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Tax Changes Are Coming Next Year, but You Can Plan for Them Now

Wealth Matters

By PAUL SULLIVAN DEC. 7, 2017

The Senate and House may spend most of the month ironing out the differences in their tax bills. Or they may be delayed by other legislation and not enact a new tax code until the new year.

Either way, high-earning taxpayers cannot afford to wait and see what happens; they need to act this month before certain opportunities go away. And betting on a delay in a final vote is not wise planning: Accountants predict that the new code will take effect on Jan. 1 even if it has to be made retroactive at some point next year.

The two tax bills have differences for sure — the most obvious being the Senate's seven tax brackets to the House's four. They also have more nuanced discrepancies, like how they treat mortgage interest deductions and small businesses whose owners pay their company's taxes on their own returns.

But even if accountants have not perfected the Excel formulas that will allow them to make exact comparisons, they are already talking to their wealthier clients, particularly those in high-tax states, about what they should do now before deductions go away or are decreased.

For some high earners, lower tax rates could be offset by the end of deductions they have counted on for decades, namely those for state and local taxes, and reduced deductions for mortgage interest and property taxes.

But the higher standard deduction — at least $24,000 per couple, up from $13,000 — and the absence or limitation of these other deductions could also lessen the tax benefits of charitable deductions. A more arcane provision in the Senate bill — regarding blocks of stocks bought at different times — could make the benefits of harvesting tax losses, a staple of basic financial planning, harder to accomplish.

"The loss of some of the deductions will go a long way toward tax simplification but not necessarily toward tax savings," said Timothy M. Steffen, director of advanced planning at Baird, a wealth management firm. "It's going to be easier to figure out how much more you're going to have to pay."

For those who would like to take advantage of tax benefits now, here are strategies they can follow.

Pay property taxes early. Both the House and Senate bills allow for $10,000 in real estate tax deductions, which is high enough for taxpayers in many states.

Nine counties in the United States with populations of 100,000 or more, however, have an average real estate tax that exceeds that amount, according to an analysis by Attom Data Solutions. No. 1 is Westchester County, outside New York City, at $16,500 a year. The other eight are in New Jersey, New York, Northern California and southern Connecticut.

There are 32 additional counties — in Illinois, Massachusetts, Virginia and Massachusetts — where the average property tax is $7,000 or more, meaning people who own larger homes in those areas will feel the bite.

Most municipalities set property tax rates in the middle of the year. Homeowners either pay them as part of their mortgage or directly to their town semiannually. If the latter is the case, advisers say to pay the installment due in early 2018 now. And if the taxes are paid as part of the mortgage payment, they advise checking with the bank to make sure the tax is paid this month and not in January.

Prepay state taxes. Advisers suggest paying state taxes early, to the extent that is possible, by making an estimated tax payment for what is owed this year. This is something that affects more people, because 41 states tax earned income.

Joseph J. Perry, the tax and business services leader at Marcum, a national accounting firm, said his firm was exploring a novel strategy for clients to prepay New York State tax for the first, second and third quarters of 2018. He said it appeared to be allowed under a mechanism in the state tax code.

But early payment strategies work only if you do not qualify for the alternative minimum tax. Once taxpayers set off the A.M.T., their income is taxed at 28 percent, but they lose these deductions.

High earners with savvy accountants could, however, work the math to accelerate income while qualifying for the A.M.T. this year to pay less in taxes than they might next year, Mr. Perry said.

"If you're at a higher rate next year, you're not going to have that state deduction to bring you down," he said. Therefore, if high earners could receive a bonus this month instead of early next year, they could potentially have that money taxed at the lower rate. (Like all tax strategies, though, this requires running various calculations with an accountant.)

Make large charitable donations. Calculating the tax value of charitable donations is a little trickier.

The wealthiest will still get a benefit under certain circumstances. For example, if a married couple had a $1 million mortgage with a 4 percent interest rate, it could deduct $40,000 for its mortgage interest plus $10,000 for real estate taxes under the Senate version of the tax bill. This would give the couple $50,000 in deductions, which is above the standard deduction of $24,000, allowing them to claim charitable donations as a deduction.

Under the House proposal, which caps the mortgage that can be used for the deduction at $500,000, they would have $20,000 in mortgage interest and $10,000 for real estate taxes. At $30,000 in deductions, their charitable gifts would still count.

But if that same couple rents instead of owns, it would not have those other deductions to get above the standard amount. So any benefit it gets today from itemizing charitable deductions would be subsumed under the standard deduction.

If the tax math works — and given that the income tax rates are likely to be higher this year than next year — people who can make large charitable deductions this year are likely to get more benefit.

Those who do not want to give outright to a charity can make a donation to a donor-advised fund. In doing so, they get the deduction this year but can make the grants to charities later.

Harvest stock losses. The Senate bill has a seemingly arcane provision that addresses the adequate identification rule, which has to do with selling blocks of stock. As the rule stands, people who bought blocks of stock at different times can choose which blocks to sell or give away for tax purposes.

Under the proposed changes, an investor would have to sell the oldest stock first — under the premise of first in first out, said Gary M. DuBoff, principal in the tax and accounting department at MBAF, an accounting firm.

The shares with the highest embedded taxes are the ones that people usually donate to charity, but Mr. DuBoff pointed out that this change would have an effect on tax-loss harvesting, a strategy in which an investor sells stocks that have performed poorly to take a capital loss. This still works if someone is selling the entire position, but not if the investor wants to sell more recently purchased blocks, which may have gone down in value while earlier blocks are still up, Mr. DuBoff said.

So this is a good time to make sure your adviser is harvesting losses on blocks within large stock holdings, particularly if earlier blocks have appreciated.

Don't act hastily. There are risks to acting now without full information. In 2012, Congress and President Barack Obama were locked in a tense debate over tax rates as the United States inched toward what was called the fiscal cliff — meaning that after Dec. 31, taxes would rise automatically if an agreement was not reached.

As the year was nearing an end, a swath of wealthy taxpayers rushed to make taxable gifts, thinking that Mr. Obama would reduce what had been a generous estate and gift tax exemption of $5 million a person.

Instead, the opposite happened. Mr. Obama and the House speaker, John Boehner, [reached an agreement] to make that exemption permanent and index it to inflation. That exemption essentially eliminated the estate tax for all but a few Americans, but it was bad news for some people who had made irrevocable gifts solely for tax purposes. Their money was gone before it had to be.

Planners say the risk this year is lower, and they predict that any changes to the bills are going to be on the margins.

"People aren't going to get blindsided here," said Jay Messing, senior director of planning for Wells Fargo Private Bank. "Most itemized deductions are going away. If there's a change and it didn't make sense to donate this year, maybe you just gave money to your favorite charity a little early."

It's smart to act now on some strategies, but others should wait until 2018. Thinking through those will be the focus of next week's column.