Managing Deductions and Expenses Under
The Tax Cut and Jobs Act of 2017

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The new deduction rules of the *Tax Cut and Jobs Act* (the "Act") offer a significant, as yet uncharted opportunity for tax and financial planning. Some of these planning opportunities stand formerly conventional wisdom on its head by making it unwise for taxpayers to incur expenses that qualify as itemized deductions – even under the more restrictive rules of the Act.

This white paper addresses the interplay of the Act's new rules for tax deductions. We provide a framework to help taxpayers determine whether to incur deductible expenses and some planning opportunities to maximize the tax benefits these deductions can provide.

The interplay of standard and itemized deductions

We'll start with a quick refresher on how tax deductions work. The tax law (both before and after the Act) provides a standard deduction amount that a taxpayer may choose to subtract from adjusted gross income to calculate taxable income. The tax law also designates certain expenses that qualify as "itemized deductions." If the total of a taxpayer's itemized deductions exceeds the standard deduction amount, then the taxpayer reduces adjusted gross income by ("claims") this total. Conversely, if the itemized deduction total is less than the standard deduction amount, then the taxpayer claims the standard deduction.

For taxpayers who itemize, incurring a deductible expense reduces the after-tax cost of that expense. For instance, if a taxpayer who pays tax at a 35% marginal rate incurs a $100 deductible expense, that expense costs only $65 after taxes. Taxpayers who claim the standard deduction, however, get no tax benefit from incurring expenses that qualify as itemized deductions; for them, the $100 expenditure still costs $100 after taxes.

The new standard deduction

Compared to prior law, the Act roughly doubles the standard deduction to $24,000 for joint filers and $12,000 for single filers, a simplification measure intended to free more people from the chore of recording and reporting their itemized expenses. The tax writers estimate that this increase in the standard deduction will reduce the number of taxpayers who itemize from roughly one-third to fewer than 10%. *Committee on Ways and Means, Tax Cuts and Jobs Act Section by Section Summary (November 2017).*

Thus, under the Act, over 90% of taxpayers are expected to claim the standard deduction. If this prediction is correct, then very few taxpayers will receive a tax benefit from incurring deductible expenses. This new paradigm offers an opportunity for tax planning. Some taxpayers may choose to forego making expenditures, while others may move the outlays to different years to maximize their tax benefit. Below we discuss these planning opportunities in the context of the new rules for itemized deductions.

State and local taxes

Under the Act, taxpayers may deduct state and local taxes only up to $10,000 annually. Any state and local tax, including state income and property tax, may be included in this calculation, but the aggregate deduction may not exceed $10,000. This limitation applies only to state and local taxes imposed on individuals. Businesses may continue to deduct these taxes without limitation. Taxpayers should scrutinize their state and local tax payments to determine if any might be regarded as business-related.

Affluent taxpayers living in most states are likely to find that their individual state tax payments significantly exceed $10,000. Of course, these taxpayers receive no tax benefit from incurring state tax payments in excess of this limitation.

Mortgage interest

The Act permits a homeowner to deduct interest paid on aggregate mortgage principal up to $750,000, down from $1 million under prior law. As under former law, the mortgages may be held on one or two residences, provided the total amount does not exceed this limitation. Existing home mortgages are grandfathered.

The Act also eliminates the deduction for interest paid on home equity lines of credit (HELOCs), including interest paid on existing line of credit borrowings. The IRS recognizes an exception to this new disallowance where HELOC proceeds are used to buy, build, or substantially improve the taxpayer's home that secures the loan. Thus, for example, interest on home equity loan proceeds used to build an addition to that home is typically deductible, while interest on the same loan used to pay personal living expenses, such as credit card debt or college tuition, is not. *IR-2018-32 (Feb. 21, 2018).*

Obviously, interest incurred on mortgage debt in excess of $750,000 produces no tax benefit (absent grandfather protection). But, for the projected 90% of taxpayers who do not itemize, interest on a lower loan amount also produces no tax benefit. Suppose, for instance, a taxpayer is considering the purchase of a house for $500,000, taking out a $400,000 mortgage. At today's rates, interest payable on the mortgage is roughly $12,000 a year. Assuming the taxpayer pays meaningful state taxes and incurs no other expenses that qualify, his itemized deductions total

$22,000 ($12,000 mortgage + $10,000 state tax). The taxpayer, then, will choose the standard $24,000 standard deduction rather than itemize.

This taxpayer receives *no tax benefit whatsoever* from incurring the mortgage interest expense. The taxpayer might therefore come out ahead by taking out a smaller mortgage -- or even making an all-cash purchase if his holdings allow.

Note how the doubling of the standard deduction has altered the conventional wisdom. Taxpayers typically have been encouraged to maximize residential borrowings, as the government pays a substantial portion of the carrying cost through reduced taxes. For the vast majority of taxpayers, this is now no longer the case. Only those few taxpayers who itemize will continue to get a tax benefit from paying interest on their mortgages.

