Tax Reform and Families: 3 Essential Changes

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–Debra Taylor, CPA/PFS, JD, CDFA

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If you are struggling to understand the new tax act and how it will affect you, so are millions of American families! Indeed, there is both good and bad news. With about 60% of the tax cuts going to families, according to the federal government, you need to understand how to get the best for your family.

1. The child tax credit has improved

The child tax credit was originally designed to help working families with the costs of raising their children. Prior to the new law, the child care credit was $1,000 per child, phasing out when a taxpayer's AGI exceeded $75,000 for single filers and $110,000 for married couples filing jointly.

Under the new law, taxpayers can now claim up to $2,000 for each child under age 17. The credit won't phase out until a single filer's income is $200,000 and $400,000 for those married couples filing jointly. This is a huge difference!

This change in the phase-out limit will allow more middle- and upper-income families to claim the credit (but they took the additional exemptions for children away, so they are trying to make up for it here.) Up to $1,400 is refundable, meaning a taxpayer can receive money back even if taxes are not owed.

This is beneficial for all income levels, especially those who do not owe any tax. Because the tax credit is doubled and up to $1,400 is fully refundable, families will likely have more money in their pockets. However, families will now need to provide their child's Social Security number to receive the credit. Prior to the act, taxpayers did not need to provide this information.

Taxpayers can also reduce their tax bill by $500 for other dependents who are not children, such as elderly parents. This nonrefundable credit is an incentive for families to take care of loved ones other than children.

2. New calculation for the kiddie tax

On a related note, there is a change to the way the "kiddie tax" is calculated. Previously, a child's net unearned income over $2,100 was taxed at the parent's top marginal rate. Under the new law, ordinary and capital gains rates applicable to trusts and estates are applied to the net unearned income of a child.

For example, let's say a child has unearned income from an UTMA of $5,000 that is subject to the kiddie tax and the parents have taxable income of $80,000. The tax rate of the parents is 25%.

Prior to the act, this amount is taxed at the parent's highest tax bracket of 25%, thus the child would owe

$1,250 in taxes. In 2018, the rates for trusts and estates would apply. For the same couple, under the new tax laws which apply the trust and gifts tax brackets, the first $2,550 is taxed at 10% and the remaining $2,450 is taxed at 24%. The result is a tax bill of $843.

3. 529 plans just got better

Section 529 plans are tax-advantaged savings vehicles that have grown in popularity since they were created in 1996. According to the College Savings Plans Network, 529 plans account for $275 billion in assets. Previously, 529 plans were limited to payments for post-secondary education. The new law allows a $10,000 annual distribution from 529 savings plans (not prepaid tuition plans) to pay for K-12 private or parochial education at the elementary and high school level.

The new limit on state and local tax deductions up to $10,000 per return will most likely make these accounts even more appealing than ever, as they receive a state tax deduction in certain states. Almost 36 states already offer an income-tax deduction or credit for a 529 plan contribution. New York and Connecticut allow a full deduction for a contribution of up to $5,000 for a single filer and $10,000 for a married couple filing jointly. For example, if you live in New York and open a 529 plan and invest $10,000 for your child's private school tuition, you could avoid $600 in state income tax.

This is a boon for parents sending their children to private school, however there are some downsides. One disadvantage is that institutions may want to know about 529 plans when making aid decisions. Also, you will need to consider that withdrawing money from a 529 plan to pay for private school shrinks the time that the assets can compound tax-free.

Of course, to take full advantage of a 529 plan, you need to establish the account as soon as possible. Each state has its own rules about contributions and distributions, so be sure to check with your advisor. In some cases, there may be penalties for withdrawals.

Also, you can now roll a 529 plan to a 529 ABLE account, which provides tax advantages to people under the age of 26 who are blind or disabled, without limiting their ability to take Medicaid and Supplemental Security Income benefits. Note that after the death of a beneficiary, funds in an ABLE account can go to the state to repay Medicaid benefits if they were receiving these monies. The designated beneficiary of the 529 plan must already own an ABLE account.

While the tax act provides many benefits to assist families, talking with a financial advisor is needed to go through these new and ever-changing laws.

Debra Taylor, CPA/PFS, JD, CDFA, writes for Horsesmouth, an organization providing unbiased insight into the critical issues facing financial advisors and their clients.