Client Bulletin

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

March 2019

The new math of municipal bonds

Stock market volatility has some investors thinking about putting some money into bonds, which historically have offered relatively stable prices. One key decision facing bond market investors is whether to choose regular, taxable bonds or tax-exempt municipal bonds. (This discussion concerns investments in taxable accounts because tax-exempt municipals and muni funds typically don't belong in a tax-favored retirement account.)

Taxable bonds generally offer higher yields than tax-exempt bonds. On the other hand, the after-tax return from munis may be higher after investors pay tax on taxable bond interest. Thus, the appeal of municipal bonds increases as investors' tax rates move up.

Lower rates, tougher calls

The Tax Cuts and Jobs Act of 2017 (TCJA) reduced tax rates for many taxpayers, which could make municipal bonds less attractive.

Example 1: Assume, hypothetically, that a taxable bond fund yields 4%, and a muni fund with similar characteristics (default risk, interest rate risk) yields 3%. Al Brown, in a top 37% tax bracket, would net 2.52%, after paying 1.48% (37% of 4%) in tax. Carl Davis, in a 12% bracket, would net 3.52%, after paying 0.48% (12% of 4%) in tax.

Therefore, high-bracket taxpayers could get a substantial increase in after-tax yield from a muni fund, whereas those in lower brackets might profit by choosing taxable issues. Those in between, perhaps in the 22% or 24% bracket, might find scant difference in after-tax yield between taxable and tax-exempt bonds.

State of the art

The numbers provided previously use *federal* income tax rates to find the after-tax yield. Many investors, though, would also pay state and even local income tax on interest from taxable bonds. That leads to a further calculation.

Example 2: Suppose Al Brown from example 1 has $100,000 invested in a taxable bond fund yielding 4%. Therefore, he collects $4,000 a year in taxable interest income. As mentioned, Al is in the 37% tax bracket, so his federal income tax on that interest income would be $1,480. Assume Al also owes 8% in state income tax, or $320 on his $4,000 of interest income, for a total tax bill of $1,800, which would leave him with $2,200 of net interest income after state and local income tax.

In prior years, Al might have been able to deduct the state income tax paid on his

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Student loan debt

With 44 million borrowers owing a total of $1.5 trillion, student loan debt now exceeds credit card debt.

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bond interest income. Multiplying the $320 of state income tax by the 37% saved by a federal income tax gives him a tax savings around $118, raising his net payout from his taxable bond fund to $2,318.

However, Al may not be able to deduct that $320 of state income tax paid under the TCJA. That could be the case if he takes the standard deduction, rather than itemize deductions such as taxes paid. Even if Al itemizes deductions, the $10,000 cap on state and local tax deductions may keep him from getting any tax benefit from the tax paid on his bond interest, keeping his after-tax income at $2,200, or 2.2% on his $100,000 investment.

Summing up

The TCJA provides cross-currents for bond investors. Lower stated tax rates make municipal issues less appealing, but the possible absence of a deduction for taxes paid effectively raises the tax rate, which favors munis.

High bracket investors traditionally favor tax-exempt bonds, and that will continue to be the case. In high tax states, the new law may increase the lure of home state munis and funds specializing in such bonds because the payouts usually avoid state and local income tax.

Low bracket investors may find better yields, after tax, from taxable bonds. Those in the middle — investors with roughly $40,000 to $160,000 in taxable income, or $80,000 to $320,000 on a joint return — may find the choice between taxable and municipal issues a close one. Our office can help you work through the numbers when you're planning an investment in bonds, including the possible impact of the 3.8% surtax on net investment income, which may be owed by high-income taxpayers.

Handling qualified charitable distributions

As the filing season for 2018 tax returns reaches a peak, many people will learn that they're no longer itemizing deductions. The TCJA placed limits on some deductions and increased the standard deduction significantly, so most taxpayers are taking the standard deduction, rather than itemizing.

One result is that charitable contributions offer no direct tax benefit for many donors. An indirect benefit may be available for people who are 70½ or older. They can take qualified charitable distributions (QCDs) from their IRAs and effectively reduce their income in a maneuver solidly supported by the tax code.

(Taxpayers under age 70½ will report taxable income if they send IRA dollars to charity, so this tactic won't work. That said, people under the QCD age should inform their parents and other valued seniors about this give-and-take option.)

ABCs of QCDs

IRA owners can send QCDs to recognized charities, up to $100,000 per person per year. They receive no deduction for the contribution, but they also do not have to include the distribution in income. Moreover, a QCD counts toward required minimum distributions (RMDs), which IRA owners must take after age 70½.

Example 1: Ken and Linda Martin are both age 75 with IRAs. Ken has a $20,000 RMD in 2019; Linda's RMD is $12,000. If they take only RMDs, the Martins will increase their taxable income by $32,000 this year.

Each year, the Martins donate $10,000 to their favorite charities. Even with a $10,000 charitable contribution, it will not pay for this couple to itemize deductions in this hypothetical example.

Therefore, Linda sends $10,000 to selected charities from her IRA via QCDs. Now Linda needs to take only another $2,000 from her IRA to satisfy her $12,000 RMD for the year; Ken will take his $20,000 RMD. In this scenario, the Martins report $22,000 in taxable IRA distributions this year, rather than $32,000. Effectively, they have deducted $10,000 from their income by using QCDs.

Realistic expectations

Using QCDs may not be a straightforward exercise. IRA custodians differ in the way they handle the procedure.

Taxpayers may have to call their IRA custodian and speak to a designated person who is familiar with QCDs. Charitable recipients can be named, along with their mailing addresses. Securities might have to be sold, if the QCD is to be made in cash, and a form might have to be signed by the IRA owner for each charity, permitting the QCD.

