Impact of Recent Tax Reform on Individuals

The changes made by the Tax Cuts and Jobs Act (the Act) are significant. This edition of Professional Notes will provide an overview of some of the income and estate tax changes and their impact on individual taxpayers. Most of the changes have a “sunset” provision and expire after 2025. Touted as tax simplification, the Act, in fact, contains a number of provisions that actually increase the complexity of U.S. tax law.

Personal Income Taxes

The changes have been characterized as massive tax cuts. Certainly, the reduction of the maximum tax rate for federal personal income tax from 39.6 percent to 37 percent may be beneficial to married taxpayers filing jointly with income over $600,000 and single taxpayers with income over $500,000. Whether a particular taxpayer actually pays more or less tax depends not only on the highest marginal tax rate, but also on the changes in deductions, credits, and other changes discussed in this article.

Carried interests in partnerships. Among investors, one much-discussed aspect of the Act is its treatment of the “carried interest” in investment vehicles taxed as partnerships. Carried interest income is now re-characterized in certain limited cases. Long-term capital gain allocated by a partnership to an individual partner as a carried interest is taxed as short-term capital gain if the carried interest was held by the investor for...
three years or less. This three-year holding period also applies to gains allocated to the carried interest holder attributable to the disposition of property held by the partnership.

**Child tax credit.** For taxpayers with families, the Act increases the child tax credit from $1,000 to $2,000 for each qualifying child under age 17, and the phase-out does not begin until income exceeds $400,000 for married taxpayers filing jointly ($200,000 for single taxpayers). This expanded tax credit will be meaningful for millions of taxpayers; it is projected to reduce tax revenue by $573 billion over the 10 years it will be in effect.

**Standard deduction.** The standard deduction has been raised from $12,700 to $24,000 for married taxpayers filing jointly (and from $6,350 to $12,000 for single taxpayers). But the increase in the standard deduction comes with a cost—the loss of the $4,050 personal exemption for each taxpayer, spouse, and dependents.

**Itemized deductions.** For itemizing taxpayers, the Act eliminates or reduces a number of deductions; at the same time, it eliminates the so-called Pease limitation, which phased out deductions and exemptions for taxpayers with income above a certain threshold. For example, the miscellaneous itemized deductions, which previously were deductible to the extent they exceeded 2 percent of adjusted gross income, are eliminated under the Act. This includes tax preparation expenses, unreimbursed employee expenses, and investment fees and expenses.

Also eliminated is the deduction for alimony paid under a divorce settlement, if it is executed or modified in 2019 or later. Alimony payments will cease being taxable income to the recipient. Based on the assumption that the payor of alimony is typically in a higher tax bracket than the recipient, the impact of this change will be to tax the alimony at the higher tax rate of the payor.

In New York and other high-tax states (e.g., Connecticut, New Jersey, and California), the greatest pain is likely to come from the Act’s $10,000 cap on the federal income tax deduction for state and local taxes (SALT).

The mortgage interest deduction—previously limited to the interest on up to $1 million in mortgages to acquire or improve a qualified residence, plus the interest on up to $100,000 of a home equity loan used for any purpose—is cut back. For mortgage debt incurred after December 15, 2017, a deduction is allowed only for the interest on up to $750,000 of principal, which may include a home equity loan used to buy or improve a qualified residence. Outstanding indebtedness on a qualified residence is grandfathered, but not a home equity loan used for a purpose other than acquiring or improving a qualified residence.

Despite these new deduction limitations, the income tax charitable deduction remains intact—and has even been sweetened slightly. The new law allows charitable contributions of cash to a public charity to be deducted up to 60 percent of the donor’s adjusted gross income (AGI), instead of 50 percent. Even so, this modification is unlikely to change an enduring fact of charitable giving: Gifts of appreciated stock, though subject to a lower deductibility threshold (up to 30 percent of AGI), are often the most tax-efficient choice because these gifts can be deducted at fair market value without requiring the donor to recognize the inherent gain.

