State and Local Tax and Homeownership Provisions

Higher Standard Deduction May Offset SALT Limit

This article is the third in a five-part series regarding the Tax Cuts and Jobs Act *signed into law December 22, 2017*

The Tax Policy Center estimates that, of the approximately 46 million households that itemized deductions under the old law, about 19 million households will do so in 2018—meaning 27 million fewer households are likely to itemize deductions in 2018. This anticipated change is attributed to the nearly doubled new standard deduction covered in the previous article.

The *Tax Cuts and Jobs Act* ("The Act") dramatically affects the tax deductions attributable to homeownership as well as other restrictions on state and local tax ("SALT") deductions. This article will focus on these provisions as well as other rules affecting individuals.

SALT PROVISIONS

Under prior law, taxpayers who itemized their deductions could deduct state and local income taxes,* real estate taxes (both foreign and local), and personal property taxes such as automobile excise taxes, without limitation. Of course, large deductions for SALT expenses were not deductible for alternative minimum taxes, so higher-bracket taxpayers often realized only a limited benefit from these deductions. (*Or sales tax in low- or no-income-tax states.)

Under The Act, the total deduction for SALT cannot exceed $10,000. In addition, no deduction is permitted for foreign income and foreign real estate taxes unless incurred in a trade or business or incurred in an income-producing activity.

The effect of these new rules is as follows.

	2017	2018
Adjusted Gross Income	$200,000	$200,000
Itemized Deductions:		
State Income Tax	$10,000	
Real Estate Tax	$5,000	
Excise Tax	$1,000	
SALT Deductions Limit		$10,000
Home Mortgage Interest	$10,000	$10,000
Charity	$5,000	$5,000
Total Itemized Deductions	($31,000)	($25,000)
Personal Exemptions	($8,100)	0
Taxable Income	$160,900	$175,000
Tax	**$31,397**	**$30,579**

The preceding chart refers to a married taxpayer couple with total income of $200,000, upon which they pay $10,000 in state income tax. In addition, they pay $5,000 in local real estate tax and $1,000 in excise tax on their cars. They also have non-SALT deductions of $5,000 in charitable contributions and $10,000 in home mortgage interest.

Despite the fact that taxable income has increased by $14,100, the total tax liability has decreased as a result of the decrease in tax rates.

RENTAL PROPERTY AND PROPERTY IN TRUSTS

Property tax on a rental or income property (such as a second home that is rented out for all or part of the year) would not be subject to the new $10,000 limitation on SALT. Taxpayers whose SALT deductions would exceed the $10,000 limit, due to property tax on a second or vacation home, may want to consider converting that property to a rental/income property during 2018. This way, the taxpayers would be able to benefit from the new law.

In addition, moving property into certain types of trusts can also provide tax benefits. If this is a possibility, taxpayers should consult with their advisors as there are many variables to consider.

HOME MORTGAGE INTEREST DEDUCTIONS

In view of the importance of homeownership to the economy, there is always concern when Congress tinkers with the home mortgage interest deduction. While this year was no exception, The Act did make changes in the home mortgage interest deduction. But these changes will affect only homeowners with very large "jumbo" mortgages. A jumbo loan is defined as a mortgage of more than $424,100 in most counties, and more than $636,150 in others.

Taxpayers itemizing their deductions are permitted to deduct qualified residence interest ("QRI"). For these purposes, QRI is interest incurred in purchasing a qualified residence in which the mortgage must be secured by the residence.

While the mortgage interest on a principal residence is still deductible, the amount of the acquisition indebtedness cannot exceed $750,000, reduced from $1,000,000 prior to The Act. In other words, the interest on only the first $750,000 of the indebtedness is tax-deductible. This new limitation does not apply to debt incurred before December 15, 2017; interest on those larger loans will still be deductible up to $1,000,000.

Under prior law, interest on home equity loans of up to $100,000--to wit, loans secured by a residence-- was deductible notwithstanding the fact that the loan proceeds were used for other purposes, such as tuition, consumer purchases and the like. This tax policy gave homeowners added incentive to use the equity in their homes as a cheap way of avoiding credit card or student loan debts with higher interest rates. Beginning in 2018 and through 2025, interest on home equity loans will not be deductible.

CHARITABLE CONTRIBUTIONS

Taxpayers itemizing their deductions are permitted to deduct their charitable gifts, with attention to the rules applicable to the type of property given, the identity of the donor, etc. The Act's increase in the standard deduction may have a significant impact on the tax benefit of charitable giving.

In the following example, a married couple filing a joint return has other itemized deductions of $13,000 and donates $10,000 annually to charity.

	Tax Year 2018	Tax Year 2019
Adjustesd Gross Income	$150,000	$150,000
Less: Other Itemized	($13,000)	($13,000)
Less: Charitable Donations	($10,000)	($10,000)
Standard Deduction	$24,000	$24,000
Taxable Income	$126,000	$126,000

In the above, example for both years, the new standard deduction of $24,000 exceeds total itemized deductions of $23,000 so that no tax benefit results from the charitable gifts.

By accelerating the 2019 gift into 2018, the following tax consequences result:

	Tax Year 2018	Tax Year 2019
Adjustesd Gross Income	$150,000	$150,000
Less: Other Itemized	($13,000)	($13,000)
Less: Charity	($20,000)	(0)
Standard Deduction	$24,000	$24,000
Taxable Income	$117,000	$126,000

Now the $33,000 of itemized deductions in 2018 exceeds the standard deduction of $24,000. So, the 2018 taxable income is reduced by $9,000 which, in this case, would have been taxed at the 22% rate. This simple tax planning technique saves the taxpayers $1,980 in 2018, without any tax increase in 2019.

The Tax Policy Center estimates that, compared to the 37 million households that claimed itemized deductions for gifts to non-profits in 2017, fewer than 16 million households will do so in 2018—a drop of 21 million households. **FT**

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