Get your clients ready for tax season

Recent changes to deductions and tax rates should guide planning for the rest of 2018.

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The legislation known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, for the most part took effect on Jan. 1, and now is the time to make sure you and your clients are ready for the many changes that affect individuals' taxes this year. Here is a look at this year's important changes and tips for advising clients so that they can be in the best position at year end.

IMPORTANT CHANGES

The TCJA made a large number of changes that affect individuals, including new tax rates (see the table, "2018 Income Tax Rates for Individuals"), new rules for the kiddie tax, new thresholds for various capital gain rates, an elimination of personal exemptions, and a much larger standard deduction. Miscellaneous itemized deductions that were subject to the 2%-of-adjusted-gross-income (AGI) floor under prior law are no longer available.

Compare standard vs. itemized deductions

The first item to discuss with clients is whether it will be better for them to itemize or take the standard deduction — and if they do itemize, how to maximize their deductions.

The TCJA increased the standard deduction to $24,000 for married taxpayers filing jointly, $18,000 for heads of household, and $12,000 for all other individuals. (Compared with $12,700/$9,350/$6,350 in 2017.) The additional standard deduction for elderly and blind taxpayers was not changed. But somewhat offsetting the increased standard deduction, the act repealed all personal exemptions, which last year were $4,050 per person (subject to phaseouts above certain AGI levels).

Clients should determine what their anticipated itemized deductions for the year will be to see whether they will exceed their standard deduction. Those whose current itemized deductions fall far short of the standard deduction may want to postpone deductible expenses until next year; those that are close to the standard deduction amount may want to move planned 2019 spending into 2018 to maximize 2018 itemized deductions. They can then take the standard deduction next year.

Here are the itemized deductions clients should be thinking about:

Medical expenses: The TCJA reduced the threshold for deduction of medical expenses to 7.5% of AGI, but just for 2017 and 2018. So clients who anticipate being near the 7.5% threshold and expect discretionary medical expenses in the near future should try to move those expenses into 2018, if possible.

State and local taxes: The TCJA capped the deduction for state and local income or property taxes at $10,000 ($5,000 for married taxpayers filing separately). Some states have passed legislation to allow taxpayers to contribute money to funds controlled by state or local governments in exchange for credits against their state or local taxes. These funds are designed to allow taxpayers to get around the $10,000 cap. The IRS has warned that it plans to issue regulations in response to this state legislation and said it would apply a "substance-over-form" analysis in determining how these payments will be treated for federal income tax purposes. This suggests that the new regulations will provide that these payments will not be treated as deductible charitable contributions for federal tax purposes.

Mortgage interest: Mortgage interest is still deductible, although the limit on acquisition indebtedness was reduced to $750,000 (from the prior-law limit of $1 million). Clients with prior existing mortgages (entered into before Dec. 15, 2017) can still deduct interest on them up to $1 million of acquisition indebtedness. Clients who entered into a binding written contract before Dec. 15, 2017, to close on the purchase of a principal residence before Jan. 1, 2018, and who purchased that residence before April 1, 2018, are considered to have incurred acquisition indebtedness prior to Dec. 15, 2017, and so are also allowed the prior-law $1 million limit on that debt. Mortgages entered into on or after Dec. 15, 2017, are subject to the $750,000 limit. Interest on home-equity loans is no longer deductible — except to the extent the home-equity loan is considered acquisition indebtedness (i.e., it is used to buy, build, or substantially improve the taxpayer's home that secures the loan).

Also note that Sec. 163(h)(3)(E), which allowed taxpayers whose income was below certain thresholds to deduct the cost of premiums on mortgage insurance purchased in connection with acquisition indebtedness on the taxpayer's principal residence, expired at the end of 2017 and, as of this writing, has not been extended.

Charitable donations: The TCJA increased the income-based percentage limit for charitable contributions of cash to public charities to 60%. It also denies a charitable deduction for payments made for college athletic event seating rights. Since charitable contributions are entirely at the client's discretion, they present the best opportunity for 2018 tax planning on Schedule A, *Itemized Deductions*. What clients should try to avoid is "wasting" the charitable contribution's deductibility in years when the client is taking the standard deduction.

One way to avoid this is to bunch charitable donations into specific years. To do this, clients can combine several years' worth of expected future charitable contributions into a single year. The relatively large charitable contributions in that year will help the client's itemized deductions exceed the standard deduction. Then in the future years, when the client would otherwise have made those bunched donations, the client takes the standard deduction. The client may wish to donate to a donor-advised fund, which can then make donations to charities over the next few years.

