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Tax Topics

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Omnibus spending bill passed

On March 23, 2018, President Trump signed into law the "Consolidated Appropriations Act, 2018" (Pub. L. 115-141). This 2000+ page piece of legislation averted a government shutdown, and funds the government through September 30, 2018, the close of the 2018 Fiscal Year; its price tag is $1.3 trillion. In addition to addressing the nation's budget, the Act has a handful of other provisions, including a Congressional statement regarding the importance of combating human trafficking, amendments to the "National Child Protection Act of 1993," and some tax provisions.

In part, the Act's tax provisions: 1) fix the so-called "grain glitch" in the new 20% deduction for pass-through income (see below); 2) increase the state housing credit ceiling for 2018 through 2021; and 3) have various "technical corrections" to prior tax acts and to the partnership audit rules (a "technical correction" generally is not substantive, but cleans up prior drafting issues).

The 20% deduction for pass-through income (new Code Section 199A, for tax mavens) is part of the major tax legislation enacted on December 22, 2017 (Public Law 115-97, which is informally known as the Tax Cuts and Jobs Act (TCJA)). The deduction currently runs from 2018 through 2025, and was designed to benefit the owners of pass-through businesses. (Such businesses are typically structured as S corporations, partnerships or limited liability companies; the business's income is not taxable to the entity itself, but passes through to the entity owner and is taxable on the owner's individual tax return.) This new 20% deduction is relatively straightforward IF the business owner's taxable income is less than $157,500 (single taxpayers) or $315,000 (married joint filers), but rapidly becomes complex if the owner's income exceeds those amounts or the business is a proscribed "specified service trade or business" (such as law or accounting).

As originally drafted, the "grain glitch" in the 20% deduction further enhanced the tax benefits farmers receive when they sell to agricultural cooperatives (as opposed to non-cooperative businesses). To fix this perceived inequity, the Act adds significant new language, and even more complexity, to Section 199A and how it applies to certain agricultural businesses. In the meantime, other taxpayers who might benefit from the deduction are eagerly anticipating the IRS's promised guidance on the subject (that guidance is supposed to be out sometime in June; forms "translating" the deduction probably won't be out until the fall).

Revised 2018 inflation-adjusted numbers

The Tax Cuts and Jobs Act, mentioned above, made many changes to the tax law, including temporarily lowering income tax rates but permanently altering how various items, such as income tax brackets, are annually indexed for inflation. That is, prior to TCJA, tax numbers were adjusted for inflation using the Consumer Price Index for All Urban Consumers (CPI-U). Using this measure, the IRS issued Revenue Procedure 2017-58 on October 19, 2017, and published the 2018 inflation-adjusted numbers.

Yet because TCJA changed that inflation measure to the "chained" CPI for All Urban Consumers (C-CPI-U), *effective as of 2018*, the IRS needed to revisit those previously issued 2018 inflation-adjusted numbers. Revenue Procedure 2018-18, released on March 5, 2018, is the result. Although some of the previously issued numbers remain the same, many numbers have gotten smaller (that's the goal of a "chained" CPI – it slows down inflation increases and therefore means more revenue for the government).

Projected gift and estate tax exclusion shrinks. Of note is the revised gift and estate tax exclusion. To explain, prior to TCJA, the gift and estate tax exclusion was $5 million, indexed for inflation (the 2017 number was $5.49 million, or $10.98 million per married couple). The 2018 number, published last October, was set to increase to $5.6 million (or $11.2 million per married couple). From 2018 through 2025, however, TCJA doubles the $5 million exclusion to $10 million, indexed for inflation. Because of that doubling, many assumed that as of 2018, the exclusion would be $11.2 million per individual, or $22.4 million per married couple. Not so under the chained CPI: the revised $10 million inflation-indexed number is $11.18 million. Thus, in 2018, an individual can protect $11.18 million from gift and estate tax (or $22.36 million per married couple). Successive chained CPI inflation adjustments will continue to increase the exclusion, though presumably not as much as the "old" CPI.

$15,000 annual exclusion gift still stands. The annual exclusion – $10,000, indexed for inflation – refers to the annual amount that a donor can give to as many people as he or she wishes, *without* eroding any of the donor's gift and estate tax exclusion. From 2013 through 2017, the annual exclusion was $14,000 per donee. Under the old CPI, the 2018 annual exclusion was scheduled to increase to $15,000; under the chained CPI, this number remains the same, as does the $152,000 annual exclusion amount for gifts to non-citizen spouses.

