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Client Tax Letter

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January/February/
March 2019

In this issue

A grain of SALT in IRS notice

Taxpayers who itemize deductions on Schedule A of their tax returns have been able to deduct outlays for state and local income tax as well as property tax with no upper limit. (State and local sales tax may be deducted instead of income tax.) However, as of tax returns for 2018, the Tax Cuts and Jobs Act of 2017 provides that no more than $10,000 of these state and local tax (SALT) expenses can be deducted on single or joint tax returns ($5,000 for married individuals filing separately).

Example: Marge Williams might have been able to deduct $20,000, $50,000, or even more in SALT payments in 2017. For 2018 and subsequent years through 2025, Marge's SALT deduction will be capped at $10,000. Thus, her SALT payments over $10,000 will be made with 100-cent dollars. Previously, those state and local tax bills might have effectively been paid with, say, 65-cent or even 60.4-cent dollars, depending on her federal tax bracket.

Political figures in high tax states worry that this sizable increase in net tax obligations will cause residents to flee to other states with lower taxes; moreover, residents of other states might be reluctant to move to places where taxes are steep. That may or may not be the case. After all, taxpayers subject to the alternative minimum tax have been making SALT payments with 100-cent dollars for years—SALT is an add-back item in the alternative minimum tax calculation, wiping out the tax benefit—so the new rule might not be as painful as it appears.

First responder

Nevertheless, high tax states are enacting countermoves. For example, New York, has passed two-fold legislation. One aspect of this legislation is allowing New Yorkers to make contributions to designated health and education state charitable funds, which, theoretically, would qualify for federal and state charitable income tax deductions. Local governments are also authorized to create charitable funds.

Taxpayers making contributions to state charitable funds would also get state income tax credits, and taxpayers making contributions to a local charitable fund would get a property tax credit. The result could be reducing residents' non-deductible SALT expenses while increasing deductible charitable donations.

The second part of the New York plan involves a voluntary payroll tax, paid by employers, starting at 1.5% and escalating to 5% in two years. This voluntary payroll

Higher education

Measured by market share, total accounts, and assets under management (over $66 billion), Virginia529 is the largest 529 plan in the nation.

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Explaining the proposed regulations

- For example, suppose Ann Clark contributes $20,000 to a state sponsored health or education charity.
- Ann expects to receive a $14,000 state income tax credit (70% of $20,000).
- Ann's state tax credit is greater than 15% of her contribution.
- These IRS proposed regulations say that Ann's charitable deduction will be reduced by $14,000, regardless of when she claims the tax credit.

tax also will generate state income tax credits. Apparently, the idea is that employers would offset the extra expense by cutting wages, which will wind up as a wash for employees because of the tax savings.

IRS takes notice

Observers wondered what the IRS would think about such "work arounds" of the new SALT limits. Their questions were answered in IRS Notice 2018-54, released last May. The IRS characterized such state efforts as attempts to "circumvent" the new law. Federal tax deductions are controlled by federal law, the notice pointed out: Just because a state says that certain outlays are deductible on federal tax returns does not necessarily make it the last word on the subject.

In the notice, the IRS announced that it will publish proposed regulations on this issue. The agency mentioned "substance over form," indicating that challenges are likely. Officials in New York and other high tax states reportedly will continue to seek SALT relief. Tax preparers and taxpayers may want to carefully consider whether they want to be among the proverbial dogs in this fight.

Following up

The IRS issued proposed regulations on this subject on August 23, 2018. Here, the IRS said that a taxpayer's charitable deduction will be reduced if the anticipated state tax credit exceeds 15% of the contribution. (See the Trusted advice box.) The message from the IRS is that the new SALT deduction rules will be enforced.

More give in the gift tax

The Tax Cuts and Jobs Act of 2017 increased the federal estate tax exemption to more than $11 million for 2018-2025. That's per person, so the combined exemption for a married couple can be over $22 million worth of assets this year.

The same ceilings apply to the federal gift tax, which offsets the estate tax.

Example 1: Mona McAfee plans to give $20,000 to her son Luke this year. Does that mean that Mona's estate tax exemption would be reduced by $20,000?