Theft and casualty losses: Clients should be aware that, generally, they can deduct casualty losses only if the loss is attributable to a federally declared disaster in 2018 (and through 2025). However, if they have personal casualty gains in a year, they can deduct personal casualty losses that are not attributable to a federally declared disaster in that year up to the amount of their personal casualty gains.

Miscellaneous itemized deductions: All miscellaneous itemized deductions subject to the 2%-of-AGI floor under prior law are unavailable in 2018 (and through 2025). These include a variety of expenses, including unreimbursed employee expenses, such as job travel and union dues, and tax preparation fees.

Itemized deduction limitation: One piece of good news — while itemized deductions are less available than in prior years, the overall limitation on itemized deductions does not apply in 2018 (and through 2025).

Divorce

Be sure clients who are getting married or divorced understand that their year-end marital status will affect the tax return because any taxpayer who marries or divorces during the year is treated as having had his or her Dec. 31 marital status all year.

Clients who are currently going through a divorce need to think about the timing of the divorce. This is because the rules regarding deductibility and inclusion of alimony payments will change after Dec. 31, 2018. For any divorce or separation agreement executed after that date, the TCJA provides that alimony and separate maintenance payments are not deductible by the payer spouse and not includible in income by the payee spouse. To the extent that the date of the finalization of the divorce can be controlled, clients who will pay alimony will want to finalize the divorce in 2018; clients who will receive alimony will want to hold off on finalization until next year.

Note that alimony payments under divorce or separation agreements in effect before Dec. 31 will not be affected by the new rules — they will continue to be deductible by the payer spouse and includible in income by the payee spouse. However, if a divorce or separation agreement executed on or before Dec. 31, 2018, is modified after that date, the new rules will apply if the modification expressly provides that they will apply to the modification.

Roth IRA rules

Clients should also be made aware that the TCJA eliminated one large Roth IRA conversion planning opportunity. Under prior law, a traditional IRA could be converted to a Roth IRA and the client could recharacterize the Roth conversion contribution as a contribution to a traditional IRA until Oct. 15 of the following year. This allowed the client an extended period of time to unwind an unfavorable Roth conversion without paying tax. After the TCJA, Roth conversion contributions can no longer be recharacterized. Thus, clients who convert a traditional IRA to a Roth IRA must stick with that decision.

Child tax credit

The TCJA increased the amount of the child tax credit to $2,000 per qualifying child. Up to $1,400 of the credit amount is refundable. The act also created a new nonrefundable $500 credit for qualifying dependents who are not qualifying children. Also, the threshold at which the credit begins to phase out was increased to $400,000 for married taxpayers filing a joint return and to $200,000 for other taxpayers.

Passthrough income deduction

For 2018 (and through 2025), clients can generally deduct up to 20% of "qualified business income" from a partnership, S corporation, or sole proprietorship, as

well as 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.

For these purposes, “qualified business income” means the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer. These items must be effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the year.

Qualified items of income, gain, deduction, or loss do not include short-term or long-term capital gains or losses; dividends, income equivalent to a dividend, or payments in lieu of dividends (other than certain patronage dividends and per-unit allocations); any interest income that is not properly allocable to a trade or business; certain commodity transaction or foreign currency gains or losses; income, gain, deduction, or loss related to certain notional principal contracts; amounts received from an annuity that is not received in connection with the trade or business; and items of deduction or loss properly allocable to any of these items.

“Qualified business income” also does not include any reasonable compensation paid to a taxpayer by a qualified trade or business of the taxpayer, or a partnership guaranteed payment to a partner for services provided to a qualified trade or business, or — to the extent provided in regulations — any payment to a partner who is acting in a capacity other than his or her capacity as a partner.

The term “qualified trade or business” means any trade or business other than a specified service trade or business, or the trade or business of performing services as an employee. “Specified service trades or businesses” include any trade or business in the fields of accounting, health, law, consulting, athletics, financial services, brokerage services, or any business where the principal asset of the business is the reputation or skill of one or more of its employees. It also includes any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Because specified service businesses are not considered qualified trades or businesses, income from specified service businesses generally is not included as qualified business income in determining the passthrough deduction. However, in 2018, if a taxpayer’s taxable income for a year is less than the threshold amount of $157,500 ($315,000 in the case of a joint return), the exclusion for specified service trades or businesses does not apply, and the deduction is

2018 INCOME TAX RATES FOR INDIVIDUALS

Single

Taxable income over	But not over	Is taxed at
$0	$9,525	10%
$9,525	$38,700	12%
$38,700	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$500,000	35%
$500,000		37%

Heads of household

Taxable income over	But not over	Is taxed at
$0	$13,600	10%
$13,600	$51,800	12%
$51,800	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$500,000	35%
$500,000		37%

