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How Does the Tax Reform Bill Apply To You?

Insights from the Chief Financial Officer of First Long Island Investors, LLC, Stephen J. Juchem, CPA

Yesterday, December 20, 2017, Congress passed sweeping tax reform and the President is expected to sign it into law shortly. You may be wondering how this will affect you and the amount of tax that you will pay. Are there any steps that you can take that will lower your federal income tax liability? The answer is probably yes. Effective tax planning can help reduce your tax bill, leaving you with more money to meet other financial obligations and pursue your goals. By taking certain steps now, before 2017 draws to a close, you may be able to maximize the benefits of expiring deductions and otherwise reduce the amount of taxes that will be due when you file your 2017 tax return. This update explores both traditional year-end planning techniques and also how the current tax reform legislation may impact current year-end tax planning. We encourage you to contact our office or your tax professional to discuss your specific situation.

In order to keep the cost of the tax reform bill within Senate budget rules, all of the changes affecting individuals would begin in 2018 and expire after 2025. At that time, if no future Congress acts to extend the bill's provisions, the individual tax provisions would "sunset", and the tax law would revert to its current state. Even though 2025 is a long way off, and a lot will surely change before then, we wanted you to know that the changes discussed below are temporary in nature, unless and until Congress extends or makes permanent some or all of the changes that would be implemented currently under the new law. The new tax law would permanently lower the corporate rate from 35% to 21%, and would encourage the repatriation of corporate earnings that are currently held overseas, among other things, but the remainder of this update will focus on the individual income tax provisions of the new tax law.

Tax rates: Under the tax law, tax rates for individuals would be lower for almost all taxpayers. Most taxpayers would see a reduction of about 2% in their tax rate. Those in the highest bracket would see their marginal rate go down from 39.6% to 37%. The 3.8% net investment income tax would also continue to affect higher income taxpayers. The current preferential tax treatment of capital gains and dividends would continue unchanged.

Alimony: The rules for taxability of alimony paid and received would change under the new law. For any divorce or separation agreement executed after Dec. 31, 2018, the new law provides that alimony payments are not deductible by the payor spouse. It would also repeal the provisions that provide that such payments are includible in income by the payee spouse.

Child tax credit: The new law would increase the amount of the child tax credit to $2,000 per qualifying child. The maximum refundable amount of the credit would be $1,400. The new law would also create a new nonrefundable $500 credit for qualifying dependents who are not qualifying children. The threshold at which the credit begins to phase out would be increased to $400,000 for married taxpayers filing a joint return and $200,000 for other taxpayers.

Standard deduction and personal exemptions: The new law would increase the standard deduction to $24,000 for married taxpayers filing jointly, $18,000 for heads of households, and $12,000 for all other individuals. The additional standard deduction for elderly and blind taxpayers would not be changed by the new law. Many taxpayers would see their savings from the lower tax rates given right back through the loss of many valuable tax deductions. The new law would also repeal all personal exemptions. Under the new law, many more taxpayers would file using the standard deduction instead of itemizing their deductions, since the new standard deduction would be much higher and many itemized deductions would be limited or eliminated completely under the new law, as detailed below. This is a simplification of the tax code and of the tax filing requirements for many Americans.

State and local taxes: Many of our clients are taxpayers in the alternative minimum tax (AMT) and do not derive any itemized deduction benefit from the payment of state and local income or property taxes. Under the new tax law, individuals who are not in the AMT would be allowed to deduct only up to $10,000 ($5,000 for married taxpayers filing separately) in state and local income and/or property taxes. As was the case under existing law, taxpayers in the AMT will not benefit from this deduction.

To mitigate the negative impact of this law change, there were some creative tax planning ideas being kicked around by tax professionals where additional tax benefits might be obtained by taking a deduction in 2017 for prepaid 2018 state income taxes. However, those ideas were too good to be true. Congress has decided, in the final text of the bill, that 2018 state estimated tax payments paid in 2017 will not be deductible in 2017.