Happily for charitable donors, the IRA “charitable rollover” remains intact. This provision permits a donor who is at least 70 1/2 years old to contribute up to $100,000 to qualified charities from an IRA without having to take the distribution into income. With its 90-year record of working with donors, The New York Community Trust can help your client achieve his or her charitable interests with an IRA distribution.
New York’s Effort to Reduce Impact of SALT Deduction Limitations

Before passage of the Act, some 30 percent of taxpayers itemized deductions, and 95 percent of those claimed state and local taxes, for an average SALT deduction of just over $12,000. But the numbers were much higher in New York, where the average SALT deduction claimed was approximately $22,000. The deduction has the effect of subsidizing state and local tax payments, particularly on high-income (and high-deduction) taxpayers.

New York has sought to reduce the impact of the cap on SALT deductions in two ways. First, it has created two state charitable funds (one for health, the other for education) to encourage charitable contributions in lieu of taxes. Second, it has provided for an optional employer-side payroll tax. These provisions were included in the New York State budget legislation that pass at the end of March 2018.

New York’s first approach contemplates that a taxpayer making a donation to either of the new funds will claim a charitable deduction for federal income tax purposes, effectively converting state (and local) taxes into charitable contributions. New York would allow the taxpayer making this donation to claim a state tax credit equal to 85 percent of the donation amount. In addition, school districts and other local governments are authorized to create similar charitable funds. Donations to these funds would allow the taxpayer to claim a reduction in local property taxes through a local property tax credit up to 95 percent of the donation.

It is widely expected that the Internal Revenue Service will challenge this effort. On May 23, 2018, the IRS and Treasury Department issued Notice 2018-54, announcing that proposed regulations will be issued addressing the deductibility of payments by taxpayers to state-operated charitable fund where the taxpayer can treat the payment as satisfying some or all of its state and local taxes.

Federal tax law is clear that a voluntary contribution that stems from disinterested generosity to state or local government is deductible as a charitable gift. The question is whether a donation that results in a state tax credit is a voluntary charitable contribution. The taxpayer who gives $10,000 to charity for a table at a fundraising dinner does not get a deduction for the portion of the gift allocable to the value of the dinner.

Some would argue there’s no difference if, in exchange for a “contribution,” a taxpayer’s tax liability is discharged by means of a tax credit. However, at least one group of commentators has examined charitable contributions where the gift entitles the donor to a state tax credit, and their paper argues that a tax credit is not a “quid pro quo” or value received in exchange for the contribution.

Nonetheless, this approach seems susceptible to attack insofar as the discharge of tax liability is the reason for the contribution—there is arguably no charitable intent to the extent the donation results in a tax credit. It remains to be seen whether New York’s approach will ultimately prevail before the IRS and the courts. And it also remains to be seen how many taxpayers will embrace the New York approach, which requires an additional payment—over and above the amount of the tax liability—to offset the portion of the donation that does not qualify for a tax credit. There is also the specter—at least for the time being—of an IRS demand for interest and penalties if the taxpayer’s charitable deduction is successfully challenged.

New York’s second effort to reduce the impact of the SALT limitations—known as the Employer Compensation Expense Program—is intended to convert the income tax paid by wage earners to a payroll tax paid by employers. The economics behind this measure rely on an
An employer lowering an employee’s gross salary in an amount that is essentially equivalent to the payroll tax the employer will pay. Reducing gross salary will reduce federal income taxes. Conceptually, for employees, this will be advantageous because, even though their gross pay has been reduced, their net pay is anticipated to remain the same as it was before the federal cap on the deduction for state and local income taxes was enacted.

Employers that opt in would be subject to a 5 percent tax on all annual payroll expenses in excess of $40,000 per employee, phased in over three years, beginning on January 1, 2019; employees do not have a choice. The tax cannot be withheld from or directly passed through to employees, but covered employees receive a credit against the state income tax otherwise due on wages. Even if this effort is sustained for federal income tax purposes, the provision may be too complex to garner much popularity.