Probably not. In addition to the lifetime exemption numbers now in effect, there is also an annual gift tax exclusion. Due to an ongoing process of inflation adjustment, that exemption increased to $15,000 in 2018, where it now remains based on information available at press time. Therefore, in 2019, each person can give up to $15,000 to any number of recipients without incurring gift tax consequences. That's up from an annual $14,000 exclusion, which was in effect the previous five years.

Here, Mona's $20,000 gift would be partially covered by the $15,000 exclusion, so only $5,000 will have gift tax consequences. Mona would have to report a $5,000 taxable gift on IRS Form 709. That $5,000 taxable gift will reduce her current federal estate and gift tax exemption amount by $5,000, assuming no other taxable gifts have been made.

As the recipient of the gift, Luke will pay no taxes.

Real world relevance

Most people won't have estates close to $11 million, so this exercise might seem academic. Still, the $15,000 annual gift tax exclusion can have practical effects in many situations. It's also worth noting that paying someone else's medical or education bills directly won't be included in the $15,000 allowance.

Example 2: Rhonda Cole wants to provide financial support for her son Mark's two children, Ken and Julie. To do so, Rhonda pays tuition bills

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for Ken and Julie directly to their colleges. The total is $50,000. In addition, Rhonda gives them each $15,000 in 2019 and no other gifts.

Rhonda also decides to give Mark $15,000 this year and pays $5,000 worth of bills from Mark's medical procedures directly to the health care providers. In total, Rhonda has given $100,000 to her loved ones, reducing her taxable estate by that amount. However, she hasn't gone over the $15,000 exclusion for any recipient in 2019, so Rhonda hasn't made any taxable gifts and will not have to file a gift tax return.

Note that the $15,000 limit presents a handy ceiling for making family gifts each year without the bother and expense of filing a gift tax return. This strategy won't work as well if Rhonda gives Mark $50,000 so Mark can pay his children's college bills. Then, Rhonda will have made a taxable gift of this amount and will be required to file Form 709.

Paired planning

Other possibilities exist if a married couple holds assets jointly, perhaps in a bank or brokerage account. A gift from such an account, or a gift of other property, by one spouse can be considered to be divided equally between the two spouses, so the annual gift tax allowance effectively increases to $30,000. There are two ways to do this. The easy way would be for each spouse to write a separate check for $15,000. If this is not practical, the spouses can get the benefit of a $30,000 annual exclusion by electing "gift splitting" on Form 709.

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Gift tax notes

- The gift tax lifetime exemption ceiling of $11 million+ will increase with inflation to $11.4 million (projected), but much lower limits are scheduled after 2025. There is some uncertainty about how this reduction, if it takes effect as scheduled, will affect large taxable gifts.
- Any future reduction in the lifetime gift tax exemption is unlikely to affect gifts that conform to annual gift tax exclusion rules.

How the new tax law affects 529 plans

For many years, 529 college savings plans have offered a tax-favored way to save for higher education. These plans, officially qualified tuition programs, are named for the IRC section that provides their advantages.

In brief, 529 plans are funded with after-tax dollars. In college savings plans, account owners choose from a menu of investments, and any earnings are untaxed. Distributions are also tax-free if they do not exceed the qualifying educational expenses of the account beneficiary: payments of tuition, fees, supplies, and certain housing expenses for the account beneficiary's study at an eligible educational institution. Before 2018, eligible educational institutions included only post-secondary institutions.

Youth movement

Under the Tax Cuts and Jobs Act of 2017, the benefits mentioned previously (tax-free investment earnings, potentially tax-free distributions) remain as they were. The difference is that for tax years beginning after December 31, 2017, 529 plans are no longer limited to higher education at a post-secondary institution. Now they can be used for elementary and secondary education, as well. That includes learning in public, private, and religious schools.

There is one key caveat: Tax-free distributions for elementary and secondary education are capped at $10,000 per student per year. As before, there is no annual limit on qualified distributions from 529 plans for higher education.

Example 1: Bill and Claire Dawson open a 529 account for their newborn son Noah. Over the years, they invest thousands of dollars there. When Noah is age 10, in the fifth grade, he goes to a private school where the tuition is $15,000. The Dawsons take $10,000 from Noah's 529 account to pay part of his tuition with a tax-free distribution. A larger distribution could lead to an income tax obligation and possibly an additional 10% tax on the amount of the taxable distribution.