In order to ensure that you take full advantage of the permitted state tax deduction in 2017, we recommend that you and your tax advisor discuss this topic and plan accordingly. First you should try to estimate whether you will be in AMT in 2017. If you believe you will not be in AMT and if you project that you will have a state and/or local income tax balance due for 2017, then you should pay this by December 31, 2017, and you should also prepay all assessed 2018 property taxes (including school taxes) by December 31, 2017, to maximize the state tax deduction in 2017 before it is limited to $10,000 in 2018.

For taxpayers subject to the AMT, and who are also subject to the net investment income tax (i.e. 3.8% tax on net investment income), consider paying the balance of your 2017 state and local income taxes by December 31, 2017. While these payments are not deductible for AMT purposes, they are a deduction against net investment income, which will reduce your net investment income tax.

Mortgage interest: The home mortgage interest deduction would be modified under the new law to reduce the limit of the deduction of interest on new acquisition indebtedness to $750,000 (from the current-law $1 million). Existing acquisition indebtedness mortgages are grandfathered at the $1 million limit. Also, the home equity loan interest deduction will be repealed under the new law (with no grandfathering).

Other itemized deductions: Under the new law, taxpayers would only be able to take a deduction for casualty losses if the loss is attributable to a presidentially declared disaster. The moving expense deduction would also be repealed, except for certain members of the armed forces on active duty who move. Additionally, all miscellaneous itemized deductions subject to the 2% floor under current law would be repealed by the new law. Lastly, since there were so many itemized deductions taken off the books, the new law would avoid adding insult to injury by repealing the overall limitation on itemized deductions.

Pass-through income deduction: Under the new law, individuals would be allowed to deduct 20% of “qualified business income” from a partnership, S corporation, or sole proprietorships, as well as 20% of qualified real estate investment trust (REIT) dividends, and qualified publicly traded partnership income. This means that income derived from a pass through entity may be taxed at an otherwise lower rate, unless one of the exclusions or phase outs described below applies.

A limitation on the deduction would be phased in based on W-2 wages. The deduction would also be disallowed for specified service trades or businesses with income above a threshold. “Qualified business income” would not include an S corporation shareholder’s reasonable compensation, guaranteed payments, or—to the extent provided in regulations—payments to a partner who is acting in a capacity other than his or her capacity as a partner. “Specified service trades or businesses” include any trade or business in the fields of accounting, health, law, consulting, athletics, financial services, brokerage services, or any business where the principal asset of the business is the reputation or skill of one or more of its employees. The exclusion from the definition of a qualified business for specified service trades or businesses would phase in for an individual taxpayer with taxable income in excess of $157,500 or $315,000 in the case of a joint return.

For each qualified trade or business, the taxpayer would be allowed to deduct 20% of the qualified business income with respect to such trade or business. Generally, the deduction would be limited to 50% of the W-2 wages paid with respect to the business. Alternatively, capital-intensive businesses may yield a higher benefit under a rule that takes into consideration 25% of wages paid plus a portion of the business's basis in its tangible assets. However, if the taxpayer's income is below the threshold amount, the deductible amount for each qualified trade or business would be equal to 20% of the qualified business income with respect to each respective trade or business.

Individual mandate: The new law would eliminate the penalty imposed on taxpayers who do not obtain insurance that provides at least minimum essential coverage, effective after 2018. Since it is anticipated that many healthy taxpayers will drop health insurance coverage once this new rule takes effect, many taxpayers may end up with increased out-of-pocket health care expenses. Accordingly, the new law would reduce the threshold for deduction of medical expenses to 7.5% of adjusted gross income retroactively for 2017 and also for 2018 to help mitigate the impact of these additional expenses.

Alternative minimum tax: Under the new law, the AMT would remain in place, but it would impact fewer taxpayers because the exemption amounts are increased. The AMT exemption amount would increase to $109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return) and $70,300 for all other taxpayers. The phase-out (gradual reduction of the exemption amount) thresholds would be increased to $1 million for married taxpayers filing a joint return and $500,000 for all other taxpayers. The exemption and threshold amounts would also be indexed for inflation.

