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To Our Clients and Friends:

As the end of year approaches, it is a good time to think of planning moves that will help lower your tax bill for this year. Year-end planning for 2019 takes place with continued impact from the major tax reform changes enacted in 2018. We have compiled a list of tax-saving suggestions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your situation, but you (or a family member) will likely benefit from many of them.

Tax-Smart Strategies for Individuals

Despite the major changes, the time-tested approach of deferring income and accelerating deductions to minimize taxes still works for many taxpayers, along with the tactic of bunching expenses into this year or the next to get around deduction restrictions.

Standard and Itemized Deductions. For 2019, the standard deduction amounts are $12,200 for singles and those who use married filing-separate status, $24,400 for married joint-filing couples, and $18,350 for heads of household. If your total annual itemizable deductions for 2019 will be close to your standard deduction amount, consider making additional deductible expenditures before year-end. Accelerating other deductions could cause your itemized deductions to exceed your standard deduction in 2019. For example, consider making bigger charitable donations this year and smaller contributions next year to compensate. Also, consider accelerating elective medical procedures, dental work, and vision care. For 2019, medical expenses are deductible to the extent they exceed 10% of Adjusted Gross Income (AGI), assuming you itemize. The easiest deductible expense to accelerate is included in your house payment due on January 1. Accelerating that payment into this year will give you 13 months' worth of interest in 2019.

Even though miscellaneous deductions such as tax-preparation fees, advisor fees, union dues and unreimbursed employee business expenses are no longer deductible for federal tax purposes, or are limited in the case of property taxes, California has not conformed to this law change. Therefore, continue to gather this data for use in potentially reducing your California state income tax liability. Deductions pertaining to rental properties or businesses remain deductible.

Year-End Investment Moves. Gains on the sale of appreciated securities that have been held for over 12 months are taxed at 15% for most taxpayers, although it will reach a maximum of 20% at higher income levels. The 3.8% Net Investment Income Tax also will apply at higher income levels.

To the extent you have recognized capital losses, including carryovers from pre-2019 years, selling appreciated securities this year will not result in any tax hit. Sheltering net short-term capital gains with capital losses is a sweet deal because net short-term gains would otherwise be taxed at higher ordinary income rates. And, any net capital loss can be used to shelter up to $3,000 of 2019 ordinary income with a carryforward to next year and beyond.

Qualified Opportunity Fund. Any capital gains can be deferred to the end of 2026 if invested in a Qualified Opportunity Fund (QOF). Up to 15% of the deferred gain is permanently excluded from income if the opportunity zone investment is held for more than seven years. And, any post-2026 gains are permanently excluded if the investment is held in the QOF for 10 years. The rules can be complicated, such as the investment must be within 180 days of the capital gain and the QOF must invest 90% of its assets in Qualified Opportunity Zones. We can help if you're considering this unique federal-only long-term investment.

Principal Residence Gain Exclusion. Gains of up to $500,000 on the sale of a principal residence are tax-free for qualifying married couples who file joint returns ($250,000 for single and married filing-separate returns). To qualify for the gain exclusion, you normally must have owned and used the home as your principal residence for a total of at least two years during the five-year period ending on the sale date. This is lowered to one in five years for homeowners who can't care for themselves and have moved to a nursing home. Limitations may apply if the home had previously been used as a rental.

Individual Retirement Accounts. Don't forget to take your required minimum distributions (RMD). Individuals with retirement accounts must generally take withdrawals based on the size of their account and their age every year after they reach age 70-1/2. Failure to take a required withdrawal can result in a penalty of 50% of the amount not withdrawn. Also, if you turned age 70-1/2 in 2019, you can delay your 2019 required distribution until April 1, 2020. However, waiting until 2020 will result in two distributions in 2020 which might throw you into a higher tax bracket or have a detrimental impact on your tax deductions.

New life expectancy tables that reflect longer lives have been proposed to calculate RMDs in 2021.

