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CLOSING IN ON THE CLOSE OF 2019

Year 2019 is rapidly coming to an end along with opportunities to plan for this year's income taxes. After the significant tax law changes from a year ago that first affected 2018 tax returns, there have been few changes for 2019 tax returns. Nevertheless, we believe that it will be helpful to recap some of the important changes from a year ago that remain applicable to 2019 tax returns.

Increased Standard Deduction. Many taxpayers without significant itemized deductions will benefit from the 2019 standard deduction amounts of $24,400 for married couples filing jointly, $12,200 for individuals, and $18,350 for heads of households.

Charitable Contributions - Bunching. The high standard deduction creates a planning opportunity for a taxpayer whose total itemized deductions are less than but near the standard deduction amounts, who might consider staggering ("bunching") charitable donations every other year so that the taxpayer claims itemized deductions with a higher charitable contribution in one year and the standard deduction the next year.

Charitable Contributions – Directly from an IRA – Taxpayers who are over age 70½, who will be taking the standard deduction, and who have an IRA with required minimum distributions might consider making charitable contributions directly from the IRA. Such IRA distributions made directly to a qualified charity are treated as nontaxable income, and the taxpayer still enjoys the full standard deduction.

State and Local Tax Deduction. The itemized deduction of personal state and local income, property, and sales taxes is limited to $10,000. For investment property, however, property taxes and other taxes remain fully deductible as an itemized deduction. Taxpayers whose itemized deduction for state and local income, property and sales taxes would exceed $10,000 will want to separate those taxes that are applicable to their investments from their personal taxes to obtain the maximum combined itemized deduction amounts. State and local taxes related to a taxpayer's business remain fully deductible against business income.

Home Mortgage Interest (Home Equity Loans). Beginning in 2018 and through 2025, interest paid on a home equity loan is deductible only if the proceeds were used either in your business (business interest), to purchase an investment (investment interest), or to make substantial improvements to your personal residence (home mortgage interest). Interest on a loan used for other personal reasons (e.g., a nonbusiness vehicle) is not deductible.

Investment and Employee Business Expenses – Nondeductible. Current law disallows formerly deductible miscellaneous itemized deductions, including unreimbursed employee business expenses, investment expenses, expenses

(Continued on reverse)

for production or collection of income, tax determination expense, and expenses allowed under the "hobby loss" rules. With the disallowance of these deductions, the most common itemized deductions remaining are mortgage and investment interest expenses, medical expenses (above the threshold of 7.5 percent of Adjusted Gross Income (AGI)), charitable contributions (generally limited to 60 percent of AGI), and state and local taxes subject to the limit discussed above.

The Hobby Loss Trap. Taxpayers with small, sideline, or start-up businesses operating at a loss have long been vulnerable to an assertion by the Internal Revenue Service (IRS) that the activity was not an activity engaged in for profit but was instead a "hobby." When taxpayers with a loss from such an activity are audited, the IRS will often assert that the activity is a hobby and disallow the loss deduction. Under the law prior to the Tax Cuts and Jobs Act, the disallowance of the loss generally resulted in increasing taxable income by the excess of the activity expenses over the activity income. For example, assume a taxpayer has an activity of raising race horses with $20,000 of sales revenue and $52,000 of expenses resulting in a loss and a reduction in net taxable income of $32,000. If, on examination, the activity was ultimately determined to be a "hobby," the taxpayer's income would, under prior law, only increase by the $32,000 net loss. Now, if such an activity is adjusted on audit, the results are different. The $20,000 of sales revenue will be fully included in taxable income, but none of the $52,000 of deductions will be allowed. Thus, the taxpayer's income increases after audit not by the net loss of $32,000, but by the disallowance of the expenses of $52,000. In other words, the "hobby" resulted in an economic (net-of-tax) loss of $32,000 plus the tax on $20,000 revenue ($8,000 for a 40 percent taxpayer), or $40,000. If the activity was not a hobby but was a business, the net-of-tax loss would be $19,200 ($32,000 x 60% = $19,200), or less than one-half as much as "hobby" status classification.

Under the prior law, the deductible expenses were limited to the revenue from the activity and were deductible as miscellaneous itemized deductions – that is, prior law allowed itemized deductions sufficient to offset the included income. Now, with the disallowance of virtually all miscellaneous itemized deductions (which include hobby expenses), the income tax consequence of an activity that is ultimately determined to be a hobby is extreme – that is, taxpayers must include their hobby gross income but may not deduct any of the expenses necessary to produce the included income.

Casualty Losses. Deductions for casualty losses are now limited to losses incurred in federally-declared disaster areas.

Excess Business Loss. Business losses (including farm losses) can fully offset other business income but can only offset non-business income (e.g., dividends, interest, royalties, rentals, etc.) for the year up to a maximum of $250,000 for a single taxpayer or, for a married couple filing jointly, a maximum of $500,000. A nondeductible net business loss above the limit will be treated as a net operating loss carried forward to the subsequent taxable year.

