

Hess & Hess, LLP

Quarterly Tax Newsletter

Federal Income Tax: How Did We Get Here?



April 16, 2019 was an important day for many of us. But do you know why? It was Tax Freedom Day — the day when the average American theoretically earned enough to pay his or her tax obligations for the

year. According to the Tax Foundation, Americans will pay \$3.4 trillion in federal taxes in 2019, more than they spend on food, clothing, and housing combined.* But it wasn't always this way. In fact, income taxes are a fairly new development in the overall history of America. So how did we get to this point?

In the beginning...

The United States was founded, in part, on the premise that colonists didn't want to pay taxes without representation, which led to the famous tossing of tea into the Boston Harbor and the American Revolution. However, not long after the colonies gained their freedom from England, Congress passed the Stamp Act of 1797, which essentially was our nation's first estate tax. Otherwise, from the early 1790s to 1802, the U.S. government was supported by taxes on such items as spirits (alcohol, not the ghostly kind), sugar, tobacco, and corporate bonds.

Wars played a big part in the history of taxation in this country. To fund the War of 1812, Congress taxed sales of gold, silverware, jewelry, and watches. In 1817, tariffs on imported goods provided the main source of revenue to run the government.

With the onset of the Civil War, Congress enacted the nation's first income tax law, the Revenue Act of 1861, which included a flat tax of 3% on annual incomes exceeding \$800 to help pay for the costs of the war. That tax law was repealed and replaced by the Revenue Act of 1862, which established the Office of the Commissioner of Internal Revenue (forerunner to the Internal Revenue Service), levied excise taxes on most goods and services, and replaced the flat tax with a progressive tax.

The 16th Amendment

However, it was not until 1913 with the adoption of the 16th Amendment to the Constitution, that the income tax became a permanent fixture in the American tax system. Congress now had the authority to tax income of both individuals and corporations. It didn't take the IRS long to start inundating us with forms, beginning in 1914 with the introduction of the first income tax form, the dreaded Form 1040. Enactment of the Revenue Act of 1916 introduced tax rates and income scales.

Tax rates

Here's a sobering fact: In 1913, the top federal income tax bracket was 7% on all income over \$500,000, and the lowest tax bracket was 1%. During the Great Depression, Congress raised the highest tax bracket to 63%. Wars can be expensive, as evidenced by the jump in the highest tax rate to 94% during World War II. In 2018, the highest income tax rate was lowered to 37%.

Trying to get it right

Over the years, there have been frequent attempts to reform the tax law in some manner. We've seen the adoption of the alternative minimum tax, Social Security tax, taxes on cigarettes and alcohol, gasoline taxes, aviation taxes, property taxes, telecommunication taxes, not to mention state and local taxes. To quote Will Rogers, "The difference between death and taxes is death doesn't get worse every time Congress meets."

Tax laws are always changing and will likely remain a political hot potato. Only time will tell what changes are ahead, but there is no doubt that through taxation, what the government giveth, it inevitably taketh back again.

**Tax Freedom Day 2019 was April 16, as calculated by the Tax Foundation, taxfoundation.org.*

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Charitable Giving After Tax Reform
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Some of the recent changes to the standard deduction and itemized deductions may affect your ability to obtain an income tax benefit from your charitable contributions. Incorporating charitable giving into your year-end tax planning may be even more important now. If you are age 70½ or older and have a traditional IRA, you may wish to consider a qualified charitable distribution.

Charitable Giving After Tax Reform

Tax reform changes to the standard deduction and itemized deductions may affect your ability to obtain an income tax benefit from charitable giving. Projecting how you'll be affected by these changes while there's still time to take action is important.

Income tax benefit of charitable giving

If you itemize deductions on your federal income tax return, you can generally deduct your gifts to qualified charities. However, many itemized deductions have been eliminated or restricted, and the standard deduction has substantially increased. You can generally choose to take the standard deduction or to itemize deductions. As a result of the changes, far fewer taxpayers will be able to reduce their taxes by itemizing deductions.

Taxpayers whose total itemized deductions other than charitable contributions would be less than the standard deduction (including adjustments for being blind or age 65 or older) effectively have less of a tax savings incentive to make charitable gifts. For example, assume that a married couple, both age 65, have total itemized deductions (other than charitable contributions) of \$15,000. They would have a standard deduction of \$27,000 in 2019. The couple would effectively receive no tax savings for the first \$12,000 of charitable contributions they make. Even with a \$12,000 charitable deduction, total itemized deductions of \$27,000 would not exceed their standard deduction.

Taxpayers whose total itemized deductions other than charitable contributions equal or exceed the standard deduction (including adjustments for being blind or age 65 or older) generally receive a tax benefit from charitable contributions equal to the income taxes saved. For example, assume that a married couple, both age 65, have total itemized deductions (other than charitable contributions) of \$30,000. They would be entitled to a standard deduction of \$27,000 in 2019. If they are in the 24% income tax bracket and make a charitable contribution of \$10,000, they would reduce their income taxes by \$2,400 (\$10,000 charitable deduction x 24% tax rate).

