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Year-End Tax and Financial Planning Ideas

After a busy year in 2018 adjusting to the new tax laws, 2019 was relatively quiet. That doesn't mean taxpayers should neglect considering year-end tax and financial planning strategies.

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It was just two years ago that Congress passed one of the most comprehensive sets of tax law changes in recent memory. Many of those laws are still being fully defined by the IRS in the form of regulations, including rules around the qualified business income deduction, the limitations on state tax deductions, investing in qualified opportunity funds and others. Combine that with many in Washington already gearing up for the 2020 presidential election and an economy and stock market that have shown periodic signs of weakness, it's not surprising that new tax legislation hasn't really been a priority in 2019.

And that's okay. When you have as many significant changes as there were in the 2017 Tax Cuts & Jobs Act (TCJA), having some time to absorb all the changes is a good thing. 2018 was the first year for taxpayers to navigate the new rules on itemized deductions, the larger (but temporary) estate tax exemptions and even new tax withholding tables, and it's safe to say taxpayers were caught off guard by the impact of those changes.. Take for example the confusion over how tax liabilities were lower for the majority of taxpayers, yet tax refunds were often lower than prior years – if not non-existent.

There is still the possibility for some legislative activity this year. The SECURE Act would expand retirement savings options for many employees and change when and how retirees and their heirs access those funds. This bill felt like a certainty to be passed in the spring, but has since stalled. Even if it does eventually pass, most of the key provisions wouldn't take effect until 2020. Perhaps the bill is added to a bill to address several expired provisions, or maybe as part of a broader spending bill. This will be something to watch through the last part of 2019.

In the meantime, what should taxpayers be focusing on for the rest of this year? It's unlikely that any significant legislation is passed before year-end, and with 2020 being an election year it's likely to be quiet next year, too. In that case, taxpayers who aren't facing a material change in their situation for 2020 are back to the usual strategy – defer income into next year and accelerate deductions into this year. The exception to that would be taxpayers looking to implement a bunching strategy with their deductions. If 2019 is an "off" year for deductions, then the payment of deductible expenses – in particular charitable contributions – should be delayed to 2020.

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 2019 and 2020 – 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 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 advisor. 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. The tax rules for capital gains (as well as qualified dividends) are virtually unchanged for 2019, so it's really business-as-usual in this area.

- For 2019, married taxpayers with taxable income below $78,750 (singles below $39,375) 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 2019 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 capital gain bracket are subject to a 20% marginal tax. This rate applies for couples with taxable income over $488,850 and singles over $434,550 in 2019.
- Lastly, couples with Modified Adjusted Gross Income (MAGI) above $250,000 for 2019 ($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 2018 may find they're over it for 2019.

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 2020 due to retirement, realizing a gain in 2019 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 2020. 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 net loss can be used to offset other income that year. Losses in excess of $3,000 are carried over to the next year to offset gains in that year, and these excess losses can be carried forward indefinitely.
- Another thing to consider when trying to zero-out capital gains for the year would be mutual fund distributions. When mutual fund investors sell their fund shares, it forces the fund managers to sell positions to generate cash. In a year like 2019 where the market has shown some volatility, investors who sell their fund shares may force a fund

to realize gains they otherwise would have avoided. As a result, 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

Beyond issues concerning when to recognize capital gains and losses, there are other portfolio planning opportunities to consider before year-end:

- 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 2018 but did not at the end of 2019. 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 2019 will remain 37%, although the income level at which that rate applies, like that of all other tax brackets, was adjusted upward for inflation. Beyond those annual inflation adjustments, there were no changes to the tax brackets for 2019.

- Taxpayers should review federal withholding and estimated income tax payments in order to avoid underpayment penalties. In the case where a taxpayer’s 2019 tax liability may have increased from 2018, they don’t necessarily have to pay that increased tax to the IRS before the end of the year. To avoid a penalty for 2019, 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 2018 Adjusted Gross Income (AGI) was more than $150,000).

  - Taxpayers whose income in 2019 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.
  - For 2018, the IRS lowered the 90% target to 80% due to confusion over how the new tax laws and withholding tables would be implemented that year. It's unlikely the IRS will make a similar concession for 2019, so taxpayers must be sure to hit one of those two targets to avoid a penalty.

- Some taxpayers may be in the habit of always making estimated payments for the year based on the prior year's tax liability. Taxpayers whose 2019 tax liability will be less than it was in 2018 should verify they aren't paying too much with their estimated payments for this year. Those who have been overpaying for this year can always reduce their 4th quarter payment before it's paid.
  - 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 2019 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 2020 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 2019, the first $1,100 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 $1,100 is taxed at the child's tax rate, but any income over $2,200 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 $12,750 of income in 2019. The top capital gain tax rate of 20% applies once the child's income exceeds just $12,950 (compared to $488,850 for a married parent).
  - These Kiddie Tax rules 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

Among the most talked-about changes in the TCJA were the changes to itemized deductions. Between the caps on some deductions, the elimination of others and the new larger standard deduction, the percentage of taxpayers who itemize fell from a historical norm of 30% to approximately10% for 2018.