Married taxpayers filing joint returns and surviving spouses

Taxable income over	But not over	Is taxed at
$0	$19,050	10%
$19,050	$77,400	12%
$77,400	$165,000	22%
$165,000	$315,000	24%
$315,000	$400,000	32%
$400,000	$600,000	35%
$600,000		37%

Married taxpayers filing separately

Taxable income over	But not over	Is taxed at
$0	$9,525	10%
$9,525	$38,700	12%
$38,700	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$300,000	35%
$300,000		37%

available for income from the specified service businesses of the taxpayer for that year. A phaseout of the exclusion applies to taxpayers with taxable income over the threshold amount but less than the upper phaseout amount of $207,500 ($415,000 in the case of a joint return). For taxpayers with taxable income above these upper phaseout amounts, none of their specified service income is included as qualified business income in determining the deduction.

In addition, in general, the passthrough deduction is limited to 50% of the W-2 wages paid with respect to the business or 25% of wages paid plus 2.5% of the unadjusted basis (immediately after acquisition) of certain qualified property. However, in 2018, this limitation on the deduction does not apply to taxpayers with taxable income below the threshold amount of $157,500 ($315,000 in the case of a joint return) and phases in for taxpayers with taxable income above the threshold amount but less than the upper phase-in amount of $207,500 ($415,000 in the case of a joint return).

WITHHOLDING AND ESTIMATED TAXES

With the changes in the individual tax rates, clients may find themselves over- or under-withholding in 2018. The IRS issued a new Form W-4, *Employee's Withholding Allowance Certificate*, and new withholding tables, which employers were supposed to implement by Feb. 15. However, it is important to confirm a client's expected net income for 2018 and expected withholding, to ensure the appropriate amount of tax has been withheld for the year. This includes determining whether the client has any investment income that will be subject to the net investment income tax or nonwage income on which tax has not been withheld and estimated tax payments have not been made.

If it looks as if a client's income tax withholdings will not be enough, have the client file a new Form W-4 with his or her employer to increase the withholdings through the end of the year or make estimated tax payments. Having additional tax withheld may be more beneficial than making estimated payments, because taxes withheld are considered paid equally throughout the year, even if they are bunched near the end of the year. On the other hand, if it appears the client will have overpaid his or her taxes for the year, suggest filing a Form W-4 to decrease withholding and get a refund upfront, rather than giving the IRS an interest-free loan.

For taxpayers who expect to owe at least $1,000 in tax, the required tax payment to avoid underpayment of tax penalties is the lesser of 90% of the tax shown on the current year's return or 100% of the tax shown on the prior year's return. However, if an individual's gross income for the preceding year was more than $150,000 ($75,000 if the filing status for the current year is married filing separately), 110% is substituted for 100% in determining the amount of tax that must be paid by Jan. 15, 2019, to avoid penalties.

YEAR-END GIFTS

Now is a good time to evaluate whether clients should be making year-end gifts. A year-end gift of appreciated property can move taxable gain to family members in a lower tax bracket. Also, a client can make gifts to any number of donees before year end, and, as long as each gift is no more than $15,000, the gifts will not be taxable or count against the donor's unified estate and gift tax exemption. Married clients can make joint gifts of up to $30,000 to each donee under the gift-splitting rules. Remind clients that they must make any gifts by Dec. 31 for the gifts to count as being made in 2018, and that a gift made by check generally will not count as a 2018 gift for gift tax purposes if it is not cashed or deposited by the donee in 2018.

POSTPONING INCOME AND ACCELERATING DEDUCTIONS

Usually, it makes sense for clients to defer income into later years and to accelerate deductions into the current year. Besides reducing the amount of the client's income subject to tax, this strategy also reduces his or her AGI, which may allow the client to avoid being subject to the net investment income tax or losing all or part of certain deductions that are subject to phaseout or elimination based on AGI.

Clients who have money to donate but do not know which charity they want to contribute it to can consider donating the money to a donor-advised fund. The client can then take the deduction in the current year while advising the fund on which charities to give the contributed funds to over the next couple of years.

ACCELERATING INCOME AND POSTPONING DEDUCTIONS

Postponing income and accelerating deductions is not always the right strategy. If a client expects a substantial increase in income or anticipates using a less-favorable tax filing status in future years, accelerating income into the current year may be an appropriate strategy to lessen the client's tax bill next year. This can be accomplished by moving up planned retirement distributions (assuming the 10% additional tax does not apply), selling gain-generating assets, billing clients in advance, or deferring deductions (e.g., delaying the purchase of business property that will generate Sec. 179 deductions and depreciation) to the following year. ■