The increased standard deduction, along with the curtailment of deductions for mortgage interest and property taxes, has raised a concern that the new tax law will adversely affect real estate values. Taxpayers who now claim the standard deduction have no tax incentive to pay mortgage interest or property taxes, while those who continue to itemize find that the tax benefit of those items is now limited. *See New Tax Law Expected to Slow Rise of Home Values, Washington Post (December 29, 2017).* No longer may taxpayers be willing to "stretch" for that larger home because the government is helping to foot the bill.

Charitable contributions

The Act does not impose more restrictive rules on charitable contribution deductions. Indeed, the Act increases the percentage of current year income from which charitable contributions may be deducted from 50% to 60%.

But, once again, the doubling of the standard deduction will limit the tax benefit of charitable contributions made by most filers. Suppose the taxpayer above who pays mortgage interest of $12,000 and incurs state taxes of $10,000 also typically makes annual charitable contributions of $1000. Because the sum of these three deductions ($12,000 + $10,000 + $1,000) does not exceed the standard deduction ($24,000), the taxpayer receives no tax benefit from these donations.

Once again conventional wisdom is reversed. Taxpayers were encouraged to make charitable donations because the government would pay part of the outlay. Now almost all taxpayers will bear the full cost of their donations, and thus have no tax reason to make them. Only taxpayers who itemize will get a tax benefit from their contributions. Although, of course, individuals contribute to charities for reasons other than to save tax, charitable organizations are concerned that the new tax legislation will adversely affect the donations they receive.

With some planning, however, taxpayers may be able to claim a tax benefit from charitable contributions that otherwise would not yield one. Here are two ideas:

- *Bundling contributions with donor advised funds:* Taxpayers who otherwise take the standard deduction could consider "bundling" a number of years' charitable contributions into a single year, so as to exceed the standard deduction in that year and receive a tax benefit. For instance, instead of donating $1000 a year for five years, the taxpayer in the above example could make five years' worth of contributions ($5000) in a single year. In that case his itemized deductions would total $27,000 (12,000 mortgage + $10,000 state tax + $5,000 charitable), exceeding the standard deduction of $24,000 by $3000. Assuming a 35% marginal tax rate, this $3000 additional deduction would produce $1050 in tax savings. Thus, the taxpayer would incur a net outlay of $3950 ($5000 - $1050), instead of the net outlay of $5000 had he contributed $1000 per year for five years.

  Taxpayers considering this "bundling" might not want their charities to receive five years' contributions at once, or they might wish to change the charitable recipients in future years. To meet these concerns, the taxpayer could consider establishing a "donor advised fund" (DAF). Contributions to a DAF are deductible when made. But the DAF is not required to distribute the proceeds to charities immediately. Instead, the DAF could dole out the funds in succeeding years. (Of course, the taxpayer does not receive a second deduction when the DAF distributes the funds.) The taxpayer even can change the charitable entities that receive the DAF disbursements along the way.

  In the above example then, the taxpayer could contribute $5000 to his DAF, claiming the $1050 tax benefit. The DAF then could distribute $1000 to designated charities over each of the next five years, mirroring the taxpayer's prior contribution methodology. To obtain an additional tax benefit, the taxpayer could contribute appreciated assets to the DAF and avoid the recognition of capital gain.

- *IRA / charitable contribution rollover:* Non-itemizers who are receiving required minimum distributions (RMDs) from their IRAs have another way to benefit from charitable contributions. Under legislation enacted prior to the Act (and still in effect), an individual over the age of 70-1/2 may transfer up to $100,000 from an IRA to a charity and avoid tax on the IRA distribution. Moreover, the distribution to the charity counts toward satisfying the individual's RMD obligation. Even a taxpayer who claims the standard deduction can avoid taxes using this method. Thus, taxpayers over age 70-1/2 are well-advised to use IRA funds first to make their charitable contributions.

  To qualify under the IRA / charitable contribution rule, IRA assets must be transferred directly to a charity. Transfers to a DAF do not qualify. Thus, these two ideas may not be combined.

Medical expenses

Medical expenses incurred in 2017 and 2018 (and not reimbursed by insurance) qualify as itemized deductions to the extent they exceed in the aggregate 7.5% of the taxpayer's adjusted gross income. Beginning in 2019, these expenses are deductible only to the extent they exceed 10% of adjusted gross income.

Taxpayers who are contemplating medical procedures not covered by insurance might want to consider incurring the associated expense before 2019. If incurring the medical expense pushes the taxpayer's total itemized deductions over the standard deduction amount, it might make sense for the taxpayer to increase charitable contributions in that year as well, taking advantage of the year in which they itemize.

Conclusion

The interplay of the new tax law's increase in the standard deduction and restriction of itemized deductions provides new opportunities for tax planning. Taxpayers might wish to reconsider whether it makes sense to incur deductible expenses, or to shift such expenses to other years, to minimize the taxes they pay under the new regime. Because individual circumstances differ, investors should discuss these techniques with their tax advisors before taking any action.

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