



**Tax Reform Aftermath:
New Guidance For Investors**

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

This paper updates our paper of a year ago, *Tax Reform Accomplished: How Does the Legislation Affect Investors and Businesses?*. The update is intended to help investors apply the new guidance as they file their 2018 returns in April and begin their tax planning for 2019.

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

State and local taxes

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

SALT deduction workarounds

- The SALT deduction limitation applies only to state and local taxes imposed on individuals. State and local 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 investor 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.

Investors 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.

- 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)*. Presumably prepaid taxes not assessed until 2018 may be deducted in 2018.

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

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

- Some states sought to provide a deduction for taxes paid over the \$10,000 limitation by providing a dollar-for-dollar state tax credit for contributions made to a state-run charity. The states suggested that the payment was deductible 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 investor receiving the dollar-for-dollar tax credit was not out-of-pocket any funds. Because there was no net donation, there was no charitable contribution for which a deduction could be claimed. Thus, an investor 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.

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

Mortgage interest

The Act 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).*

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

Charitable contributions

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

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

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

Charitable contribution workarounds

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

Suppose an investor has \$23,000 of itemized deductions, which includes a \$1000 donation to charity. The investor in this case will claim the standard deduction of \$24,000. Because the investor does not itemize, the charitable contribution produces no tax benefit. Suppose instead the investor "bundles" an additional five years' contributions in that year. The itemized deductions now total \$28,000, greater than the

\$24,000 standard deduction. The investor will itemize deductions, saving up to \$1480 in taxes $((28,000 - 24,000) \times 37\%)$. The investor would then claim the standard deduction (and make no charitable contributions) for the next five years.

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

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

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

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

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

Medical expenses

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

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

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 investor's state might have a lower exemption than the federal exemption for purposes of computing that state's death tax.)

Taking advantage of the higher exemption

- 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 investor 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 make upon death. Investors 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, investors should consider making lifetime gifts up to the larger exemption as soon as practicable. Investors 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 (2) 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 investor purchases a ticket to take a client to a baseball game. During the game, the investor buys the client a beer. Because the beer is purchased separately from the ticket, the investor may deduct the cost of the beer (but not the cost of the ticket). Suppose instead the investor takes the client to a luxury box, where food is provided without additional charge. In that case the food is part of the entertainment expense and not deductible, unless the investor receives a separate invoice for the food cost apart from the cost of the luxury box.

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

Miscellaneous itemized deductions

The Act repeals the miscellaneous itemized deductions subject to the 2% floor. This repeal includes the deduction for investment fees and expenses available under prior law. Thus, an investor holding assets in a separately managed account (SMA) that produces \$100,000 of income and imposes a \$1000 fee pays tax on \$100,000, because the \$1000 fee that the investor pays directly is no longer deductible.

Receiving a benefit for investment expenses

- The new disallowance notwithstanding, fees that the investor incurs indirectly by way of a reduction in income *inside* the investment does provide a tax benefit. For instance, suppose instead of investing in an SMA, the investor purchases a mutual fund with the same earnings and fees. In that case the \$1000 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.

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

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

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