However, the amount of your income tax charitable deduction may be limited to certain percentages of your adjusted gross income (AGI). For example, your deduction for gifts of cash to public charities is generally limited to 60% of your AGI for the year, and other gifts to charity are typically limited to 30% or 20% of your AGI. Charitable deductions that exceed the AGI limits may generally be carried over and deducted over the next five years, subject to the income percentage limits in those years.

Year-end tax planning

When making charitable gifts during the year, you should consider them as part of your year-end tax planning. Typically, you have a certain amount of control over the timing of income and expenses. You generally want to time your recognition of income so that it will be taxed at the lowest rate possible, and to time your deductible expenses so they can be claimed in years when you are in a higher tax bracket.

For example, if you expect that you will be in a higher tax bracket next year, it may make sense to wait and make the charitable contribution in January so you can take the deduction next year when the deduction results in a greater tax benefit. Or you might shift the charitable contribution, along with other itemized deductions, into a year when your itemized deductions would be greater than the standard deduction amount. And if the income percentage limits above are a concern in one year, you might consider ways to shift income into that year or shift deductions out of that year, so that a larger charitable deduction is available for that year. A tax professional can help you evaluate your individual tax situation.

Qualified charitable distribution (QCD)

If you are age 70½ or older, you can make tax-free charitable donations directly from your IRAs (other than SEP and SIMPLE IRAs) to a qualified charity. The distribution must be one that would otherwise be taxable to you. You can exclude up to \$100,000 of these QCDs from your gross income each year. And if you file a joint return, your spouse (if 70½ or older) can exclude an additional \$100,000 of QCDs.

You cannot deduct QCDs as a charitable contribution because the QCD is excluded from your gross income. In order to get a tax benefit from your charitable contribution without this special rule, you would have to itemize deductions, and your charitable deduction could be limited by the percentage of AGI limitations. QCDs may allow you to claim the standard deduction and exclude the QCD from income.

QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to receive from your IRA, just as if you had received an actual distribution from the plan.

Caution: *Your QCD cannot be made to a private foundation, donor-advised fund, or supporting organization. Further, the gift cannot be made in exchange for a charitable gift annuity or to a charitable remainder trust.*



529 plan assets reach \$333 billion

Assets in 529 plans reached \$333 billion as of September 2018 — \$310 billion (93%) in college savings plans and \$23 billion (7%) in prepaid tuition plans.

Source: Strategic Insight, 529 Data Highlights, 3Q 2018

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information is available in each issuer's official statement and applicable prospectuses, which contain this and other information about the investment options, underlying investments, and investment company, and should be read carefully before investing. Also consider whether your state offers a 529 plan that provides residents with favorable state tax benefits and other benefits, such as financial aid, scholarship funds, and protection from creditors. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated.

Rules on Opening a 529 Plan Account for College

Year over year, participation in 529 plans continues to rise.¹ Anyone can open an account, lifetime contribution limits are typically over \$300,000, and there are tax benefits if the funds are used for college. Here are some common questions on opening an account.

Can I open an account in any state's 529 plan or am I limited to my own state's plan?

Answer: It depends on the type of 529 plan you have: college savings plan or prepaid tuition plan. With a college savings plan, you open an individual investment account and direct your contributions to one or more of the plan's investment portfolios. With a prepaid tuition plan, you purchase education credits at today's prices and redeem them in the future for college tuition. Forty-nine states (all but Wyoming) offer one or more college savings plans, but only a few states offer prepaid tuition plans.

529 college savings plans are typically available to residents of any state, and funds can be used at any accredited college in the United States or abroad. But 529 prepaid tuition plans are typically limited to state residents and apply to in-state public colleges.

Why might you decide to open an account in another state's 529 college savings plan? The other plan might offer better investment options, lower management fees, a stronger investment track record, or better customer service. If you decide to go this route, keep in mind that some states may limit certain 529 plan tax benefits, such as a state income tax deduction for contributions, to residents who join the in-state plan.

Is there an age limit on who can be a beneficiary of a 529 account?

Answer: There is no beneficiary age limit specified in Section 529 of the Internal Revenue Code, but some states may impose one. You'll need to check the rules of each plan you're considering. Also, some states may require that the account be in place for a specified minimum length of time before funds can be withdrawn. This is important if you expect to make withdrawals quickly because the beneficiary is close to college age.

Can more than one 529 account be opened for the same child?

Answer: Yes. You (or anyone else) can open multiple 529 accounts for the same beneficiary, as long as you do so under different 529 plans (college savings plan or prepaid tuition plan). For example, you could open a college savings

plan account with State A and State B for the same beneficiary, or you could open a college savings plan account and a prepaid tuition plan account with State A for the same beneficiary. But you can't open two college savings plan accounts in the same 529 plan in State A for the same beneficiary.