Estate, gift, and generation-skipping transfer taxes: The new law would double the estate and gift tax exemption. The basic exclusion amount would increase from $5.49 million to approximately $11 million ($22 million for married couples). We recommend that those clients who have assets above $5.49 million evaluate doing additional estate planning in 2018 to reduce the size of their taxable estate at no gift tax cost especially because this doubling of the gift and estate tax exemptions is set to expire in 2026, such that the exemptions will revert back to the amounts under current law. Accordingly, planning now while the gift tax exemption is doubled for the next several years may prove to be quite valuable. We are happy to work with you and your advisors to implement creative estate planning techniques which could save your family millions of dollars.

Other year-end tax planning strategies: In addition to planning for the current tax law changes, individuals should also take a look at traditional year-end tax planning techniques. One traditional technique is to defer the recognition of taxable income and to accelerate the payment of deductible expenses. This may come into play for individuals who are able to postpone year-end bonuses or maximize deductible retirement contributions. Individuals should also consider the prepayment of real estate taxes (if they are not subject to AMT, as discussed earlier) or prepayment of mortgage interest (regardless of AMT status). Deferring income or accelerating deductions will be especially valuable for this year's round of year-end planning, since income tax rates will generally be lower in 2018 as compared to 2017.

Another technique to consider is to make charitable donations prior to year-end. This technique may be especially beneficial this year if you anticipate itemizing your deductions in 2017, but taking the increased standard deduction in 2018. In addition to making cash gifts to qualified charities, there are other creative ways to make use of the charitable contribution deduction. We have assisted clients in making use of donor advised funds and family foundations to secure a current tax benefit for charitable gifts intended to be made over several future years.

Another tax efficient way to make a charitable contribution is to donate appreciated securities. We have assisted many clients in donating appreciated securities to charity. As long as the securities have been held for more than one year, you can generally claim a deduction for the full market value, while avoiding the capital gains tax that would apply if you sold the securities first and then donated the sales proceeds as a cash contribution. Please be aware of the time required for transfers when initiating this process before year-end.

Gift-making, in general, should also be part of a year-end review. Individuals can make an unlimited number of tax-free gifts of $14,000 per recipient during 2017. Married couples may combine their gift-tax exclusion amounts and make tax-free gifts per recipient of up to $28,000 during 2017. There is also an important and often over-looked provision affecting gifts. An individual can make unlimited tax-free gifts used for qualified tuition or medical expenses of another person. The qualified tuition or medical expenses must be paid directly to an educational or medical institution.

Gifts which are not otherwise excludable can be offset by any unused remaining lifetime exclusion amounts. This lifetime exclusion is indexed for inflation and has increased by $40,000 to $5,490,000 for 2017. Individuals who had utilized their lifetime exclusion in gifts made prior to or during 2016 can make $40,000 of additional gifts in 2017 gift tax free. Also, beginning in 2018 the exemption amount would increase to approximately $11 million. As stated earlier, we recommend that those clients who have assets above $11 million (couples with above $22 million) consider doing additional estate planning in 2018 to reduce the size of their taxable estate at no gift tax cost.

Additionally, we at FLI are aware that our clients are doing year-end planning and we try to do our part to help. When managing your investments, we, and the outside investment managers we utilize in some strategies, are sensitive to the tax consequences of our investment decisions. We are mindful that by timing the recognition of capital gains and losses, we can, in some cases, defer your capital gains tax and/or accelerate deductible capital losses.

Life changes can also impact traditional year-end tax planning. Individuals who got married or divorced, changed jobs, retired, or experienced other life events in 2017 need to review how these events may impact their tax planning. A change in employment, for example, may bring about severance pay, sign-on bonuses, stock options, moving expenses, and COBRA health benefits, which all must be taken into account in year-end tax planning. At FLI, we specialize in working with clients who have experienced life changes to ensure that their financial approach is properly adjusted to reflect these changes. We are happy to discuss with you and your advisors whether any changes or additions are needed for your insurance or your estate planning. It is always a good idea to review these items periodically to be sure that they are current, regardless of whether you have had any recent life changes.

For more information about the new tax law and year-end planning ideas discussed, please call us at 516-935-1200 or your tax professional. We stand ready to work with you and your tax professional to discuss how the tax law affects you. We believe that every individual has a unique tax situation, and that personal attention to your individual circumstances could help to reduce or defer your income tax expense.