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Tax Reform And Us

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January 2018

As if December wasn't already one of the busiest times of the year. In between planning menus, shopping for presents, getting groceries, lighting candles, coordinating travel arrangements, and taking care of the regular year-end checklist of charitable gifting and tax-loss harvesting, we had to add to our list a call to our accountant for help on responding to the most significant federal tax law reform in over 30 years.

There were some positioning decisions to make, such as prepaying taxes, pushing off income, and increasing charitable gifting, but it wasn't completely straightforward. In addition to the possibly neutralizing effect of AMT, there was much confusion about whether tax prepayments would be accepted, and the intelligence on this changed by the hour, and by geography.

We were not the only ones scrambling after December 22nd; the IRS also did not have much time to prepare. It is important to recognize that the IRS has yet to write the Treasury Regulations and Revenue Rulings and Internal Revenue Bulletins in support of the new legislation. In 2016, the Center for Budget Priorities noted that the IRS budget has been cut by 17% since 2010 and the number of IRS employees declined by 14%. The IRS folks must be working overtime. I wonder if the tax reform bill will result in new hires at the IRS. The written regulations and procedures can be four times as long as the tax code itself, many of the tax laws are interpretive, and final rulings are often arrived at following precedent setting court cases. Until this supporting work is done there will continue to be confusion and difference of opinion on some of the more detailed nuances and applications of the bill.

Be that as it may, there are certain things that we know for sure. For individuals, the tax rates have been lowered, standard deductions increased, and Schedule A items have been severely limited. The tax reform bill was promised as tax reduction for the middle class, but although still out, the jury is leaning toward a "no" vote. Perhaps it depends on how one defines middle class.

There is no consensus definition or official government definition of middle class. It is subjective, not easily defined, and can encompass anywhere from 25% to 66% of all households; altogether a rather mushy statistical point to base an argument on.

Sociologists, think tanks, economists and federal agencies have all used different ways to measure and identify the middle class. Sociologist Dennis Gilbert of Hamilton College (and others) added upper-middle, middle-middle, and lower-middle categories to the definition, identifying key characteristics as conceptualizing, creating and consulting which generally come with a college education. The Pew Research Center defines the middle class as earning two-thirds to two times the national median income for your household size; approximately $46,960 to $140,900 of income for a four-person household. New York University Professor Edward Wolff defines the middle class by wealth in order to include retired households into the calculation. He suggests that the middle class falls into the middle three-fifths of the wealth spectrum, from $0 in net worth (but having no debt) to $400,000 of net worth. And Notre Dame Professor James X. Sullivan uses consumption spending, suggesting that households spending between approximately $38,000 to $49,000 on basic living expenses such as food, transportation, entertainment, and housing could be categorized as middle class.

One thing I know for certain is that by none of those standards would a person living in the Bay Area feel that they were middle class. Geography plays a very big part in having a comfortable standard of living and significant economic security; common tenets of being in the middle class.

According to Zillow, the current median home price in San Francisco is $1,275,700, and $2,883,600 in Palo Alto. As of this new year, the middle class aspiration of owning a home in a good school district will no longer be fully assisted by a Schedule A deduction, as the limit on new home purchase mortgage deductibility is now limited to $750,000 of mortgage value. This, along with the limit of SALT (State and Local Tax) deductions to $10,000, is one of the biggest issues for people who live in California, along with a few other states.

The loss of these deductions suggest it could be prudent to revisit the cost analysis of mortgage debt and home equity lines of credit (HELOC). **Please call us and we can review your mortgage and HELOC strategy with you.**

While income tax rates have been lowered and the brackets redefined, payroll taxes were raised through increasing the maximum wages subject to FICA (Federal Insurance Contributions Act) which funds Social Security benefits. Now salaries up to $128,400 will be used to contribute to Social Security, an increase of $1,200. Medicare tax remains the same, as does the additional high-income surcharge of 0.9%. **The lower tax brackets will impact all withholdings and future estimated payments.**

Prior to 2012, one of the complaints about AMT (Alternative Minimum Tax) was that by not indexing the brackets, inflation alone created a sneaky tax with more and more people becoming subject to AMT over time. One of the early tax reform proposals eliminated AMT altogether, but it remains in the final signed 2018 tax bill. Indexed to inflation since 2012, and now with increased exemption and phase out levels, it is suggested that fewer people will be subject to AMT going forward. **If this applies to you, it may be possible to begin claiming your AMT Credit. IRS Form 8801 Credit for Prior Year Minimum Tax can take you through the calculation, as can your accountant.**

However, “bracket creep” reappears in a different form going forward. All tax brackets will now be increased for inflation using a different, slower, inflation measure, the chained Consumer Price Index (CPI). The chained CPI grows more slowly than the current inflation measure, so taxpayers across the board will pay slightly more, with the impact growing over time.

There has been talk of a motion in California to change tax-payers’ support of state institutions and programs into a charitable deduction rather than calling it a tax. The idea is to circumvent the limitation on State Tax Schedule A deductions. I love the creativity in this State – but I am not confident that simply calling a tax a charitable donation will allow a tax deduction of that amount.

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Traditional charities are concerned that charitable giving might be reduced as more people will be taking the increased standard deduction rather than itemizing. A solution to capturing a charitable donation Schedule A deduction is to plan out and bunch several years of donations into one year and making a contribution into a donor advised fund. These funds allow contributors to take a tax deduction of the donated money in the year of donation, but to still pay the money to selected charities over time. **There are many donor advised fund options available, and we would be happy to discuss the pros and cons of these plans with you.** Charities may find auction-based fundraisers becoming more popular as the ability to deduct donations decreases.

A change was made to 529 education plans. Money saved in these accounts used to be available only for college education costs, and with the new tax reform bill, money in these accounts can now be used for K-12 education. However, $15,000 per year is the most that can be gifted free of gift tax, and the 529 plans' greatest benefit is the tax free growth that takes years to manifest, so I am uncertain of how beneficial this added flexibility will be. We are also waiting to see if the 529 plan providers will be increasing their maximum allowable contributions to facilitate the added years of education costs that can now be paid. **Stay tuned for an update on how to best pay for children's education under the new rules.**

Business owners can deduct 20% from their taxes on pass-through qualified business income of up to $315,000, protecting $63,000 from taxes. The deduction for business owners with income above this level is based on a ratio of wages paid and capital invested in the business. In combination with the lower tax rates for individuals delivered by the new law, this deduction reduces the effective tax rate for small businesses to no more than 29.6%. **If you own your business, you will want to talk with your accountant about your business tax structure.**

Social Security retirement benefits get a 2% increase in 2018, the biggest COLA increase in six years. But don't spend it all in one place because the increase is accompanied by higher basic Medicare Part B and Medicare Part D prescription drug plan premiums. The Medicare Part B monthly surcharges remain the same this year, but some of the income tiers that trigger the surcharges have changed. This year's premiums are based on 2016 tax returns, as a result, single individuals with income exceeding $133,500 and married couples with income topping $267,000 in 2016 will pay higher Medicare premiums in 2018 even if 2016 income did not increase from 2015.

The overall cost of the tax bill is approximately $1.5 trillion, adding to the $20,600,918,039,678 in National Debt (as of 11:36am on 1/5/2018) and is likely to be somewhat inflationary, adding to the increased likelihood that the Fed will raise rates this year at least the three times that they are expected to. Tax reform and its repercussions require a whole new way of thinking. We are happy to work together with you and your CPA or tax professional. **Let's set a time to review your strategy.**