Wealth Planning Insights

Helpful Tips for Year-End Tax Planning and Charitable Giving

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Highlights

- The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, will significantly affect income tax and philanthropic planning for 2018 and beyond.
- While the suspension of certain popular deductions have mostly negative effects, there are useful planning opportunities to explore.
- TCJA included a new deduction of up to 20% for individuals for flow-through business income, as well as a new incentive program for investing in economically distressed areas.
- In this *Wealth Planning Insights*, we provide a brief summary of the key tax changes and their broader implications as well as some helpful tips for your tax and philanthropic planning as we head into year-end.

The passage of the Tax Cuts and Jobs Act (TCJA) in late December 2017 will have far-reaching implications for tax and philanthropic planning. Key changes are detailed in Exhibit 1. Note that while the corporate tax changes are permanent, the individual tax changes are set to expire at the end of 2025.

Exhibit 1: TCJA Changes

Positive Changes

- Top individual tax rate lowered from 39.6% to 37%
- Top corporate tax rate reduced from 35% to 21%
- Income-based reduction of itemized deductions suspended
- Deduction for qualified flow-through business income of up to 20%
- Expanded deductibility for cash contributions to public charities
- Standard deduction doubled to $24,000 for married taxpayers filing jointly

Negative Changes

- State and local tax deduction limited to $10,000
- Miscellaneous itemized deduction suspended
- Deductible mortgage interest limited for future loans to interest on debt up to $750,000
- Deduction for home equity loan interest suspended

Alternative Minimum Tax

Prior to passage of the TCJA, many higher-income taxpayers were subject to the alternative minimum tax (AMT), a parallel tax system that disallows certain itemized deductions and has a top tax rate of only 28%. The disallowed deductions that commonly triggered the AMT were state and local taxes and miscellaneous itemized deductions.

Since these deductions have been limited or suspended under the new law, we believe that few taxpayers will be subject to this additional tax. However, the alternative minimum tax base is now similar to the TCJA tax base, which has a top rate of 37%. This may result in a tax increase for high-income taxpayers, especially those who live in high-tax states.

What Should You Do About Tax Planning?

- **Maximize the 20% deduction on flow-through business income.** This new provision effectively reduces the top tax rate from 37% to 29.6% on qualified flow-through business income. It is not an itemized deduction, so it will also be allowed for taxpayers who do not itemize deductions. Strict limitations apply for taxpayers with taxable income beyond certain thresholds. The limitations will reduce or eliminate the deduction for income from specified service businesses and will be based on the taxable wages paid and depreciable property used in the business.

  Taxpayers who cannot claim the deduction due to their taxable income level may consider additional charitable contributions to push their taxable income below the applicable thresholds. Using this strategy, the charitable contribution would generate a second tax benefit by freeing up the 20% deduction.

  Other tax strategies may apply for taxpayers with multiple sources of flow-through business income. These should be fully explored with your tax advisor.

- **Take advantage of qualified retirement planning opportunities.** If you report business income or are self-employed, you may wish to utilize the favorable tax treatment of qualified retirement planning opportunities, including a simplified employee pension individual retirement account (SEP IRA) or solo 401(k). Similar to the tax treatment of a traditional IRA, a taxpayer who contributes to a SEP may take a deduction against income equal to the allowable contribution amount. As the tax deduction is available for an individual who funds his or her own retirement plans, we often describe a SEP IRA as a way to reduce a tax bill by moving money from one pocket to another.

- **Consider front-loading charitable contributions to take advantage of the increased standard deduction.** In many cases, taxpayers without deductible mortgage interest may now claim deductions only for charitable contributions and $10,000 in state and local taxes. These individuals may consider a strategy referred to as bunching of charitable deductions to gain an extra benefit from the expanded standard deduction. Exhibit 2 on page 3 illustrates this strategy.

- **Qualified charitable distributions.** Taxpayers over age 70.5 may benefit by making qualified charitable distributions directly from their IRA in lieu of cash contributions.

- **Keep track of passive income and losses.** Many higher-income taxpayers report significant passive income — that is, rental income or income from businesses in which the individual is not actively involved.

  If you do have substantial passive income, you and your advisor should explore ways to increase your involvement in the venture since you may benefit if it can be classified as nonpassive. The income from the nonpassive investment would be excluded from 3.8% net investment income tax.

  Generally, passive losses can only be used to offset passive income. Unused losses are suspended and carried forward indefinitely to offset passive income in future years. However, once the investment is disposed of, any remaining suspended passive losses will become fully available to offset taxable income, even if nonpassive.

- **Explore Qualified Opportunity Funds.** This new incentive program was designed to spur economic development and job creation in economically distressed communities. It provides investors with significant tax incentives to reinvest gains realized from the sale of an investment into a qualified fund within 180 days from the date of sale. You may wish to discuss the benefits and risks of this program with your tax advisor.

