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Wealth Management

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# Tax Topics

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## The Bipartisan Budget Act of 2018

On February 9, 2018, President Trump signed The Bipartisan Budget Act of 2018 into law (P.L. 115-123). This Budget Act was significant. Among other things, it increased caps on discretionary spending for Fiscal Years (FYs) 2018 and 2019, suspended the debt limit through March 1, 2019, supplied additional funds for disaster relief, extended funding for the Children's Health Insurance Program (CHIP) through FY 2027, and addressed certain tax provisions (see below). In addition, to end the brief government shutdown that occurred earlier in February and provide continuing funding for the government, the Budget Act had a "continuing resolution" (CR), which runs through March 23rd.

This latest CR was the fifth one in FY 2018, which started on October 1, 2017 and ends on September 30, 2018. It means that unless Congress agrees to a budget for FY 2018 by March 23rd (or passes an additional CR), another government shutdown is possible in March. Stated differently, while the Budget Act addressed many issues and removed them as possible points of discussion prior to the mid-term elections this November, there are still budget bumps in the road.

The Budget Act's tax provisions basically fell into two categories: "extenders" and what we'll call "cutting-room floor" items. "Extenders" are temporary tax provisions that Congress typically renews, sometimes before they expire. "Cutting-room floor" items are certain provisions that didn't make it into the final version of what's known as the Tax Cuts and Jobs Act (TCJA, P. L. 115-97), the sweeping tax legislation that was enacted on December 22, 2017.

**"Extenders."** Over 30 extenders had expired at the end of 2016. Three of them dealt with individuals: the tuition deduction, exempting the forgiveness of mortgage debt from income and treating mortgage insurance premiums as deductible. 12 fell under the caption of "growth, jobs, investment and innovation," and included the provision treating race horses as 3-year (instead

of 7-year) depreciable property and extending the 7-year depreciation period for motorsports entertainment complexes. 17 of the extenders dealt with energy production and conservation; they included the credit for two-wheeled plug-in electric vehicles as well as the credit for biodiesel and renewable diesel incentives. Most of these provisions were extended through 2017, although a few went beyond that date – meaning that most of these provisions have already expired again, but now apply to 2017 taxes.

What that means for the IRS, which started accepting 2017 returns at the end of January, is that they've had to reprogram their systems to take account of these revived tax benefits. Add that to the efforts the IRS is already making to come up with new forms and guidance to implement and explain the numerous tax changes in TCJA, and this makes for an even more challenging time for those charged with administering our nation's tax laws.

**Cutting-room floor.** As to the cutting-room floor items, these include several that were deemed "extraneous" to TCJA and were stricken at the last minute. One such provision exempts private colleges or universities that don't have at least 500 tuition-paying students from the new 1.4% excise tax on the institution's net investment income (this is aimed at helping Berea College in Kentucky, which doesn't charge tuition and has a large endowment); another shields private foundations from a 200% excise tax on "excess business holdings" if a) the foundation meets certain requirements regarding how it acquired that business holding, and b) the business distributes all of its profits to the foundation (this is aimed at helping Newman's Own Foundation, which was founded by the late actor Paul Newman, and receives all of the profits from Newman's Own products).

**1040SR.** Another provision that was dropped from TCJA but made it into the Budget Act permits a new simplified tax form for "seniors"; this Form 1040SR will be as "similar as practicable" to the Form 1040EZ, which can only be used by a narrow group of taxpayers, namely those:

- Who are under age 65 and not blind
- Whose filing status is single or married joint, with no dependents
- Who have less than $100,000 of taxable income, which can only be from wages, salaries and tips, taxable interest under $1500 and unemployment compensation and Alaska Permanent Fund dividends
- Who claim the earned income tax credit as their only tax credit

The 1040SR, which will be available for tax years beginning in 2019 (2019 tax returns will be filed in 2020), is only for taxpayers who are at least 65 by the end of the tax year. Such taxpayers can still use this form even if they have Social Security benefits, retirement plan distributions, "annuities or other such deferred payment arrangements," interest and dividends and capital gains, regardless of "the amount of any item of taxable income or the total amount of taxable income for the taxable year."