- As a result, many taxpayers are implementing a “bunching” strategy, where they accelerate or defer the payment of deductible expenses in order to maximize their tax benefit. In that case taxpayers should pay extra attention to the timing of the payment of tax-deductible expenses.
  - 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 another, 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 2019 will be a year in which they itemize or take the standard deduction, and then plan the timing of their charitable gifts accordingly. For more suggestions on charitable giving, see the section specific to that topic below
- When it comes to timing the payment of state income and property taxes, the decision may be less about tax deductibility and more about cash flow management. The TCJA capped the state tax deduction at $10,000, meaning any taxes paid during the year in excess of that amount are non-deductible. Taxpayers who have already reached that threshold for 2019, or who will be claiming the standard deduction this year, may as well defer any additional state tax payments as long as possible in order to maintain control over their cash during that time.
  - 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 subject to this additional tax. While the AMT can’t be ignored, it’s very unlikely that it should influence the timing of state tax payments.
  - Some 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.
  - Also, be aware of any penalties assessed by the state for late payment of any tax bill. The value of maximizing a tax deduction can be offset if the state were to assess a penalty for missing a payment deadline.
- Another aspect of the TCJA temporarily made it easier to deduct medical expenses. However, that tax break has now expired, and for 2019 and forward medical expenses are only deductible to the extent they exceed 10% of a taxpayer’s AGI. This new threshold applies to all taxpayers, regardless of age or filing status.
  - While it is difficult to manage the timing of most medical expenses, it may be best to undergo elective items (dental or vision exams, prescription refills, etc.) in a way that maximizes their tax deductibility, such as grouping as many of them into one year as possible.
- The personal exemption amount has been temporarily reduced to $0 through 2025, meaning there is no longer a flat deduction amounts for dependents. However, identifying those dependents is still important for 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 any dependent that doesn’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, the same as for 2018.

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, 2019. 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 2019 (due to a sale of a business, stock option exercise, deferred compensation payment, etc.) may want to consider accelerating future giving into this year when it may provide a larger tax benefit.
    - In that case, perhaps consider making that gift to a donor advised fund. With this type of gift, the tax benefit is realized immediately without having to commit to a specific charity until later. Donor advised fund assets can be held in the fund and invested, while deferring distributions to charities until sometime in the future. 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 a Qualified Charitable Distribution (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 non-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 or 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.
    - QCDs are capped at $100,000 per IRA owner, regardless of the taxpayer's RMD amount.
    - Transfers must be made to a public charity. Private foundations, donor advised funds, charitable trusts and other similar 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 2019 contribution limits to most forms of retirement plans have increased from 2018:
    - 401(k), 403(b) and 457 plans - $19,000 (up from $18,500)

  - Traditional and Roth IRAs - $6,000 (up from $5,500)
  - SIMPLE IRAs - $13,000 (up from $12,500)
  - SEP IRAs - $56,000 (up from $55,000)

- 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 2019, married couples with MAGI over $103,000 (singles over $64,000) will begin to lose the benefit of the IRA deduction, and it is fully phased out once MAGI reaches $123,000 ($74,000 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 2019, full contributions to a Roth IRA are only allowed for joint taxpayers with AGI below $193,000 (singles below $122,000), with contributions phased out at $203,000 ($137,000 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 2019 should be aware of this increased IRA or employer plan contribution amount. The catch up amounts for 2019 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 unchanged from 2018.
- 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. 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, 2019, with the amount based on the January 1, 2019 value of the account. IRA owners who turned 70½ during 2019 are able to defer their first RMD until April 1, 2020, but then must take a second RMD for 2020 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.
  - A provision in the SECURE Act would delay the start of RMDs until a taxpayer reaches age 72. At this point, those rules have not been enacted, but they would only apply to taxpayers turning 70½ in 2020 or later. They would not impact anyone who is currently subject to the RMD rules.

OTHER FINANCIAL PLANNING CONSIDERATIONS

- The annual gift tax exclusion amount remained $15,000 for 2019. Taxpayers trying to minimize a future estate tax liability can begin by making annual gifts to family members. Keep in mind that payments made directly to a university for tuition or to a medical provider do not count towards the $15,000 limit.

- The estate tax exemption amount increased to $11.4 million for 2019, and 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 $22.8 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 2019, 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 2020 to do so. That will allow them to still contribute $15,000 to the 529 for 2019 before doing the 2020 through 2024 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, and 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).
  - As a result of 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 www.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.