Alimony. For divorce or separation agreements executed after December 31, 2018 (and for some prior agreements modified after December 31, 2018), alimony and separate maintenance payments are not deductible by the payer spouse and not taxable to the payee spouse.

Like-Kind Exchanges – For transfers after 2017, the tax-free exchange of an asset for a like-kind asset applies only to real property. For example, taxable gain or loss now is recognized on the trade-in of a business vehicle.

Affordable Care Act Penalty. One change from 2018 for 2019 is the elimination of the penalty tax associated with the Affordable Care Act's individual mandate.

Estate and Gift Tax. The lifetime estate and gift tax exemption for transfers for 2019 is $11,400,000. The annual exclusion for 2019 remains at $15,000. A married couple has twice those limits and, accordingly, can give $30,000 by annual exclusion to a donee and has a combined lifetime exemption of $22,800,000.

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Tax & Business Alert

NOVEMBER 2019

BUSINESS OWNERS, YOUR BAD DEBTS MAY BE DEDUCTIBLE

If you hold a business-related debt that's become worthless or uncollectible, a "bad debt" deduction may allow you to cut your losses. But there are a few hoops to jump through.

BUSINESS OR NONBUSINESS?

Business bad debts generate ordinary losses; *nonbusiness* bad debts are reported as short-term capital losses. The latter can be used only to offset capital gains (plus up to $3,000 in ordinary income). Also, you can't take a deduction for *partially* worthless nonbusiness bad debts. They must be totally worthless to be deductible.

A business bad debt is a loss related to a debt that was either created or acquired in a trade or business or closely related to your trade or business when it became partly or totally worthless. Common examples include credit sales to customers for goods or services, loans to customers or suppliers and business-related guarantees.

Some debts are considered both business and nonbusiness (personal). For example, say you guarantee a loan on behalf of one of your best customers, who also is a friend. If your friend later defaults, the test for whether your loss is business or nonbusiness is whether your "dominant motivation" in making the guarantee was to help your business or your friend.

If a bad debt is related to a loan you made to your business, the IRS may deny a bad debt deduction if it finds that the loan was a contribution to capital.

To qualify for a bad debt deduction, the underlying debt must be bona fide. That is, you must have loaned the money or extended credit with the expectation that you would be repaid and with the intent to enforce collection if you weren't repaid. Proper documentation is key.

INCLUDED IN INCOME?

Not all bad debts are deductible. The purpose of the deduction is to offset a previous tax liability. So, you must have previously included the receivable in your income.

Typically, that's not the case with respect to accounts receivable if your business uses the cash-basis method of accounting. Cash-basis taxpayers generally don't

HANDLE ACCOUNTING FOR "CHARGE-OFFS" CAREFULLY

You can deduct a partially worthless portion of business debt, but only if that amount has been "charged off" for accounting purposes during the tax year. The IRS takes the position that simply recording an allowance or reserve for anticipated losses isn't enough. You must treat the amount as a *sustained* loss, which requires specific language in your books. Deductions for *totally* worthless debts don't require a charge-off. But it's a good idea to do so anyway because, if the IRS determines the debt was only partially worthless, it can disallow the deduction absent a charge-off.

report income until they receive payment. If someone fails to pay a bill, the business simply doesn't include that amount in income. Permitting a bad debt deduction on top of that would give the business a windfall from a tax perspective.

Accrual-basis taxpayers, on the other hand, report income as they earn it, even if it's paid later. So, a bad debt deduction may be appropriate to offset uncollectible amounts previously included in income.

PURSUING A DEDUCTION

Review your business debts to assess whether any became partially or totally worthless during 2019. If so, and if you're an accrual-basis taxpayer, we can help you pursue a deduction. ■

MAKING GIFTS TO LOVED ONES? DON'T FORGET TAX PLANNING

Many people want to pass assets to the next generation during their lifetimes, whether to reduce the size of their taxable estates, to help family members or simply to see their loved ones enjoy the gifts. If you're considering lifetime gifts, be aware that the type of assets you give can produce substantially different tax consequences.

MULTIPLE TYPES OF TAXES

Federal gift and estate taxes generally apply at a rate of 40% to transfers in excess of your available gift and estate tax exemption. Under the Tax Cuts and Jobs Act, the exemption has approximately doubled through 2025. For 2019, it's $11.4 million (twice that for married couples with proper estate planning strategies in place).

Even if your estate isn't large enough for gift and estate taxes to currently be a concern, there are income tax consequences to consider. Plus, the gift and estate tax exemption is scheduled to drop back to an inflation-adjusted $5 million in 2026.

