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The New Tax Law: 3 Areas That Affect Families

By Debra Taylor, CPA/PFS, JD, CDFA

At 1097 pages, the new tax act is the most far-reaching and complex tax code passed by Congress since 1986. This article looks at ramifications in the areas of deductions, divorce, and estate plans.

The Tax Cuts and Jobs Act (TCJA) is old enough now that you've probably had an opportunity to review many of its highlights and consider how the changes may impact your family. It's the most far-reaching and complex federal tax code passed by Congress since 1986, but whether its impact will be negative or positive for you depends completely on the particulars of each situation. Let's review three potential issues with the act and some viable solutions.

ISSUE 1: DEDUCTIONS

How can taxpayers still make the most of the few deductions available to them?

The Congressional Budget Office estimates that 90% of taxpayers will take the standard deduction moving forward, so tax planning should focus on whether taxpayers should incur expenses that potentially are itemized deductions, and how best to benefit from that expense. As a result, they may want to “bunch” available itemized deductions (for example shifting the timing of state estimated tax payments and property taxes to one year) to receive the standard deduction.

For example, Bob is a single filer with a $200,000 mortgage and his total itemized deductions are $13,250. If he underpays his state estimated taxes in 2021 and then defers payment of state taxes or other deductible items until next year, he’ll receive the full benefit of the $12,550 standard deduction this year and can potentially itemize in 2022.

By underpaying his state taxes, he will incur additional deductions for the subsequent year and will realize a significant tax savings. Obviously, careful planning with a tax advisor is required to avoid an underpayment penalty for any state taxes, but you get the idea.

Another example of when it might make sense to “bunch” deductions is for medical expenses. Under previous law and after 2020, taxpayers are allowed to deduct out-of-pocket medical expenses that exceeded 10% of their adjusted gross income (AGI). As a result of the TCJA, filers could deduct expenses that exceeded 7.5% of AGI until 2020. Taxpayers can take advantage of the larger standard deduction by perhaps claiming the standard deduction in one year, and then bunching medical expenses into the next year which will enable them to take advantage of the higher itemized deduction in an alternate year. For example, you could prepay in one year for a child’s braces in order to itemize or opt for elective surgery in conjunction with dental work.

Also, if you are close to the standard deduction threshold, you can “front load” charitable contributions into a Donor-Advised Fund (DAF) so as to exceed the standard deduction and take fullest advantage of the deductions. In a DAF, donors can make a large up-front donation, gain an immediate tax benefit, and then allocate the funds to charities over a period of years. In short, the taxpayer makes multiple years of charitable donations in one year to get the highest tax benefit (and itemize that year) but spreads the actual contribution across subsequent years, in which the taxpayer claims the standard deduction.

Also, if you are over the age of 70½ and do itemize, you can contribute up to $100,000 out of your IRAs directly to a charity and have your donations count toward your required minimum distributions (RMDs). (Not: RMDs do not start until age 72.) This is not only a convenient way to contribute to a charity, but the amount satisfies the RMD and it doesn’t increase your adjusted gross income (AGI), which would help reduce taxes on Social Security benefit and avoid Medicare premium charges.

ISSUE 2: DIVORCE

How will the TCJA impact divorcees?

Prior to the new law, alimony was considered tax-free for the payor and taxed as income to the payee. This setup typically increased cash flow to divorcing spouses. Now, alimony is no longer deductible for the payor nor is it considered income to the payee, for agreements executed after 2018. As a result, there will likely be less money for the two parties. For example, John agrees to make an annual $120,000 alimony payment to Jane over five years. Under the former law, John would be able to save about $37,000 of taxes per year due to the deduction and Jane might owe $20,000 of taxes on her alimony payments. Under the new law, John may push to pay a lower alimony amount because of the lack of the deduction.

Make sure you understand that you will need to more closely budget for two households because of potentially less funds that are available. In the past, the higher earning spouse would typically agree to higher alimony, say $120,000, as he could save $40,000 per year where the recipient would only pay, say $20,000 on the $100,000.

The alimony deduction was important when the paying spouse didn’t have liquid assets to fund a settlement or pay support. The deduction also helped with cash flow issues typically connected with supporting two households. According to the *Wall Street Journal*, the alimony deduction also helped as a bargaining chip as it would shrink any potential lump sum settlement since a lump sum doesn’t receive preferential tax treatment.

Those negotiating a divorce will need to be prepared to be more creative in divorce negotiations. We anticipate increased acrimony in this area.

In addition, many people may have signed prenuptial agreements that could have assumed the tax deduction, and that will also need to be reexamined. But the bottom line is that payouts to the lower earning spouse will likely be lower.

ISSUE 3: ESTATE PLANNING

Are estate plans still current?

The TCJA doubled the unified estate and gift tax exemption amounts from their current levels, which turned the scheduled 2018 exemption of $5.6M into an $11.7M individual estate tax exemption and $23.4M for married couples. Step-up in basis remains, as does the top 40% tax rate on gifts and estates, as well as the existing rules on generation-skipping taxes. This change is due to sunset in 2026.

Although the increase in the lifetime exclusion is a welcome benefit for the truly wealthy, everyone needs to contact their estate planning attorney to review any wills in light of the new exemption amounts. Many of these documents have formula clauses tied to the amount of the exclusion, which could now result in unintended estate dispositions.

For example, if someone signed a will or revocable trust in 2003 when the estate exemption was just $1 million, the funding might have worked like this: "I give the maximum amount to a credit shelter trust that won't create an estate tax and the rest to my husband." The credit shelter trust might have been for the benefit of the children from a prior marriage, or even her children and a spouse. The estate in this scenario was worth $4 million and $1 million funded the credit shelter trust and the remaining $3 million went to the husband. However, under the new law, the entire estate ($4 million) will fund the credit shelter trust and nothing will be left to the husband. That could be a huge problem.

Also, many people may no longer need insurance policies that were purchased to pay federal estate taxes because of the doubling of the exemption amount. Many of these affluent policy holders are over the age of 65. To surrender the policies, you can cash them out, and you may need to consider private placement insurance or selling policies in the life settlements market, which may net a more favorable outcome to the policyholder because of recent tax law changes.

Of course, the TCJA is still subject to possible revisions in the future, which adds another level of uncertainty to these issues. Indeed, the political shift in 2020 could significantly change the laws and other provisions that are due to sunset in 2026. But now is the time to review your financial plans by knowing some of the top vexing issues created by the new law.

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