IRA owners and beneficiaries who have reached age 70-1/2 can make qualifying cash donations (QCDs) to public charities directly out of their IRAs. If married, you and your spouse can give up to $100,000 each from your separate IRAs. These QCDs count as required minimum distributions, but they are not taxable and are not added to your adjusted gross income, so they won't affect certain income/deductions impacted by the AGI limitations, including Medicare premium surcharges. You get no charitable write-off, but this is a good strategy to reduce taxable income for those who don't itemize due to the higher standard deduction.

Miscellaneous Tax-Saving Strategies for 2020. Consider increasing the amount you set aside for next year in your employer's health flexible spending accounts (FSAs). If your company has a healthcare and/or dependent care FSA, before year-end you must specify how much of your 2020 salary to convert into tax-free contributions to the plan. Be sure to estimate conservatively since these plans are "use-it or lose-it" accounts. If you are enrolled in a high-deductible health plan and don't have any other coverage, you may be eligible to make pre-tax or tax-deductible contributions to an HSA. Distributions from the HSA will be tax-free if the funds are used to pay unreimbursed qualified medical expenses. Amounts remaining in the HSA at the end of the year can be carried over indefinitely. California does not allow an HSA contribution as a tax deduction.

Estate Planning and Gifting. Thanks to the Tax Cuts and Jobs Act (TCJA), the unified federal estate and gift tax exemption for 2019 is an historically huge $11.4 million, or effectively $22.8 million for married couples. The 2019 annual gift exclusion per donee is $15,000. Even though these big exemptions may mean you're not currently exposed to the federal estate tax, your estate plan may need updating to reflect the current tax rules. In 2026, the estate and gift tax exemption is scheduled to revert to the much-lower pre-TCJA level. Depending on political developments, that could happen much sooner than 2026. However, late last year the IRS issued proposed regulations that would protect estates that make large gifts while the ultra-generous TCJA exemption is in place. These rules haven't been finalized, so place your bets and act accordingly.

Don't gift away shares that have declined in value. Instead, you should sell the shares and book the resulting tax-saving capital loss. Then, you can give the sales proceeds to your beneficiary. On the other hand, you should give away appreciated shares. Most likely, the recipient will pay lower tax rates than you would pay if you sold the same shares. These principles for tax-smart gifts to beneficiaries also apply to donations to IRS-approved charities. Giving away stocks that pay dividends is another tax-smart idea. As long as the dividends fall within the gift recipient's 0% rate bracket, they will be federal-income-tax-free.

If you gift securities to someone who is under age 24, the Kiddie Tax rules could potentially cause some of the resulting capital gains and dividends to be taxed at the higher rates that apply to trusts and estates. That would defeat the purpose. California law still uses the parent's rate if subject to the Kiddie Tax.

Contribute to 529 plans to help your kids and grandkids with their education. You may contribute up to $75,000 in a single year per beneficiary ($150,000 with your spouse). This is treated as a $15,000 gift for each of the next five years and would require a gift tax return to be filed.

Update your retirement plan beneficiaries as well as your will and living trust for any life changes.

Health Care Coverage. California will impose an individual health care mandate penalty even if the federal government does not. Effective January 1, 2020, California residents must obtain minimum essential health care coverage to avoid the new California individual health care mandate. California's new mandate is like the federal program adopted under the original Affordable Care Act, ensuring that plans maintain certain baseline coverage and subjecting individuals to penalties if they fail to obtain health insurance.

Tax-Smart Strategies for Your Business and Business Owners

If you own a business, we have highlighted tax strategies to minimize your 2019 tax bill as well as items to watch out for with respect to the impact of 2018 tax law changes.

Ramp Up Investments in Equipment, Software, and Certain Real Property. If you have plans to buy a business computer, office furniture, equipment, vehicle, or to make certain improvements to real property, you might consider doing so before year-end to capitalize on the following tax breaks:

- *Section 179 Deduction.* For 2019, the maximum Section 179 deduction is $1,020,000 (assuming property purchases for the year don't exceed $2,550,000). Watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction, as you cannot claim a Section 179 write-off that would create or increase an overall business tax loss. California's limits are significantly less.