Also keep in mind that if you do open multiple 529 accounts for the same beneficiary, each plan has its own lifetime contribution limit, and contributions can't be made after the limit is reached. Some states consider the accounts in other states to determine whether the limit has been reached. For these states, the total balance of all plans (in all states) cannot exceed the maximum lifetime contribution limit.

Can I open a 529 account in anticipation of my future grandchild?

Answer: Technically, no, because the beneficiary must have a Social Security number. But you can do so in a roundabout way. First, you'll need to open an account and name as the beneficiary a family member who will be related to your future grandchild. Then when your grandchild is born, you (the account owner) can change the beneficiary to your grandchild. Check the details carefully of any plan you're considering because some plans may impose age restrictions on the beneficiary, such as being under age 21. This may pose a problem if you plan to name your adult son or daughter as the initial beneficiary.

What happens if I open a 529 plan in one state and then move to another state?

Answer: Essentially, nothing happens if you have a college savings plan. But most prepaid tuition plans require that either the account owner or the beneficiary be a resident of the state operating the plan. So if you move to another state, you may have to cash in the prepaid tuition plan.

If you have a college savings plan, you can simply leave the account open and keep contributing to it. Alternatively, you can switch 529 plans by rolling over the assets from that plan to a new 529 plan. You can keep the same beneficiary when you do the rollover (under IRS rules, you're allowed one 529 plan same-beneficiary rollover once every 12 months), but check the details of each plan for any potential restrictions. If you decide to stay with your original 529 plan, just remember that your new state might limit any potential 529 plan tax benefits to residents who participate in the in-state plan.

¹ Strategic Insight, 529 Data Highlights, 3Q 2018

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Do I need to pay estimated tax?

Taxpayers are required to pay most of their tax obligation during the year by having tax withheld from their paychecks or pension payments, or by making estimated tax payments. Estimated tax is the primary method used to pay tax on income that isn't subject to withholding. This typically includes income from self-employment, interest, dividends, and gain from the sale of assets. Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes reported on your income tax return.

Generally, you must pay federal estimated tax for the current year if: (1) you expect to owe at least \$1,000 in tax for the current year, and (2) you expect your tax withholding and refundable tax credits to be less than the smaller of (a) 90% of the tax on your tax return for the current year, or (b) 100% of the tax on your tax return for the previous year (your tax return for the previous year must cover 12 months).

There are special rules for farmers, fishermen, and certain high-income taxpayers. If at least two-thirds of your gross income is from farming or fishing, you can substitute 66-2/3% for 90% in general rule (2)(a) above. If your adjusted

gross income for the previous year was more than \$150,000 (\$75,000 if you were married and filed a separate return for that year), you must substitute 110% for 100% in general rule (2)(b) above.

If all of your income is subject to withholding, you probably don't need to pay estimated tax. If you have taxes withheld by an employer, you may be able to avoid having to make estimated tax payments, even on your nonwage income, by increasing the amount withheld from your paycheck.

You can use Form 1040-ES and its worksheets to figure your estimated tax. They can help you determine the amount you should pay for the year through withholding and estimated tax payments to avoid paying a penalty. The year is divided into four payment periods. After you have determined your total estimated tax for the year, you then determine how much you should pay by the due date of each payment period to avoid a penalty for that period. If you don't pay enough during any payment period, you may owe a penalty even if you are due a refund when you file your tax return.

Withholding and estimated tax payments may also be required for state and local taxes.



Have you checked your tax withholding lately?

If you were unpleasantly surprised by the amount of tax you owed or the amount of your tax refund when you filed your 2018 tax return, it may be time to check your withholding.

It may also be time if there are changes in your life or financial situation that affect your tax liability. For example, have you recently married, divorced, had a child, purchased a new home, changed jobs, or had a change in the amount of your taxable income not subject to withholding (e.g., capital gains)?

You can generally change the amount of federal tax you have withheld from your paycheck by giving a new Form W-4 to your employer. You can use a number of worksheets for the Form W-4 or the IRS Withholding Calculator (available at irs.gov) to help you plan your tax withholding strategy.

If changes reduce the number of allowances you are permitted to claim or your marital status changes from married to single, you must give your employer a new Form W-4 within 10 days. You can generally submit a new Form W-4 whenever you wish to change your withholding allowances for any other reason.

In general, you can claim various withholding allowances on the Form W-4 based on your tax filing status and the tax credits, itemized deductions (or any additional standard deduction for age or blindness), and adjustments to income that you expect to claim. You might increase the tax withheld or claim fewer allowances if you have a large amount of nonwage income. (If you have a significant amount of nonwage income, you might also consider making estimated tax payments using IRS Form 1040-ES.) The amount withheld can also be adjusted to reflect that you have more than one job at a time and whether you and your spouse both work. You might reduce the amount of tax withheld by increasing the amount of allowances you claim (to the extent permissible) on the Form W-4.

You can claim exemption from withholding for the current year if: (1) for the prior year, you were entitled to a refund of all federal income tax withheld because you had no tax liability; and (2) for the current year, you expect a refund of all federal income tax withheld because you expect to have no tax liability.