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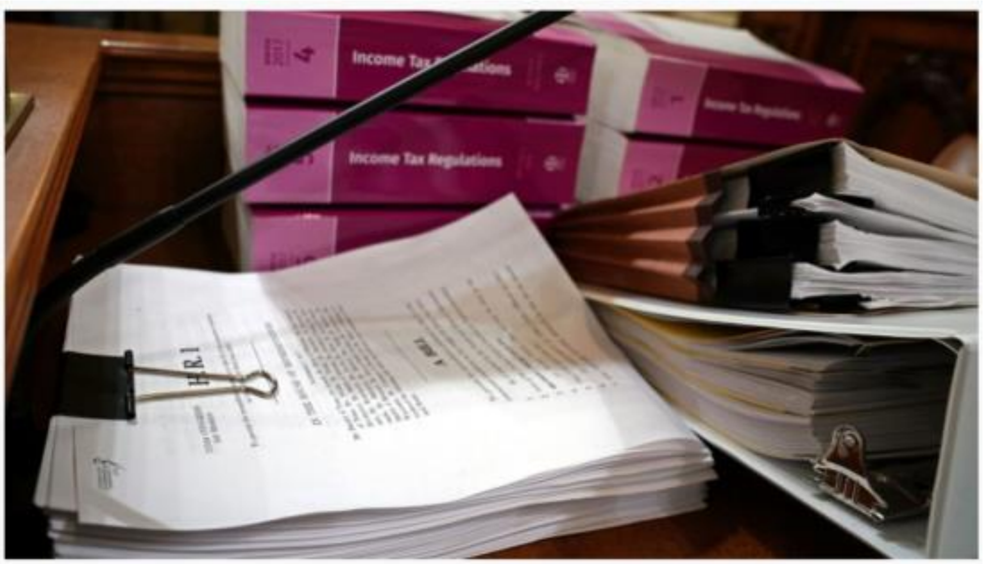
Senate tax bill full of minefields for taxpayers

By Michael Cohn

Taxpayers can expect many of their cherished deductions for charitable contributions, family members, and state and local taxes to go away under the Senate tax reform legislation.

Gary DuBoff, a principal in the Tax and Accounting Department at MBAF, a Top 100 Firm, advises charitable contributions should be made before the end of the year, particularly when they involve gifts of stock.

“Hidden in the Senate bill was an elimination of the adequate identification rules,” he said. “Adequate identification basically says that if you sell a security, and you’ve got two tranches, a low-basis and a high-basis tranche, you can pick the one that you want to sell. That also applies to charitable donations. If you want to gift your low-basis shares to avoid paying the tax on the gain, you can choose to gift your low-basis shares and keep your high-basis shares. In 2018 you’re not going to have that option. In 2018, it’s going to come out of your low-basis shares first, which is OK for charitable giving, but not a good result for investments.”



A printout of Congress's tax reform bill, "The Tax Cuts and Jobs Act," alongside a stack of income tax regulations
Bloomberg News

He advises taxpayers to make charitable donations out of their low-basis shares this year. That strategy maintains the high basis for next year so if they choose to sell those securities in the future, they won’t have to worry about the "first in, first out" rule because their remaining shares would probably be higher basis than where they started. Plus, there are other benefits in making charitable donations before the end of 2017.

“One of the advantages of doing the charitable donation this year is obviously the tax rate,” said DuBoff. “Right now we’re at 39.6 [percent] for the highest tax bracket, and then under the Senate bill it’s 38.5. It remains to be seen whether the House or the Senate will prevail, but obviously there’s potential for a higher deduction this year. A lot of people I’ve spoken to think the Senate’s seven brackets are going to prevail over the House.”

Both the House and Senate bills eliminate the state and local tax deduction, which is likely to end up costing taxpayers in jurisdictions with state and local income taxes. Those losses might not be offset by the doubled standard deduction in both versions of the Tax Cuts and Jobs Act.

“To take an example, a taxpayer who makes $250,000 who might have a state and local tax of less than $20,000 could potentially lose the benefit of their charitable donation next year if they’re eligible for the standard deduction,” said DuBoff. “If you don’t have a big state and local tax and you don’t own a home, you may not get your charitable deduction next year. You’ll get the standard deduction, but this year you can get a charitable deduction because the standard deduction is that much lower. So there is some advantage to making your charitable donation this year. And if your tax bracket is higher this year than it is next year, it’s obviously advantageous to do that.”

Homeowners who sell their homes may not be able to get the same tax breaks they have received under current law. Currently they can deduct the profits if it’s been their primary residence for two out of the past five years. The tax reform bill changes that to five out of the past eight years.

“That will limit the exclusion on the sale of your home to long-term homeowners as opposed to a shorter-term homeowner, and then the home equity indebtedness potentially will be gone as well,” said DuBoff. "You can talk about simplification, but I don’t think this is. The only simplification is that at the lower end of the spectrum, for people who no longer itemize deductions because their standard deduction is higher than what would be their itemized deductions, it eliminates the requirement to file a Schedule A deduction. It probably keeps me fully employed, but a lot of the other tax preparers who were working with lower wage earners will probably have less to do.”

Both the House and Senate bills would eliminate personal exemptions for taxpayers and their dependents, which will hurt many taxpayers even with the doubling of the standard deduction and the enhanced Child Care Credit.

“Personal exemptions would be eliminated under both proposals, but the Child Care Credit is supposedly going up from $1,000 to $2,000,” said DuBoff. “But my understanding is it’s not refundable so if you have no tax at all, which is highly likely, then you don’t get any credit. So a taxpayer who makes a lot of money will get a Child Care Credit, whereas a taxpayer who doesn’t may not get anything as a result of some of these changes.”

It isn’t only individual taxpayers who might find themselves negatively affected by the bill.

"In the private equity world, if you're going to start to see limitations on the deductibility of interest, a lot of transactions that we get involved with are highly leveraged transactions that involve a lot of debt and therefore a lot of interest," said Chris Mann, managing partner at MorganFranklin Consulting in McLean, Va. "Therefore, if there's interest deductibility issues, that could impact on our clients' ability to change the way our clients look at potential deals. But on the flip side of that, with the focus on trying to bring money back into the U.S. with lower tax rates, that could serve as a benefit to our clients in terms of having access to capital more here in the U.S., as opposed to it being tied up internationally, which in turn could spur more transactions. It's a good news, bad news scenario from my perspective."