taking advantage of the higher exemption: Lifetime 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 individual dies in a later year when the exemption is lower. *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.

Although potentially beneficial from an estate tax viewpoint, the recipient of an appreciated asset could recognize greater taxable gain upon a later sale than the recipient of a gift made upon death. Taxpayers should consult with their advisor and estate tax counsel before making gifts.

To maximize investment growth outside the estate, and to guard against a legislative change that lowers the exemption, taxpayers should consider making lifetime gifts up to the larger exemption as soon as practicable. Individuals also should review their estate planning documents to make sure the documents properly take the new higher exemption into account.

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 (ii) the cost of the food and beverages is stated separately from the cost of the entertainment on bills or receipts. *IRS Notice 2018-76 (Oct 3, 2018).*

For example, suppose an individual purchases a ticket to take a client to a baseball game. During the game, the individual buys the client a beer. Because the beer is purchased separately from the ticket, the individual may deduct the cost of the beer (but not the cost of the ticket). Suppose instead the individual 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 individual receives a separate invoice for the food cost apart from the cost of the luxury box.

Taxpayers 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, a taxpayer 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 taxpayer 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.

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

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). (These figures are as of 2018 and will increase to reflect inflation.) 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 to 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's 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).

Owners whose taxable income exceeds $315,000 could consider taking steps to reduce their income below this amount. One way to reduce taxable 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 this 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 establishing 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.

In new regulations, the IRS threw a curve to business owners who reduce their taxable income by making a retirement plan contribution. Under these regulations, the entity's business income also must be reduced by the amount of the contribution. (This rule applies as well to the self-employed health insurance deduction and the deductible portion of the tax on self-employment income.) *IRS regulations under section 199A, pp.44, 198-199 (January 18, 2019).* As a result, the business owner does not get the full benefit of the 20% deduction.

The IRS regulations add a thick layer of complexity to the calculation of the 20% deduction. By way of example, suppose a personal service business has net income of \$500,000 flowing through to the owner. Because the owner's taxable income is over \$315,000 (assuming no other income or deductions), the owner may not deduct 20% of the business's income. Suppose the owner makes a deductible \$200,000 contribution to a qualified retirement plan. The contribution reduces the owner's taxable income to \$300,000, below the \$315,000 limitation for the 20% deduction. On its face, the owner should now be able to deduct \$100,000 (\$500,000 x 20%). But, under the IRS regulations, the business's income also must be reduced by the plan contribution amount. As a result, the business's income is \$300,000 (\$500,000 – \$200,000) and the owner's deduction is only \$60,000 (\$300,000 x 20%). In sum, the pension contribution permits the owner to claim the flow-through deduction, but the amount of that deduction is reduced by 20% of the contributed amount.

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. Owners making a retirement plan contribution should be aware that the contribution will produce a tax benefit equal to only 80% of the contributed amount.

Using Roth 401(k) for owners eligible for the 20% deduction: As explained above, an owner of a pass-through business who makes a deductible contribution to a qualified retirement plan will receive a tax benefit of only 80% of the contributed amount. Yet later withdrawals from the retirement plan will be fully taxed, producing an unfavorable result. If an owner does not need to make a contribution to qualify for the 20% deduction, the owner might consider establishing and contributing to a Roth 401(k) plan rather than a traditional plan. This Roth strategy could be useful for an owner of a non-service business, or an owner of a service business whose taxable income is less than \$315,000 before retirement contributions. Contributions to a Roth 401(k) plan are not deductible, but the owner may later withdraw amounts in the Roth account tax-free. The owner thus avoids the issue of the 20% haircut applicable to deductible plan contributions.

Owners of non-service pass-through businesses, and owners of service pass-through businesses whose taxable income is less than \$315,000, should consider making contributions to a Roth 401(k) plan rather than to a traditional qualified retirement plan.

Important caveats

- Determining whether a contribution to a traditional retirement plan or to a Roth plan makes sense in the context of the 20% flow-through income deduction is exceedingly complex. The analysis is subject to many variables, including the extent to which the owner and spouse have non-business income or deductions, the extent to which a spouse is participating in a retirement plan, the future direction of tax rates, and whether the owner's tax rate is likely to change. Thus, before taking action an owner should consult with an advisor familiar with the 20% deduction and the workings of retirement plans and contributions.
- The procedures for and consequences of establishing retirement plans also are complex. Business owners considering such an arrangement should consult with their financial advisor 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.

This Viewpoint sets out a number of suggestions that taxpayers 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 taxpayer, as effective tax planning must take into account that individual's income, investment posture and tax situation. Accordingly, individuals should review these and any other tax planning suggestions with their financial and tax advisors before filing their 2018 tax return and before undertaking potential tax planning opportunities for 2019 and beyond.

Andrew H. Friedman is the founder and principal of The Washington Update LLC and a former senior partner in a Washington, D.C. law firm. He and his colleague Jeff Bush speak regularly on legislative and regulatory developments and trends affecting investment, insurance, and retirement products. They may be reached at www.TheWashingtonUpdate.com.

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