- **Evaluate business entities.** TCJA delivered a significant reduction in the tax rate on corporations, as well as the 20% deduction on qualified flow-through business income. Other tax benefits are available for qualified small business stock and qualified opportunity

Exhibit 2: Bunching Example

- A married couple incurs $30,000 of real estate taxes and makes charitable contributions of approximately $30,000 per year.
- Over a five-year period, charitable contributions would total $150,000 and deductible real estate taxes $50,000, combining to equal total itemized deductions of $200,000.
- Bunching all $150,000 of charitable contributions into year one will result in total deductions over a five-year period of $256,000 — $160,000 in year one, and $24,000 per year in years two through five.
- The strategy may be implemented by utilizing a donor-advised fund (DAF), such as the Bessemer National Gift Fund. Annual charitable grants of $30,000 could still be achieved using a donor-advised fund, but the $150,000 deduction is taken in the year of the initial contribution.
- The additional deductions will yield a federal after-tax benefit of up to $21,000 over a five-year period.

Charitable contributions not front-loaded.
$ thousands

	2019	2020	2021	2022	2023	Total
Charity	30	30	30	30	30	150
RE Tax	10	10	10	10	10	50
Total Itemized Deductions	40	40	40	40	40	200
Standard Deduction	24	24	24	24	24	
Higher	**40**	**40**	**40**	**40**	**40**	**200**

Front-loading charitable contributions yields $56,000 in additional deductions for the exact same amount of contributions made with no front-loading.
$ thousands

	2019	2020	2021	2022	2023	Total
Charity	150	0	0	0	0	150
RE Tax	10	10	10	10	10	50
Total Itemized Deductions	160	10	10	10	10	200
Standard Deduction	24	24	24	24	24	
Higher	**160**	**24**	**24**	**24**	**24**	**256**

funds. Many of these benefits are restricted to certain types of business entities. It is more important than ever to evaluate your current business structure to determine the optimal entity.

- **Consider traditional year-end planning strategies.** Although tax rates are not scheduled to change prior to 2026, an economic benefit may be accrued by the deferral of income to future years and the acceleration of allowable deductions into the current year. Tax-loss harvesting — that is, selling an investment at a loss and replacing it with a similar investment to maintain optimal asset allocation — should also be considered to reduce current-year taxable gains.
- **Consider a tax physical.** Bessemer's tax physical — a proprietary, comprehensive analysis of your previous-year tax returns and tax-related balance sheet items — can provide you with a more informed picture of your financial health and help to identify tax planning opportunities for the year ahead.

What Should You Do About Charitable Giving?

- **Consider a contribution to a donor-advised fund (DAF).** Donor-advised funds currently provide the maximum allowable charitable tax deduction in the year the contribution is made while enabling you to recommend grants to charities in future years. For more information about DAFs and other giving vehicles, please see *Ways to Give*.
- **Consider giving long-term appreciated assets in lieu of cash to reduce capital gains taxes.** Depending on the recipient organization's ability to accept and use a gift, you may choose to give cash, securities, real estate, personal property, and/or other assets. The most suitable strategy depends on many factors, including how much you want to give and the cost basis of the asset. Nonetheless, donating a long-term appreciated asset rather than cash can be tax effective as it avoids capital gains taxes on the sale of the asset, allows you to take a charitable deduction of the fair market value, and accomplishes your charitable goals.

  If you do not have long-term appreciated securities to contribute, note that the annual deductible limit for cash contributions to public charities has now increased to 60% of adjusted gross income. Under prior law the limit was 50%.
- **Consider a charitable remainder trust if you have low-basis stock.** This vehicle provides a current charitable deduction along with an annual income stream, with the remaining balance going to charity after a period of years. In many cases, giving away low-basis stock in this manner may be economically beneficial, all while supporting your favorite charity.
- **Make sure you donate to a qualified organization.** Donations must be made to qualified tax-exempt organizations to be tax deductible. Our philanthropic advisory team can help determine if the intended recipient organization qualifies. For more information, you can refer to our *How to Select a Nonprofit to Support Financially: Four Key Steps*.
- **Be aware of any value of goods and services exchanged in consideration for a donation.** If you receive any physical merchandise, goods, or service in return for a donation, you must reduce the value of the tax deduction by the value of the merchandise, goods, or service. For example, if you make a gift to a museum and receive a seat at a dinner gala, you must deduct the value of the dinner and any entertainment. The acknowledgement letter will specify how much of the gift is eligible for tax-deduction purposes.
- **Keep deadlines in mind.** A contribution is tax deductible in the year it is made. A check that is written, mailed, and postmarked on December 31, 2018, is deductible for 2018 tax return purposes. Similarly, any contribution made via credit card that posts to the account in 2018 is tax deductible in 2018. Phone contributions are eligible in the year the funds are transferred, regardless of the verbal pledge's timing.

  If you are uncertain about choosing a nonprofit to support but still want to take advantage of the tax deduction by giving prior to year-end, you may decide to contribute to a donor-advised fund, such as the Bessemer National Gift Fund, given the flexibility it affords with regard to the timing of grant recommendations.

How Bessemer Can Help

Our mission is to help our clients develop comprehensive long-term approaches to tax and charitable planning within the context of their greater wealth planning needs.

Please contact your Bessemer Trust client advisor or senior tax consultant if you are interested in obtaining additional information about how Bessemer Trust can help you and your family with year-end tax planning and charitable donations.

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