ESTATE TAX IMPACT

If your estate is large enough that federal estate tax is a concern, consider gifting property with the greatest future appreciation potential. You'll remove that future appreciation from your taxable estate.

If estate tax isn't a concern, your family may be better off taxwise if you hold on to the property and let it appreciate in your hands. At your death, the property's value for income tax purposes will be "stepped up" to fair market value. This means that, if your heirs sell the property, they won't have to pay any income tax on the appreciation that occurred during your life.

Even if estate tax is a concern, you should compare the potential estate tax savings from gifting the property now to the potential income tax savings for your heirs if you hold on to the property.

INCOME TAX CONSIDERATIONS

You can save income tax for your heirs by gifting property that hasn't appreciated significantly while you've owned it. The beneficiary can sell the property at a minimal income tax cost.

On the other hand, hold on to property that has already appreciated significantly so that your heirs can enjoy the step-up in basis at your death. If they sell the property shortly after your death, before it's had time to appreciate much more, they'll owe no or minimal income tax on the sale.

Don't gift investments that have declined in value. A better option is generally to sell them prior to death, so you can claim the tax loss. You can then gift the sale proceeds.

Capital losses can offset capital gains, and up to $3,000 of net capital losses can offset other types of income, such as from salary, bonuses or retirement plan distributions. Excess capital losses can be carried forward until death.

CHOOSE WISELY

No matter your current net worth, it's important to choose gifts wisely. Please contact us to discuss the gift, estate and income tax consequences of any substantial gifts you'd like to make. ■

ACT NOW TO SAVE 2019 TAXES ON YOUR INVESTMENTS

Do you have investments outside of tax-advantaged retirement plans? If so, you might still have time to reduce your 2019 tax bill by selling some investments — you just need to carefully select *which* investments you sell.

BALANCE GAINS AND LOSSES

If you've sold investments at a *gain* this year, consider selling some losing investments to absorb the gains. This is commonly referred to as "harvesting" losses.

If, however, you've sold investments at a *loss* this year, consider selling other investments in your portfolio that have appreciated, to the extent the gains will be absorbed by the losses. If you believe those appreciated investments have peaked in value, you'll essentially lock in the peak value and avoid tax on your gains.

REVIEW TAX RATES

At the federal level, long-term capital gains (on investments held more than one year) are taxed at lower rates than short-term capital gains (on investments held one year or less). The Tax Cuts and Jobs Act (TCJA) retained the 0%, 15% and 20% rates on long-term capital gains. But, through 2025, these rates have their own brackets, instead of aligning with various ordinary-income brackets. For example, for 2019, the thresholds for the top long-term gains rate are $434,551 for singles, $461,701 for heads of households and $488,851 for married couples.

But the top ordinary-income rate of 37%, which also applies to short-term capital gains, doesn't go into effect for 2019 until taxable income exceeds $510,300 for singles and heads of households or $612,350 for joint filers. The TCJA also retained the 3.8% net investment income tax (NIIT) and its $200,000 and $250,000 thresholds.

CHECK THE NETTING RULES

Before selling investments, consider the netting rules for gains and losses, which depend on whether gains and losses are long term or short term. To determine your net gain or loss for the year, long-term capital losses offset long-term capital gains before they offset short-term capital gains. In the same way, short-term capital losses offset short-term capital gains before they offset long-term capital gains.

You may use up to $3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income in computing your adjusted gross income. Any remaining net losses are carried forward to future years.

CONSIDER EVERYTHING

Keep in mind that tax considerations alone shouldn't drive your investment decisions. Also consider factors such as your risk tolerance, investment goals and the long-term potential of the investment. We can help you determine what makes sense for you. ■

LIVING THE DREAM OF EARLY RETIREMENT

Many people dream of retiring early so they can pursue activities other than work, such as volunteering, traveling and pursuing their hobbies full-time. But making this dream a reality requires careful planning and diligent saving during the years leading up to the anticipated retirement date.

It all starts with retirement savings accounts such as IRAs and 401(k)s. Among the best ways to retire early is to build up these accounts as quickly as possible by contributing the maximum amount allowed by law each year.

From there, consider other potential sources of retirement income, such as a company pension plan. If you have one, either under a past or current employer, research whether you can receive benefits if you retire early. Then factor this income into your retirement budget.

Of course, you're likely planning on Social Security benefits composing a portion of your retirement income. If so, keep in mind that the earliest you can begin receiving Social Security retirement benefits

is age 62 (though waiting until later may allow you to collect more).

The flip side of saving up enough retirement income is reducing your living expenses during retirement. For example, many people strive to pay off their home mortgages early, which can possibly free up enough monthly cash flow to make early retirement feasible.

By saving as much money as you can in your retirement savings accounts, carefully planning your Social Security strategies and cutting your living expenses in retirement, you just might be able to make this dream a reality. Contact our firm for help. ■