Income tax brackets, etc. Because TCJA itself changed many items, including income tax brackets and the "standard" deduction, these will not be adjusted for inflation until next year. And yes, the chained CPI will likely produce smaller increases than the old CPI.

Estimated 2018 taxes

To avoid interest and penalties on underpayments of income tax, taxpayers must be "current" with their tax obligations, which include not just income tax on, say, wages, capital gains and rents, but other potential taxes as well, such as: 1) the 3.8% tax on net investment income (e.g., dividends, capital gains, rents and royalties); 2) the additional 0.90% Medicare tax for salaried income above $125,000 (married filing separately), $200,000 (single taxpayers) or $250,000 (married filing jointly); 3) the alternative minimum tax (AMT); 4) self-employment tax; 5) taxes on household employees; and so forth.

To avoid interest and penalties, then, taxpayers must either: 1) pay in 90% of their current year's liability, or 2) use the so-called "safe harbor," which requires paying in 100% of the prior year's income tax liability (110% if the prior year's adjusted gross income exceeded $150,000 ($75,000, if married filing separately)). "Paying in" typically takes the form of salary withholding, quarterly estimated tax payments or applying a potential tax refund to the projected tax liability. Yet because of the current lack of guidance and forms implementing the Tax Cuts and Jobs Act, it is difficult to estimate 2018 tax obligations.

To illustrate, employers of salaried employees must withhold various taxes from each employee's paycheck, including federal, state and local income taxes, based on withholding tables from the different taxing authorities. When TCJA lowered tax rates late last year, the IRS had to scrap its planned 2018 withholding tables in favor of new ones, which took effect earlier this year, and increased employees' take-home pay. When this change occurred, the IRS urged employees to ensure that the right amount of tax was being withheld from their pay. Although that was solid advice, taxpayers could be forgiven for wondering how they were supposed to do that, since no forms were available addressing TCJA. Fortunately, the IRS soon came out with a withholding calculator on its website to assist in this exercise (see: https://www.irs.gov/individuals/irs-withholding-calculator).

While this calculator is a good beginning for salaried employees, taxpayers still face many unknowns. For example, suppose that the taxpayer may (or may not) be eligible for the 20% pass-through income deduction mentioned above. Taxpayers claiming the deduction will be subject to a lower threshold for what constitutes a "substantial" understatement of tax: 5% instead of 10%. Thus, until the IRS issues guidance on the deduction and tax forms implementing it, a conservative approach might be to assume that the deduction does not apply – even though that could result in an overpayment of estimated tax if, in fact, it turns out that the taxpayer does qualify for the deduction.

Or consider the liability for the 3.8% tax on net investment income, such as dividends, capital gains, rents and royalties. This tax can apply to taxpayers with modified adjusted gross income in excess of $125,000 (married filing separately), $200,000 (single taxpayers) or $250,000 (married filing jointly). In calculating that tax, investment income is reduced by an allocable portion of "allowable" income tax deductions. Prior to TCJA, that allocation may have included a significant amount of state and local income taxes (part of the so-called "SALT" deduction, which can also include real property taxes, etc.). Yet because TCJA limits the SALT deduction to $10,000 ($5,000 for married taxpayers filing separately), the allocable portion of these state and local income taxes may virtually disappear, thereby increasing the taxpayer's 3.8% tax.

Then there is the question of whether taxpayers still need to factor in the AMT, given that the AMT exemption (and its phase-out) is higher AND that the $10,000 SALT cap will make taxpayers far less vulnerable to the AMT, which disallows the SALT deduction. And so on.

The bottom line is that taxpayers who typically file estimated tax payments may find it difficult to calculate such estimates for 2018. Accordingly, rather than trying to ballpark their 2018 income (and corresponding taxes) to fall within the 90% current payment level (or 95% if they plan on taking the 20% deduction for pass-through income), taxpayers may find that the “safe harbor” mentioned above merits consideration.

April 7520 rate

The April 2018 7520 rate is 3.2%, an increase of 0.20% (20 basis points) from the March 2018 7520 rate of 3.0% (the jump from February to March was also 0.20% – from 2.8% to 3.0%). The April mid-term applicable federal rates (AFRs) are also up: 2.72% (annual), 2.70% (semiannual), 2.69% (quarterly) and 2.68% (monthly). The March mid-term AFRs were: 2.57% (annual), 2.55% (semiannual), and 2.54% (quarterly and monthly).

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