Sooner than later

For families like the Dawsons, using 529 money for pre-college costs might not be an ideal strategy.

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Eligible schools

- For qualified tuition program tax benefits, an eligible educational institution now can be either an elementary, a secondary, or a post-secondary school.
- Among post-secondary schools, eligible schools are generally any accredited public, nonprofit, or privately owned profit-making college, university, vocational school, or other post-secondary educational institution.
- A post-secondary school also must be eligible to participate in a student aid program administered by the U.S. Department of Education.
- Eligible elementary and secondary schools include any public, private, or religious school that provides elementary or secondary education (Kindergarten through grade 12 classes).

The earlier money is withdrawn, the less time there will be for compounding earnings. Extending untaxed investment buildup, which eventually may come out as a tax-free distribution, is a prime benefit of 529 plans.

Even so, the new law can prove beneficial in some situations. When cash is short and private school costs are high, a $10,000 tax-free distribution from a 529 plan may be welcome. If students are now attending an expensive high school but are expected to attend an inexpensive college, it may make sense to use the $10,000 529 distribution each year.

Moreover, even though the new 529 provision applies to federal tax, substantial benefits might come from state taxes. Nearly every state offers a 529 plan, and most of them provide state income tax credits or state tax deductions to residents who invest in the home state's plan. (Some states have tax benefits for investing in *any* 529 plan.)

So far, states have differed on how they'll treat 529 plan distributions for kindergarten through grade 12 expenses. Assuming your state goes along with the new federal law, using $10,000 a year for pre-college costs may become especially attractive.

Example 2: Suppose Ted and Sarah Raymond live in a state that offers a 10% tax credit for 529 contributions. They invest $10,000 in their state's plan this year, getting a $1,000 credit against state tax. Then, they use that $10,000 to pay part of their daughter Gina's private high school tuition. With the $1,000 state tax saving, the Raymonds effectively reduce Gina's school cost by $1,000 by streaming their cash through their state's 529 plan.

Our office can inform you of your state's tax treatment of 529 contributions and how the state is dealing with the new rules on 529 distributions.

Moving your business to a low-tax state

As explained in the article, "A grain of SALT in the IRS notice," the Tax Cuts and Jobs Act of 2017 has put a cap on state and local tax (SALT) deductions. Beginning with your 2018 tax return, if you itemize deductions, you can count no more than $10,000 a year of SALT deductions for income and property tax on a single or joint tax return (you can choose to include sales tax instead of income tax). SALT deductions (other than those for state and local *income* taxes) are not limited if they relate to income from a trade or business or for property held for the production of income.

Therefore, paying large amounts of SALT will become more painful because there will be scant relief from a federal income tax deduction. The more you pay in SALT each year, the more the $10,000 ceiling will hurt. In addition, if you plan to make a profitable sale of your company within the foreseeable future, the state income tax on your sale could be substantial, yet not deductible.

Moreover, the new tax law's SALT cap could have a ripple effect on your company. If you have key employees, chances are they pay relatively high state and local income and property tax because of ample compensation and living in valuable homes. These employees might be thinking of their own tax-related relocation if you're in a high-tax area now.

Plan yourself first

The idea of moving to a lower tax state could be more appealing now. Such a decision should be based on careful research.

To start, determine whether you want to personally relocate. Moving your business to another state while continuing to live in your current state may cause problems. Say you have decided to move your business from New York to Florida. It may be

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difficult to convince New York that you have moved your company to Florida if your own residence is still in Manhattan or Brooklyn.

If you do decide to personally relocate, your claimed change in residence will be more convincing if you sell your home in New York and cut all ties. That could include getting a new driver's license, voter registration, local bank account, and so on. You might have to put young children into school within the new state. If you choose to keep other New York real estate after moving, it may be costly. New York will seek to tax rents on property within its borders, and the property, if still owned at death, will be subject to New York state estate tax.

Besides comparing tax burdens, look at other major costs, as well. Will home and auto insurance be higher or lower after a move? How will health insurance be affected?

