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***NOTE:* Since we originally published our alert on December 15, the House and Senate approved a final tax reform bill. This alert has been updated to reflect the provisions of the bill as finally agreed by the House and Senate.**

Planning for Tax Reform: Steps to Take Before the End of 2017

SUMMARY

Congress has just passed the most significant tax reform legislation since 1986. It is expected that the Tax Cuts and Jobs Act (the Act) will be signed into law either in late 2017 or early 2018, depending on resolution of certain budget rules. Most provisions of the Act will be effective for the 2018 tax year. This gives taxpayers a very narrow window of opportunity to take advantage of current tax rules before they expire or are scaled back. There are a number of actions that individual taxpayers should consider taking before year-end.

Pay state and local taxes before year-end, if you won't be subject to Alternative Minimum Tax in 2017. The itemized deduction for state and local income and property taxes will be limited to $10,000 per year, beginning in 2018. If you itemize deductions, and do not expect to pay Alternative Minimum Tax (AMT) in 2017, you should consider paying any remaining 2017 state and local estimated income taxes before year end, and prepaying 2018 property taxes to the extent possible. Note that any prepayments must go to the taxing authorities and cannot be left in escrow. Not all local jurisdictions will accept prepayments of property taxes, so you should check with your local tax authority. The Act does not allow any prepaid 2018 state income taxes to be deducted against 2017 federal income taxes.

Consider accelerating charitable contributions and other itemized deductions. Beginning in 2018, the standard deduction will nearly double (to $12,000 for a single taxpayer and $24,000 for a joint return). As a result of the increase in the standard deduction and the restriction on the deduction for state and local taxes, many taxpayers who currently claim itemized deductions will instead be claiming the standard deduction after 2017. If you are in this category you may want to accelerate your planned charitable contributions to 2017. You may also benefit from accelerating planned medical expenses into 2017, assuming that your level of medical expenses is sufficiently high to claim a deduction. Another benefit of accelerating your itemized deductions is that most taxpayers will have somewhat lower marginal tax rates in 2018.

New rules for deduction of mortgage interest. For years after 2017 and prior to 2026, the deduction for qualified residence interest will generally be limited to interest paid on a maximum of $750,000 of debt incurred to purchase a primary or secondary residence (assuming you are married and file a joint return). Acquisition indebtedness incurred on or prior to December 15, 2017 will continue to qualify for the existing $1,000,000 limitation on principal amount. There is limited transition relief for taxpayers who entered into a binding written contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018.

Identification of securities. The Senate bill would have required taxpayers who sell marketable securities to recover based on a "first in, first out" basis (or in some cases, the average basis method), meaning that you would no longer be able to identify which lots of securities you were selling. This controversial provision was not included in the Act.

Acceleration of long-term capital gain income. The Act does not change the tax rates imposed on long-term capital gains. There may be an advantage to recognizing long-term capital gains in 2017, rather than 2018, provided that you can prepay the state and local taxes triggered by such gain in 2017 and that you are not subject to AMT. As noted above, due to the anticipated $10,000 limit on state and local tax deductions, in many cases it will be better to pay state taxes in 2017, rather than 2018.

Deferral of ordinary income. Many taxpayers will have lower marginal tax rates as a result of tax reform. In such a case it will generally be better, where possible, to defer the recognition of ordinary income to 2018. On the other hand, due to the anticipated limits on state and local tax deductions, shifting income to 2018 may also result in the loss of the deduction for state and local income taxes on the deferred income. These two competing considerations must both be taken into account.

Like-kind exchanges. The Act limits the ability to engage in like-kind exchanges to exchanges of real estate that is held for investment or used in a trade or business. If you were planning on engaging in a like-kind exchange of other types of assets held for investment or use in a trade or business (such as artwork, cars or other collectibles), you should make every effort to effect at least one "leg" of the exchange by the end of 2017.

Pass-through deductions. Beginning in 2018, many owners of businesses held in pass-through form (i.e., an S corporation, an entity treated as a partnership for tax purposes or a sole proprietorship) will be eligible to claim a deduction of up to 20% of their qualified business income, subject to limitations based on other factors such as the type of business and the amount of wages paid to others with respect to the qualified business. This deduction does not apply to salary, guaranteed payments, or other compensation paid to the business owner. While not a 2017 action item, owners of pass-through businesses should review their overall business structure and their compensation structure and consider whether they can improve their ability to claim the pass-through deduction.

While tax planning amid the festivities of the holiday season may not be a welcome subject, you may need to act now to preserve some important tax benefits. It is also not too early to start thinking about ways to take advantage of new tax savings opportunities. While the President has not yet signed the Act, we expect he will do so very soon, and the Act will be effective in 2018.

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