> **Comment.** It will be interesting to see what shape the new 1040SR takes and how closely it matches the 1040EZ, the "easy peasy" income tax return described above, since the 1040SR seems to allow for many different types of income, and has no income caps. Fortunately for the IRS, this new form doesn't apply for the 2018 tax year and is one less item that requires immediate attention.

## Home equity loans and TCJA

The Tax Cuts and Jobs Act, mentioned above, made many changes to our tax laws, including new limits on the deductibility of home mortgage interest. That is, from 2018 through 2025 (yes, most of the individual tax provisions in TCJA are temporary), mortgage interest paid to acquire, build or substantially improve a principal residence and one other residence (e.g., a vacation home) is still deductible, although the total debt can only be up to $750,000 (rather than $1 million); interest on home equity indebtedness is no longer deductible (the debt could be up to $100,000 under prior law).

**IR-2018-32.** In response to many queries from taxpayers and tax professionals, the IRS released IR-2018-32 on February 21, 2018, which is captioned "Interest on Home Equity Loans Often Still Deductible Under New Law." This notice explains that taxpayers may still be able to deduct interest on a home equity loan, home equity line of credit or second mortgage, regardless of what it's called, provided that the proceeds of this loan are used, say, to build an addition to an existing home, and NOT for personal expenses.

The notice has three examples, all of which deal with new loans. The key point is that what the notice calls the "total qualified residence loan balance" cannot exceed $750,000 (or $375,000 for a married taxpayer filing separately). In one example, the taxpayer takes out a $500,000 mortgage in January 2018, to purchase an $800,000 primary residence; one month later, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the home, and the total indebtedness doesn't exceed the cost of the home. Because both loans don't exceed $750,000, the interest is deductible. The example notes, however, that if the taxpayer had used the home equity proceeds to pay off student loans and credit cards, the home equity interest would not be deductible.

The notice makes a clear distinction between a) total indebtedness up to $750,000 that is secured by the residence and used to purchase, build or improve it, and b) home equity dollars used for something other than the residence. While this clarification is welcome, more is needed to address the implications of refinancing grandfathered loans.

**Refinancing grandfathered loans.** Under TCJA, mortgages incurred on or before December 15, 2017 are grandfathered. Special rules, however, can affect that grandfathering if the mortgage is refinanced after that date. Those rules indicate that a refinanced mortgage will still be grandfathered "to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness," but that grandfathering does not apply to "any indebtedness after the expiration of the term of the original indebtedness."

The quoted language – read in conjunction with the notice discussed above – seems to say that if the original indebtedness was under $750,000, the interest on the refinanced indebtedness should still be deductible (even if the new debt exceeds the original debt) provided that refinanced dollars are used solely for the residence.

The question is how this language and the notice apply to indebtedness that exceeds $750,000. For instance, suppose that some years ago, T took out a $1 million, 30-year mortgage to buy a home. T

has paid the principal down to $800,000. He refinanced the mortgage in January of 2018, and took out an additional $100,000 to redo his kitchen; the term of the refinanced indebtedness is for another 30 years. Is the additional $100,000 still grandfathered even though the total indebtedness of $900,000 exceeds the refinanced amount? And what is the impact of the new 30-year term, which effectively extends the original 30-year term? Does that extension undo the grandfathering, and disqualify the interest on any amount above $750,000? Would the result be different if the new term were for 15 years, or a shorter amount of time than what remained on the original 30-year mortgage? The answers are unknown.

**To sum up.** Many provisions in TCJA are unclear and require guidance. And the IRS is peddling as fast as it can. In the meantime, taxpayers should proceed with caution if, for example, they are refinancing mortgage indebtedness that appears to be grandfathered.

## March 7520 rate

The March 2018 7520 rate is 3.0%, an increase of 0.20% (20 basis points) from the February 2018 7520 rate of 2.8%. The March mid-term applicable federal rates (AFRs) are also up: 2.57% (annual), 2.55% (semiannual), and 2.54% (quarterly and monthly). The February mid-term AFRs were: 2.31% (annual), 2.30% (semiannual), and 2.29% (quarterly and monthly).

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