CPA™

Client Bulletin

Smart tax, business and planning ideas from your Trusted Business Advisor℠

May 2019

Using the 0% tax rate

Generally, profits from selling assets such as securities and real estate held in taxable accounts are classed as long-term if the holding period was longer than one year. Tax rates on long-term capital gains are 0%, 15%, or 20%, depending on the seller's income.

To maximize use of the 0% rate, your taxable income (after all deductions) in 2019 must be no more than $39,375 for single filers and married individuals filing separately, $52,750 for heads of household, or $78,750 on a joint tax return. (Inflation adjustments may increase those numbers in the future.)

Example 1: Ryan and Ellie Ford have income over $100,000 on their 2018 tax return, reporting $60,000 of taxable income. (That's after taking the standard deduction and deducting pre-tax contributions to retirement plans.) The Fords expect to have similar income in 2019.

Suppose Ryan and Ellie sell $50,000 of shares in a U.S. stock fund, which they had bought several years ago for $35,000, generating a $15,000 long-term capital gain in a taxable account.

Assuming the Fords will have no other capital gains or losses in 2019, this gain is expected to bring their taxable income for the year from $60,000 up to $75,000. In this scenario, the Fords will owe 0% income tax on their $15,000 long-term capital gain because their taxable income would be under the $78,750 threshold.

What would happen if the Fords misjudge and wind up 2019 with taxable income of $80,000, including their $15,000 long-term capital gain? Does this prevent them from using the 0% capital gains tax rate?

No, the Fords won't have their gain completely taxed at 15%. If Ryan and Ellie have taxable income of $80,000 — $1,250 above the threshold — that $1,250 would be taxed at 15% ($187.50), the next capital gains rate, and the balance of their gain ($13,750) would be taxed at 0%. So, this couple would owe only $187.50 on a $15,000 long-term gain, which they might consider a savvy move.

Qualified dividends

Income from stock dividends may be taxed at ordinary income tax rates of up to 37% this year. However, on some dividends (subsequently discussed), taxpayers may owe 0%. Again, the cut-off points are the same as they are for 0% long-term capital gains: taxable income under $39,375 for

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Bearing more risk

According to the Centers for Disease Control and Prevention, between 2007 and 2018 the percentage of individuals under age 65 enrolled in high-deductible health plans (with deductibles of at least $1,350 or $2,700 for family coverage in 2018) increased from 17.4% to 46%, a 264% increase.

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Trusted advice

Qualified dividends

Qualified dividends must pass all these tests:

- They must be paid by a U.S. corporation or a qualified foreign corporation.
- They must not be specifically excluded by the IRS as not eligible as qualified dividends (see IRS Publication 550, p. 20). That list includes capital gains distributions and payouts that are really interest income.
- You must have held the stock paying the dividends for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. (The ex-dividend date is the first day of trading on which the buyer of a security is no longer entitled to the most recently announced dividend.)

Did you know?

Home sellers in 2018 realized an average home price gain of $61,000 since purchase, a 12-year high. That average profit represented an average 32.6% return on investment, the highest since 2006. Individual markets with the leading returns were mainly in the west, topped by San Jose (108.8%), San Francisco (78.6%), and Seattle (70.7%).

Source: attomdata.com

single filers, for example, and $78,750 on a joint tax return.

Example 2: George Drake is retired, with $55,000 in annual income, including $10,000 of income from stocks and stock funds that he holds in taxable accounts. George itemizes deductions, and his taxable income is well under $40,000 each year. As a result, George owes 0% tax on his dividend income this year.

Most dividends, including dividends passed through from stock funds, are qualified dividends that receive favorable tax treatment, although some conditions apply. (See **Trusted advice** box.) Qualified dividends are taxed at the same rates as long-term capital gains, so if your income is too high for the 0% rate, you'll owe tax at 15% or 20%.

It's a truism, for good reason, that you shouldn't let the tax tail wag the investment dog. That said, if you expect to be in the 0% bracket, you might consider holding some dividend-paying stocks or stock funds in a taxable account for untaxed income.

Working around the new "kiddie tax"

The article on page 1 of this issue of the *CPA Client Bulletin* explains that single taxpayers with taxable income up to $39,375 ($78,750 on joint returns) can pay 0% tax on long-term capital gains. That may suggest some income-shifting strategies.

Example 1: Suppose that Fred and Grace Holden plan to switch from XYZ Stock Fund to another fund. If the Holdens sell all their shares of XYZ, which has been held in a taxable account for more than one year, they would have a $30,000 long-term capital gain. With their income, in this example, Fred and Grace will owe 15% on long-term gains, so they would give $4,500 to the IRS: 15% of $30,000.

Instead, the Holdens could give their shares to their daughter Hope, a 20-year old college student who otherwise would have no taxable income this year. If Hope receives the shares in a gift from her parents, she'll pick up her parents' basis (cost for tax purposes) and holding period (long term).

Then, Hope could sell the shares immediately, realize the $30,000 long-term gain, and stay below the taxable income threshold, so she'd be in the 0% tax bracket for the gain on the sale. In this scenario, Hope's parents would have avoided a $4,500 tax bill. Wouldn't that be a great idea?

Kid stuff

Unfortunately, the 0% tax rate is not that easy to use. For one thing, there is a "tax on certain children who have unearned income," known as the "kiddie tax." This rule is designed to prevent the type of income shifting the Holdens have in mind.

A "kiddie," for this purpose, can be a youngster who was

- under age 18 at year-end;
- age 18 at year-end, with earned income no more than half of his or her support; or
- a full-time student age 19-23 at year-end, with earned income no more than half of his or her support.

Some exceptions are possible. A married individual filing a joint tax return would not be included, for instance. In our example, though, the last bullet point describes Hope, so the kiddie tax would apply.

