Tax Reform:

Beware of These New Tax Opportunities and Traps

Social Security.

Social Security can be the primary source of income for many retirees. According to the Urban Institute[1], the average couple will pay approximately $587,000 in Social Security taxes and receive $658,000 of Social Security benefits over their lifetime. It can come as a surprise to many that Social Security income is subject to income taxes. Though taxes on social security taxes are avoidable, it often requires proactive planning. Generally, a retiree's Social Security will be subject to taxation based on their level of taxable income (or "provisional income"). The following chart portrays the threshold's the IRS uses in determining the taxability of Social Security.

In many instances, the source of income that pushes a retiree above these thresholds are distributions from retirement accounts (e.g. IRAs or 401(k)). Through careful planning, strategies that consider Roth-style retirement accounts, including Roth contributions, rollovers and conversions allow a retiree to withdrawal income in ways that will not trigger additional taxable income for the retiree and therefore reduce the tax burden on social security benefits. Taking the time to create a retirement income strategy can often provide retirees with the extra income needed to meet their retirement goals.

NOTE: For 2018 and forward, the Tax Cuts and Jobs Act has removed the ability to recharacterize Roth IRA conversions. This has historically been an effective strategy that allowed an individual to manage taxable income by effectively "undoing" conversions that were made from an individual's IRA to a Roth account (generating taxable income). These "recharacterizations" were allowed all the way up to the individual's tax return due date. Due to this change, additional year end tax planning will be required in order to make final conversion decisions before December 31 of each year.

Provisional income amounts for:		
Married, filing jointly*	Other taxpayers	Then:
$32,000 or less	$25,000	Social Security income is tax free
$32,001 to $44,000	$25,001 to $34,000	Up to 50% of Social Security income is taxable
More than $44,000	More than $34,000	Up to 85% of Social Security income is taxable

Itemized Deductions.

The Tax Cuts and Jobs Act has increased the amount of the standard deduction from $6,500 to $12,000 for individuals, $9,550 to $18,000 for heads of households, and from $13,000 to $24,000 for married couples filing jointly. Those who don't have enough itemized deductions to surpass these amounts will be required to take these new standard deduction limits.

If you are in a situation where you are close to the standard deduction threshold, it may be an effective strategy to "bunch" deductible expenses in one particular year so that your combined itemized deductions exceed the standard deduction. This can be an effective strategy for someone who may be able to manage the timing of certain expenses such as mortgage payments, charitable contributions, estimated state taxes, property taxes or medical expenses.

Tax-Free Capital Gains.

Capital assets include significant pieces of property such as homes, investment properties, stocks and bonds. Individual who realize gains on capital assets are required to pay taxes in the year or realization. "Tax-loss harvesting" is the practice of selling a capital asset that has experienced a loss. By selling an asset at a loss, investors can offset any gains that may be realized during a given year lowering their overall tax burden. This has the dual benefit of lowering an individual's taxable income and potentially lowering their tax bracket. Under the new Tax Cuts and Jobs Act, Single and Married Filing Jointly returns enjoy a 0% capital gains rate on total taxable income below $39,375 and $78,750 respectively.

The only caveat when considering tax loss harvesting is that under the "wash-sale rule", you cannot buy "substantially identical" securities until at least 30 days after an initial sale. Therefore, if an individual is selling to recognize losses, that individual should weigh the tax benefits of this strategy with the overall economic benefit of selling the underlying capital asset.

Hobby-Loss Rule Change.

For-profit businesses that generate a net tax loss for the year can reduce their overall tax burden by reducing taxable income by these amounts (subject to certain limitations). However, those not engaged in for profit activities (commonly referred to as "hobbies") have historically only been allowed to deduct expenses up to the amount of revenue generated from these activities as a miscellaneous itemized deduction (to the extend they exceeded 2% of adjusted gross income).

However, beginning in 2018, the Tax Cuts and Jobs Act has eliminated write-offs for miscellaneous itemized deduction thereby eliminating the ability to deduct any expenses related to hobby activities. This change effectively requires the taxpayer to report all the revenues associated with hobby activities while prohibiting the taxpayer from writing-off any of the associated expenses. Ouch! Therefore, in order to write-off expenses incurred related to a revenue generating activity, the activity must be considered "for profit". The IRS has provided a "safe harbor provision" that says an activity must generate a profit in 3 of the last 5 years in order to be considered "for profit". When these provisions are met, the burden of proof is shifted back onto the IRS to rebut the lack of profit motive. For those that participate in activities that are close to break-even, careful consideration should be given on an annual basis to the timing of revenues and expenses so that these activities may qualify for the safe harbor provision.

Leasehold Improvements.

Qualified Improvement Property “QIP” is defined as any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Prior to the Tax Cuts and Jobs Act, QIP was eligible for 50% bonus depreciation. According to committee reports, Congress’ intended for QIP to enjoy a 15-year recovery period and 100% bonus depreciation for 2018 and forward. However, the drafters of the actual rule linked bonus eligibility to property with a recovery period of 20 years or less with the hopes that QIP, which would enjoy a 15-year life, would qualify. However, in drafting the final rules, drafters failed to specify the intended 15-year recovery for QIP therefore withdrawing it from both an expedited recovery period and bonus deprecation. At this point, barring a technical correction, QIP placed in service after 2017 is recovered over 39 years with no bonus depreciation eligibility. Therefore, if you were previously able to use a 15-year life and bonus depreciation, you should plan for improvements in 2018-2025 to be depreciated over a 39 year life the taxpayer is not electing or eligible for the Section 179 deduction.

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[1] Urban Institute, “Social Security and Medical Lifetime Benefits and Taxes”, 2017.