- *First-Year Bonus Depreciation.* Your business also can claim first-year bonus depreciation equal to 100% of the cost of most new and used equipment placed in service by 12/31/19. Note that 100% bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2019 tax year. These NOLs are subject to a business loss limitation as well as an NOL limitation. Please contact us for details on the interaction between asset additions and NOLs. California does not conform to bonus depreciation, and the NOL rules are different from federal.

Maximize the Deduction for Pass-Through Business Income. For 2019, the deduction for Qualified Business Income (QBI) can be up to 20% of a pass-through entity owner's QBI, subject to restrictions that can apply at higher income levels and based on the owner's taxable income. The QBI deduction also can be claimed for up to 20% of income from qualified REIT dividends and income from publicly traded partnerships.

Because of the various limitations on the QBI deduction, tax planning moves (or non-moves) can have the side effect of increasing or decreasing your allowable QBI deduction. So, individuals who can benefit from the deduction must be careful at year-end tax planning time. We can help you put together strategies that give you the best overall tax results for the year.

Watch out for Business Interest Expense Limit. Thanks to an unfavorable TCJA change, a taxpayer's deduction for business interest expense for the year is limited to the sum of (1) business interest income, (2) 30% of adjusted taxable income, and (3) floor plan financing interest paid by certain vehicle dealers. Fortunately, many businesses are exempt from this limit. We can help you determine if an exemption applies.

Establish a Tax-Favored Retirement Plan. If your business doesn't already have a retirement plan, now might be the time to consider the benefit. Current retirement plan rules allow for significant deductible contributions. For example, if you're self-employed and set up a SEP-IRA, you can contribute up to 20% of your self-employment earnings, with a maximum contribution of $56,000 for 2019. If you're employed by your own corporation, up to 25% of your salary can be contributed with a maximum contribution of $56,000 and the deadline for setting up a corporate SEP is 9/15/20.

The deadline for setting up a SEP-IRA for a sole proprietorship and making the initial deductible contribution for the 2019 tax year is 10/15/20, if you extend your 2019 return to that date. Other types of plans generally must be established by 12/31/19 if you want to make a deductible contribution for the 2019 tax year, but the deadline for the contribution itself is the extended due date of your 2019 return. However, to make a SIMPLE-IRA contribution for 2019, you must have set up the plan by October 1. So, you might have to wait until next year if the SIMPLE-IRA option is appealing.

Check Your Partnership and S Corporation Stock Basis. If you own an interest in a partnership or S corporation, your ability to deduct any losses it passes through is limited to your basis. Although any unused loss can be carried forward indefinitely, the time value of money diminishes the usefulness of these suspended deductions. Thus, if you expect the partnership or S corporation to generate a loss this year and you lack sufficient basis to claim a full deduction, you may want to make a capital contribution (or in the case of an S corporation, loan it additional funds) before year-end.

Consider Disposing of a Passive Activity. To reduce 2019 taxable income, consider disposing of a passive activity in 2019 if doing so will allow you to deduct suspended passive activity losses.

S Corporation Owners. A few issues related to S corporations and their owners that are hot-button items for the IRS are reasonable compensation and the treatment of medical insurance premiums.

S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee.

An item that is frequently treated incorrectly are medical insurance premiums paid on behalf of S corporation shareholders. Health and accident insurance premiums paid on behalf of a greater than 2% S corporation shareholder-employee are deductible by the S corporation and reported as wages on the shareholder-employee's Form W-2 which is subject to income tax withholding. These additional wages are not subject to social security, Medicare, or unemployment taxes. Be sure to contact your payroll provider to add these premiums to the shareholder's W-2 prior to year-end. The medical insurance premiums are treated as an adjustment to income on the shareholder's individual income tax return.

Conclusion

This letter only covers some of the year-end tax planning moves that could potentially benefit you and your business. Please contact us if you have questions, want more information, or would like us to help in designing a year-end planning package that delivers the best tax results for your circumstances.

Sincerely,

JHS CPAs, LLP