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Math lesson

In 2019, kiddies can have up to $2,200 of unearned income without owing tax. Above that amount, unearned income would be taxed according to the tax rules for trusts and estates. (This step was introduced in 2018, replacing a formula based on parents' tax rates.)

Example 2: Here, Hope Holden has a $30,000 long-term gain, of which she can exclude $2,200. Using the tax rates for trusts and estates in 2019, the next $2,650 of Hope's long-term capital gain would qualify for the 0% tax rate. Thus, each "kiddie" possibly could have up to $4,850 ($2,200 + $2,650) of long-term gains in 2019, taxed at 0%.

Larger gains, up to $12,950, would be taxed at 15%. On Hope's $30,000 long-term gain, the remainder (nearly $15,000) would be taxed at 20%, the top long-term capital gains rate.

Giving to grown-ups

If the kiddie tax doesn't apply, income shifting to use the 0% tax rate becomes much easier. Suppose that Hope is a 24-year-old graduate student, instead of a 20-year-old undergraduate. Then, the kiddie tax wouldn't apply, and giving Hope the appreciated shares to sell would, indeed, save the Holden family thousands of dollars in tax. The same could be true if Hope were married, reporting modest income on a joint return, or if the Holdens were helping Fred's parents, for instance, who might be retirees living on a modest income.

Moreover, avoiding the kiddie tax is only one factor to consider in such planning. The annual gift tax exclusion amount is $15,000 in 2019. Larger gifts probably won't trigger gift tax because the federal estate and gift tax exemption is $11.4 million per individual in 2019.

On the other hand, if any individual gives assets worth more than $15,000 to a recipient in 2019, a gift tax return must be filed. For the Holdens to give Hope shares with a $30,000 built-in gain, the value of the shares probably would be well over $30,000, requiring a gift tax return.

Let's say Fred and Grace wanted to help support Fred's parents. They could give a total of $60,000 worth of assets, such as appreciated shares. (Fred would give $15,000 of such assets to each of his parents; Grace would do the same.) Similarly, if Fred and Grace had two children beyond the kiddie tax age, they each could give $30,000 to the kids without having to worry about a gift tax return.

However, for income-shifting gifts over the $15,000 annual exclusion, pros and cons should be weighed. Are the tax savings worth the effort of transferring shares and the costs of gift tax preparation? You also must be willing to part with the relinquished assets.

Another possible benefit: Transferring shares to children for a subsequent sale can be a good way of teaching them something about investing, gains, and tax consequences.

Final regulations clarify IRC Section 199A

The IRS recently published final regulations regarding Section 199A of the IRC. That section, created by the Tax Cuts and Jobs Act of 2017, offers a 20% deduction for qualified business income (QBI). This deduction may be available to non-C-corporation taxpayers such as sole proprietors, business partners, certain LLC members, S corporation shareholders, and some others reporting business income.

As explained in the March 2019 *CPA Client Bulletin*, taxable income affects the ability to take the QBI deduction. The annual thresholds, which are indexed for inflation, are taxable income of $321,400 on joint returns in 2019, $160,725 for married individuals filing separately, and $160,700 for single taxpayers as well as heads of household.

Below the thresholds

If your taxable income is below those thresholds, taking the QBI deduction might be relatively simple. You would calculate your QBI and possibly deduct 20%.

Example 1: Jane and Keith Larsen, who file a joint tax return, wind up with $250,000 of taxable income in 2019. Keith has $90,000 of QBI from his sole proprietorship. Thus, this couple can take an $18,000 (20% of $90,000) QBI deduction.

The situation is different, though, if the Larsens have $90,000 of QBI from Keith but only $60,000 of taxable income, after deductions. Now their QBI deduction is the *lesser* of 20% of QBI or 20% of taxable income: 20% of $60,000, or $12,000, rather than $18,000.

Above the thresholds

With taxable income above the thresholds, limitations arise. One limitation is based on a formula involving employee wages or the taxpayer's unadjusted basis in

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qualified property, or both; the other limitation applies to specified service trades or business, an extensive list ranging from accounting to trading securities. In any case, reducing taxable income that's over the threshold may permit a larger QBI deduction.

Contributing to a retirement plan can reduce taxable income. However, the final regulations confirm that a pre-tax deduction for retirement plan contributions is included in the calculation of QBI. Therefore, reducing taxable income also may reduce the QBI deduction. If possible, it's better to avoid this offset.

Example 2: Suppose that Jane and Keith Larsen expect their taxable income in 2019 to be around $350,000, which would put them over the $321,400 threshold for joint filers. Reducing their taxable income by contributing $30,000 to a retirement could bring them under the threshold and increase their QBI deduction. It would be better if the retirement contribution is made by Jane, a salaried employee. Then, Keith's QBI deduction would not be decreased.

In this example, Jane may have maxed out her retirement plan contribution for the year already, so Keith would have to be the one reducing income with a retirement plan contribution. If Keith stands to lose a 20-cent QBI deduction for every $1 deferred in a retirement plan, he is only getting an 80% net benefit from his retirement plan contribution. When he withdraws money from his retirement plan in the future, Keith will owe tax at his full tax rate, with no QBI savings.

Nevertheless, Keith may be getting a double-tax saving: Contributing to his retirement plan might reduce the couple's taxable income in 2019 and also increase his QBI deduction. Your specific circumstances will determine the potential payoff from this type of planning.

Our office can go over the numbers with you to project the tax savings from such maneuvering to affect QBI. In general, the more years you'll have until required minimum distributions start after age 70½, the greater the advantage of increasing contributions to tax-deferred retirement accounts.

Tax calendar

MAY 2019

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2019. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

JUNE 2019

June 17

Individuals. If you are not paying your 2019 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2019 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2018. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2019.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

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