

Ten tax-smart strategies to consider in 2019

1. Invest in municipal bonds to generate tax-free income

Even with reduced tax rates, municipal bonds may still be attractive on a relative tax basis for higher-income taxpayers, especially those who find themselves subject to the 3.8% surtax on net investment income. The tax equivalent yield, i.e., the yield an investor would require in a taxable bond investment to equal the yield of a comparable tax-free municipal bond, is higher for those taxpayers.

2. Consider Roth IRA/401(k) contributions or conversions

A thoughtful strategy utilizing Roth accounts can be an effective way to hedge against the threat of facing higher taxes in the future. Younger investors or taxpayers in lower tax brackets should consider using Roth accounts to create a source of tax-free income in retirement. It is virtually impossible to predict tax rates in the future or to have a good idea of what your personal tax circumstances will look like years from now. Like all income from retirement accounts, Roth income is not subject to the new 3.8% surtax and is also not included in the calculation for the \$200,000 income threshold (\$250,000 for couples) to determine if the surtax applies. IRA owners considering a conversion to a Roth IRA should carefully evaluate that transaction since the option to recharacterize, or un-do, a Roth IRA conversion is no longer available.

3. Maximize deductions in years when itemizing

With the large increase in the standard deduction under recent tax law changes, and the scaleback of many popular deductions, fewer taxpayers will choose to itemize on their tax return going forward. Some taxpayers may benefit by alternating between claiming the standard deduction some years and itemizing deductions other years. If possible, it would make sense to “lump” as many deductions into those years when itemizing.

For example, taxpayers may want to consider making a substantial charitable contribution during a tax year when itemizing instead of making regular, annual gifts. In addition, with the repeal of the “Pease rule,” there are no phaseouts on itemized deductions at higher income levels.

4. Be mindful of irrevocable trusts and taxes

Because of the low income threshold (\$12,750 for 2019), which will subject income retained within an irrevocable trust to the highest marginal tax rates and the 3.8% Medicare surtax, trustees may want to reconsider investment choices inside of the trust (municipal bonds, life insurance, etc.). Or, maybe trustees should consider (if possible) distributing more income out of the trust to beneficiaries who may be in lower income tax brackets.

5. Review estate planning documents and strategies

The increase in the lifetime exclusion amount for gifts and estates (\$11.4 million per individual in 2019) may have unintended consequences for some individuals and families with wealth under that threshold. They may think that they do not have to plan for their estate. However, taxes are just one facet of estate planning. It is still critical to plan for an orderly transfer of assets or for unforeseen circumstances such as incapacitation. Strategies to consider include proper beneficiary designations on retirement accounts and insurance contracts, wills, powers of attorney, health-care directives, and revocable trusts. Additionally, existing trusts should be reviewed to determine if changes are needed as a result of the recent tax law changes.

6. Plan for potential state estate taxes

While much attention is focused on the federal estate tax, certain residents need to know that many states have estate or inheritance taxes. There are a number of states that are “decoupled” from the federal estate tax system. This means the state applies different tax rates or exemption amounts. A taxpayer may have net worth comfortably below the \$11,400,000 exemption amount for federal estate taxes, but may be well above the exemption amount for his or her particular state. It is important to consult with an attorney on specific state law and potential options to mitigate state estate or inheritance taxes.

7. Develop a strategy for low cost-basis assets

Ensure stepped-up cost basis is maintained when property is transferred at death. For example, careful consideration should be made around lifetime gifts that may jeopardize a step-up in cost basis on property at death. When property is gifted, the party receiving the gift generally assumes the original cost basis. Additionally, certain trust provisions may be utilized to ensure that property receives a step-up in cost basis at death.

8. Expand use of 529 accounts for education savings

529 college savings plans retain existing tax advantages. Account earnings are free of federal income tax, and a special gift tax exclusion allows you to elect to treat up to \$75,000 of contributions as though those contributions had been made ratably over a five-year period. Qualified education expenses were expanded in recent years to include laptops, computers and related technology. The new tax law allows families to use up to \$10,000 annually for K-12 tuition. Make sure to consult with a tax professional if considering a distribution for K-12 expenses since there may be adverse state income tax consequences.

9. Consider the charitable rollover option if you are a retiree

Retired IRA owners (age 70½ and older) may benefit from directing charitable gifts tax free from their IRA. Since even more retirees will claim the higher standard deduction, they will not benefit tax-wise from making those charitable gifts unless they itemize deductions. Account owners are limited to donating \$100,000 annually, which can include the required minimum distribution (RMD), and the proceeds must be sent directly to a qualified charity.

10. Maximize the 20% deduction for Qualified Business Income (QBI)

The Tax Cuts and Jobs Act (TCJA) introduced a new provision (Section 199A) that allows certain taxpayers to generally deduct 20% of qualified business income on their tax return. Business income from pass-through entities such as sole proprietorships, partnerships, LLCs, and S Corps may qualify for this new deduction. Certain types of businesses — defined as a specified service trade or business (SSTB) — may be limited from taking the deduction based on the taxpayer’s household taxable income. The deduction is subject to a phaseout for SSTBs once income exceeds \$160,700 (\$321,400 for married couples filing a joint return). SSTBs include businesses performing services in fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and certain brokerage services. Business owners impacted by the income phaseout may want to consider strategies to reduce taxable income such as funding retirement accounts, deferring income, or accelerating business expenses.

Consult a qualified tax or legal professional and your financial advisor to discuss these types of strategies to prepare for the risk of higher taxes in the future. Personal circumstances vary widely so it is critical to work with a professional who has knowledge of your specific goals and situation.