Other financial firms might send out a distribution booklet to be returned, along with a signature guarantee for each QCD. Yet another possible method is to handle the QCD transaction online. The process can

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be time-consuming and possibly confusing, so it's best not to wait until the waning days of December to get started.

Keep in mind that a distribution will only be a QCD if the entire distribution meets the requirements for a charitable contribution deduction, such as a charity's eligibility under Section 501(c)(3) of the tax code and substantiation requirements. QCDs can't be sent to donor-advised funds.

Trusted advice

IRAs eligible for QCDs

- Qualified charitable distributions can come from most types of IRAs, including rollover IRAs and inherited IRAs, other than "ongoing" simplified employee pension (SEP) IRAs or savings incentive match for employees (SIMPLE) IRAs.
- For this purpose, a SEP IRA or a SIMPLE IRA is treated as ongoing if it is maintained under an employer arrangement under which an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contributions would be made.
- Following the IRS' position, some IRA custodians will permit a QCD from a SEP or SIMPLE IRA for a given year if no contribution has been made to the plan that year.

Deducting qualified business income

The TCJA created a new deduction for small business owners who operate pass-through entities. That includes domestic companies operated as sole proprietorships or through S corporations, partnerships, certain LLCs, trusts, and estates. Income from such entities may allow business owners to deduct 20% of their qualified business income (QBI).

On the surface, the deduction may seem straightforward.

Example 1: Laurie Wilson runs her website design company as a sole proprietorship. In 2019, her net income from this business is $100,000. Laurie can take a $20,000 (20% of $100,000) QBI deduction on her 2019 tax return.

However, some business owners may find taking the QBI deduction more challenging.

Learning the limits

The QBI deduction may be subject to limitation if the taxpayer's QBI is from a trade or business that pays W-2 wages to employees or has certain qualified property. In addition, the deduction may be limited if the trade or business is one of certain specified service trades or businesses.

Both limitations apply only to taxpayers with taxable income over certain thresholds, which are adjusted annually for inflation. For 2019, the taxable income thresholds are $321,400 for married couples filing joint returns, $160,725 for married individuals filing separately, and $160,700 for single taxpayers as well as heads of household.

Taxpayers who have taxable income above those thresholds may find their QBI deduction reduced or eliminated altogether. In those situations, it may pay to contribute to retirement plans, bringing taxable income below the relevant threshold.

Example 2: Jerry Nolan is the 100% owner of an S corporation. In 2019, Jerry and his wife Marie expect to have taxable income of $350,000. If either or both spouses can contribute a total of $30,000 to a pretax retirement plan, that will bring their taxable income below the $321,400 threshold, helping them to get a full QBI deduction.

Business owners who already have a defined contribution plan in place, for instance, could explore setting up a defined benefit plan, as well. Our office can help you weigh the advantages and disadvantages of this strategy.

From more to lesser

Even for business owners under the taxable income thresholds, a 20% QBI deduction might not be available. That's because the QBI deduction is the *lesser* of 20% of QBI or 20% of taxable income less net capital gain.

Example 3: Steve Thomas has $200,000 of QBI from his consulting firm, which he operates as a sole proprietorship. After taking various deductions (self-employment tax, retirement plan contributions, itemized deductions), Steve winds up with $140,000 of taxable income this year. He has no capital gains for the year.

In this situation, Steve's taxable income ($140,000) is less than his QBI ($200,000), so Steve's QBI deduction would be only $28,000: 20% of $140,000.

If Steve can raise his taxable income over $200,000, he could claim a $40,000 QBI deduction. Assume that a $60,000 Roth IRA conversion would add $60,000 to Steve's taxable income, to just over $200,000. Then Steve's $200,000 QBI would be the lesser number, and he could take a

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full $40,000 QBI deduction: 20% of $200,000.

It's true that a Roth IRA conversion would add to Steve's tax bill for the year, but the added QBI deduction would be an offset. Once all the numbers are crunched, this could be a relatively low-tax way to move money into a Roth IRA, from which all distributions can be untaxed, after five years and age 59½.

Earnings don't count

Business owners should be aware that QBI is meant to be net business income, after all claimed business deductions have been taken. Thus, the QBI rules exclude salaries to S corporation shareholders and guaranteed payments to LLC members. Those amounts are not QBI, so they don't merit a 20% deduction.

Some S corporation owners may be tempted to lowball salaries and, thus, increase QBI. However, the tax code requires reasonable compensation for owner-employees. A business owner's efforts to take a reduced salary in order to increase QBI may lead to an IRS audit, recasting net business income as earnings, and perhaps generating steep penalties.

Tax calendar

MARCH 2019

March 15

Partnerships. File a 2018 calendar-year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1 (Form 1065). If you want an automatic six-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then, file Form 1065 and provide each partner with a copy of his or her final or amended (if required) Schedule K-1 by September 16.

S corporations. File a 2018 calendar-year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate that you owe. Then, file the return, pay any tax, interest, and penalties due, and provide each shareholder with a copy of the Schedule K-1 (Form 1120S) by September 16.

S corporation election. File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2019. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2020.

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

APRIL 2019

April 15

Individuals. File a 2018 income tax return and pay any tax due by April 15 (if you live in Maine or Massachusetts, the filing deadline is April 17). If you want an automatic six-month extension of time to file the return, file Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. Then, file Form 1040 by October 15.

If you are not paying your 2019 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2019 estimated tax. Use Form 1040-ES.

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

Household employers. If you paid cash wages of $2,100 or more in 2018 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2017 or 2018 to household employees. Also report any income tax you withheld for your household employees.

Corporations. File a 2018 calendar-year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate that you owe.

Corporations. Deposit the first installment of estimated income tax for 2019.

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