If your spouse works outside your company, will there be job opportunities in the new area? Determine if the total savings will justify the disruption that a move will create.

Getting down to business

Once you've decided that a personal move would be cost effective, analyze what a business move would entail. If your business is very small, perhaps just yourself and an assistant, relocating may be fairly straightforward. As long as it will pay off for your family, moving to save money paid for state and local tax could make sense.

With larger companies, though, more factors must be considered. You might have to deal with relinquishing office space and finding suitable new business premises. Other decisions could involve dealing with business property, offering employees help to relocate, providing severance pay to those who will be left behind, obtaining various licenses and registrations in the new jurisdiction, and so on. The sooner you move and the longer you operate in the low-tax state, the greater your chance of avoiding tax from your old state on a sale of the company.

The bottom line is that moving a business may be challenging, but it is doable. Such relocation is implemented all the time by many types of companies. The new tax law, with its limit on SALT deductions, may be the proverbial final straw that gets you going. Our firm can calculate the overall cost savings from such a move and help you deal with the regulatory requirements that might arise.

Education as a small-business fringe benefit

As reported in previous issues of the *CPA Client Tax Letter*, the Tax Cuts and Jobs Act of 2017 dramatically reduced taxpayers' ability to itemize deductions. Among the tax deduction opportunities that have vanished, from 2018–2025, are miscellaneous itemized deductions that exceed 2% of the taxpayer's gross income. Such deductions included unreimbursed employee business expenses.

Drilling down, those no-longer-deductible employee expenses included education outlays that were related to someone's work at your company.

Example 1: Heidi Larson is a supervisor at ABC Corp., where she is responsible for a small group of workers. Heidi is paying for online courses that will ultimately lead to an MBA and help her in her current job. Under prior law, Heidi may have been able to deduct her costs for the MBA program, but that's not the case now.

Filling the gap

Many people will be in Heidi's situation, unable to offset the cost of paying for education that will bolster their careers. In this environment, your small business can provide valuable education-related assistance. Offering help in this area may allow your company to attract and retain high-quality workers, in addition to improving your employees' on-the-job performance.

In 2018, the IRS released an updated Employer's Tax Guide to Fringe Benefits, which reflects the new tax law. This guide mentions some ways that employers can offer education

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benefits that receive favorable tax treatment.

Educational assistance programs

An educational assistance program (EAP) must be a written plan created specifically to benefit your company's employees. Under such a plan, an employer can exclude from taxable compensation up to $5,250 of educational assistance provided to each covered employee per year.

Example 2: Suppose that DEF Corp. has an EAP. Ken Matthews, a supervisor there, is taking courses in a local MBA program. DEF provides $5,000 to help Ken pay for his courses this year. DEF can deduct its $5,000 outlay, whereas Ken does not report that $5,000 as taxable income. It makes no difference whether DEF pays the bills directly or reimburses Ken for his outlay.

Some formality is required when setting up an EAP and certain requirements must be met. The plan can't favor highly compensated employees or company owners, for example, and it can't offer cash to employees instead of educational assistance. Our office can help you create an EAP that complies with IRS requirements.

Working-condition fringe benefit

The benefits in this category don't require a formal plan, there is no limit on the amount of educational assistance involved, and no explicit limit on highly compensated employees or owners applies. However, there are rules that must be followed to earn tax breaks.

The education must be required, by the company or by law, in order for the employee to maintain his or her present position, salary, or status at the firm, and the learning must have a valid business purpose for the employer. If those conditions can't be met, tax breaks still may be available if the education helps to maintain or improves job-related skills.

Regardless of the previous paragraph, tax benefits will be denied if the education is needed to meet the minimum educational requirements of the employee's current job or if the course will qualify the employee for a new trade or business.

Example 3: Nora Pearson, a supervisor at GHI Corp., is going to law school at night. Even if learning the law will help Nora do her job better, company funding for her courses won't qualify for favorable taxation because the education could enable Nora to become an attorney, a new trade for her. Any assistance from GHI will be treated as taxable compensation.

Note that it is possible to have an EAP and provide over $5,250 to an eligible employee. Assuming that all conditions are met, assistance over $5,250 might be deductible for the employer and excluded from the employee's taxable compensation as a working-condition fringe benefit.

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