Tax Reform News … January 2018

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With the new tax bill officially signed into law, we can now turn our attention to various tax planning ideas to address the changes. While there are many aspects to the tax law, the changes that will likely affect most people are the adjustments associated with itemized deductions. With the doubling of the standard deduction, it is estimated that only 10% of taxpayers will still itemize their deductions. However, as with any tax change, the impact is based upon a taxpayer's set of facts and circumstances. Let's take a look at how the significant changes to itemized deductions may affect you.

Standard Deduction for Itemized Deductions

The doubling of the standard deduction, along with the elimination of many itemized deductions and the $10,000 per year limit on state and local tax deductions, suggests taxpayers should be more mindful of the timing of certain deductions and the optimization of the standard deduction. One planning idea is to "bunch" your deductions, primarily your charitable contributions, every other year. Here are two simple examples of how using charitable deductions every other year can save you on taxes.

Example 1 – Modest amount of mortgage interest	**Option 1**	**Option 1**	**Option 2**	**Option 2**
	2018	**2019**	**2018**	**2019**
State & Local Taxes (max amount)	$10,000	$10,000	$10,000	$10,000
Mortgage Interest	$7,500	$7,000	$7,500	$7,000
Charitable Contributions	$10,000	$10,000	$20,000	$0
Total Itemized Deductions	$27,500	$27,000	$37,500	$17,000
Higher of Standard Deduction or Itemized Deductions	$27,500	$27,000	$37,500	$24,000
Tax Benefit @ 32%	$8,800	$8,640	$12,000	$7,680
Total Two Years Tax Savings		$17,440		$19,680
Additional Tax Savings				$2,240
Example 2 – No mortgage interest	**Option 1**	**Option 1**	**Option 2**	**Option 2**
	2018	**2019**	**2018**	**2019**
State & Local Taxes (max amount)	$10,000	$10,000	$10,000	$10,000
Mortgage Interest	$0	$0	$0	$0
Charitable Contributions	$15,000	$15,000	$30,000	$0
Total Itemized Deductions	$25,000	$25,000	$40,000	$10,000
Higher of Standard Deduction or Itemized Deductions	$25,000	$25,000	$40,000	$24,000
Tax Benefit @ 32%	$8,000	$8,000	$12,800	$7,680
Total Two Years Tax Savings		$16,000		$20,480
Additional Tax Savings				$4,480

The above example shows that even with the same amount of deductions over two years, the timing of the deductions can result in significant tax savings by utilizing the standard deduction in one year while itemizing in the other year. Simply timing your charitable contributions every other year can save you money.

Now, you may not want to give to your favorite charities every other year. That can be easily accomplished by establishing a Donor Advised Fund in 2018. A Donor Advised Fund will allow you to benefit from the tax deduction in 2018 while allowing the actual grants to your favorite charities to occur throughout 2018 and 2019. To make the tax deduction even more valuable, consider funding the Donor Advised Fund with appreciated assets (long-term gains only) to also avoid the capital gains. Please let us know if you have interest in establishing a Donor Advised Fund.

Mortgage Interest Deduction

As a result of the new law, homeowners can only deduct interest associated with mortgages of $750,000 or less (for mortgages taken out after December 15, 2017). The $1,000,000 limit continues to apply for existing mortgages. However, home equity interest is no longer deductible up to the previous $100,000 debt limit, regardless of when the debt was incurred.

In light of these changes, should you consider paying off your mortgage and home equity loans? For those with home equity loans, the answer is more evident. If you have a considerable amount of idle cash available, we would advocate paying off the home equity loan. You probably aren't earning much on the cash while you're likely paying 4-5% interest on the home equity loan, which will no longer be tax deductible. But if paying off the debt requires you to sell investments you are confident will earn you better than 4-5%, it would not make financial sense to do so. Additionally, by selling investments, you may incur capital gains tax. The same concept would apply to your mortgage. If the interest rate is low and you are fully invested with no idle cash, we don't see a compelling reason to pay off your mortgage.

However, the idea of paying off the mortgage vs. the home equity loan is a bit more complicated. While there is still a deduction allowed for existing mortgages, whether you are actually itemizing vs. taking the standard deduction may impact your decision. You will need to analyze whether you are "wasting" deductions because you are no longer itemizing. See the examples above about "bunching" itemized deductions.

Additionally, consider the true after-tax rate you are paying on each to determine which one to potentially pay off. Even if the interest on the home equity loan is not deductible, if your interest rate is lower than the after-tax rate of your mortgage, then the focus should be on the higher rate mortgage not the lower rate home equity loan.

Finally, the decision whether to pay off the mortgage should not be made in a vacuum or purely motivated by the tax law changes. The decision should be made within the context of your overall financial plan and cash flow. If you are near retirement, perhaps the potential limited tax deduction provides some incentive to pay it off sooner. We do not, however, recommend that you simply pay off your mortgage due to the likelihood of lost tax deductions. It all depends upon your situation and where those funds to pay off the mortgage would come from.

Medical Expenses

At one point, it was thought this deduction would be eliminated. It was actually enhanced for two years by lowering the threshold for the deduction from 10% of AGI to 7.5%. Thus, the planning technique is similar as described above – that is, "bunch" your deductions as much as possible to maximize the use of your itemized deductions and standard deduction. This would be particularly advantageous in 2018 and 2019 when the AGI deduction threshold will be lower.

The impact of these tax law changes will be dependent upon your specific situation. Please be on the lookout for further articles around other aspects of the tax bill including changes to 529 college savings plans, estate and gift changes, and pass through income. With any of the tax law changes, we would be happy to discuss how these changes may affect you and how specific planning strategies could be used to potentially save on taxes. We also encourage you to consult with your tax advisor.

Dean Johns is a principal with John D. Dovich & Associates, LLC. Dean graduated summa cum laude with a Bachelor of Science Degree in Accounting from Minnesota State University in 1991. He received his Master's Degree in Business Taxation from the University of Minnesota in 1999. Dean is a licensed Certified Public Accountant (CPA) having received the Elijah Watts Sells award for the November 1991 exam (top 100 in the country). Dean also received his CFP certification in 2013. Dean has 20-years' experience in public accounting with two international accounting firms. Before joining our firm, he was the Executive Director of Partner Matters for Grant Thornton LLP, serving as the trusted advisor for more than 500 partners and their personal financial interests of the firm.