Furthermore, significant barriers might impede the success of the program: collective bargaining agreements are likely to limit the ability to reduce many employees’ salaries to reflect the employer’s payment of taxes; local taxes such as New York City taxes are not addressed; and issues are likely to arise regarding crediting of the tax where an employer has employees who commute into New York State and are taxed in states that do not provide a credit for taxes paid under the New York system.¹

**Changes Affecting Pass-Through Entities**

For individual owners of many businesses operated in partnerships, S corporations, or limited liability companies, or operated as sole proprietorships, the Act provides for a 20 percent deduction against qualified business income, in addition to the standard deduction. Qualified business income generally is net income from an active trade or business. The 20 percent deduction is limited to the greater of (i) 50 percent of the taxpayer’s proportionate share of the W-2 wages paid by the business and (ii) 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis of depreciable property. In general, service businesses, such as law, health care, and accounting—where the reputation or skill of employees or partners is the service being sold—do not qualify for the provision, although engineering and architecture businesses do qualify.

**Estate and Gift Taxes**

The basic exclusion amount for the estate and gift tax unified credit and for the generation-skipping transfer tax exemption is doubled to $10 million

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¹ It is reported that New York State has not decided whether to participate in the Employer Compensation Expense Program with respect to its own employees. See https://on.wsj.com/2LjiuCp.
for individuals who are U.S. citizens, indexed for inflation. In 2018, this equates to $11.18 million for an individual and $22.36 million for a married couple. The exclusion reverts back to $5 million, indexed for inflation, after 2025. Under the Act, the maximum estate and gift tax rate remains at 40 percent. Researchers estimate that less than 0.1 percent of estates will be subject to estate tax in 2018.

The Act authorized the Treasury to issue regulations to address any difference between the basic exclusion amount at the time of an individual’s death and the basic exclusion amount in effect at the time gifts were made. It is understood that this is intended to address situations where a gift within the exclusion amount is made before 2026 but the donor dies after 2025, when the estate tax exclusion amount has decreased.

The annual exclusion amount for gifts increased to $15,000 in 2018, and this amount will continue to be indexed for inflation.

It should be noted that the New York estate tax exclusion is $5.25 million and is scheduled to increase on January 1, 2019, to an amount based on the prior federal $5 million basic exclusion amount (as indexed). Bills have been proposed in the Assembly and Senate to increase New York’s exemption to $11.2 million.

In light of the increase in the federal exclusion amount, practitioners will want to review formula clauses in existing documents with their clients. In drafting wills for couples with combined assets between $5 million and $22 million, lawyers will want to be mindful of the possibility that assets passed outright to a surviving spouse without estate tax because of the $10 million basic exclusion amount could be subject to estate tax if the surviving spouse dies after 2025. Because of the possibility of a decrease in the basic exclusion amount, it may be preferable to use a credit shelter trust with the surviving spouse as beneficiary. Alternatively, the surviving spouse may want a portability election to be made to take advantage of any part of the unused exemption in the deceased spouse’s estate.

Because most taxpayers will not have taxable estates, their advisors will be more focused on an asset-by-asset review to determine which assets can be sold now at the lowest capital gains costs or can be gifted now with a comparatively high carryover basis. For those seeking to minimize capital gains imposed on heirs when assets are sold, it may be advisable to hold on to low-basis assets until death, when the basis will be stepped up to market value. For example, this approach may mean waiting until death to transfer an interest in the family company to a child, or passing the family home by will instead of giving it to the children today.

For further reference, see:
IRC Section 2010(c)(3). Basic estate, gift, and generation-skipping tax exclusion amount.
IRC Section 199A. Qualified business income deduction.
NYS Assembly bill A9658 and NYS Senate bill S7820. Proposal to increase NYS basic exclusion amount to $11.2 million.
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