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Individual income tax reform: The impact on Rochester residents

On Dec. 22, 2017, President Donald Trump signed into law the most radical reshaping of the income tax system since the Reagan era.

Trump had reportedly told Congressional leaders that he wanted to name the bill the "The Cuts, Cuts, Cuts Act," but for many residents of high-tax states, it is reported to be anything but.

This article, the first in a four-part series exploring the Tax Cuts and Jobs Act in depth, looks at the impact of the individual tax changes under the act on Rochester residents.

First, we'll review the basic changes under the act. Then, with help from my friends at Insero & Co. CPAs, LLP, we'll look at the impact of the act on some imaginary Rochesterians, to see how the changes might impact you, dear reader.

The changes under the act have been much written about, but here's my take:

Rates. There's good news all around here. For the highest earners, the top rate has been decreased from 39.6 percent to 37 percent, and the threshold at which this rate applies has been increased to $600,000 for married taxpayers — an income that's probably a rare bird in these parts. For a local couple earning $200,000 a marginal 24 percent rate now applies, as compared to 28 percent for 2017. The positive impact of this drop, however, may be mitigated by some of the changes below. (Like most of the individual changes in the act, these rates phase out in 2025.)

State and Local Tax Deductions. As you likely know unless you've been sleeping under a rock for the last month or so, the new law will limit deductions for state and local income and property taxes to $10,000 through 2025. It's been called an attack on Blue States, "economic civil war," "devilish" and a "rape and pillage" on New York. (And if you think this is hyperbole, note that these statements were made by Gov. Andrew Cuomo.)

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New York is suing the federal government and exploring replacing an income tax with a payroll tax, and a California bill allowing charitable contributions to the state is actually moving through the legislative process. For now at least (and in this author's view these efforts are unlikely to be successful), the limitation is the law.

Standard Deduction. The act increased the standard deduction for married taxpayers to $24,000, nearly double the 2017 amount. (The personal exemption, which had served much the same function, but phased out for higher income tax taxpayers, was repealed.) The main impact this change will have is on whether it's beneficial to itemize deductions.

In the past, given the low standard deduction, it has almost always been better for higher income taxpayers to itemize.

We recommend that individuals review how their liabilities will change in 2018 and make sure their withholdings and estimated tax payments are accurate.

This may change, however. The two biggest deductions have always been state and local taxes (now capped) and mortgage interest (though they have not been available for taxpayers subject to the AMT). The mortgage interest deduction will remain intact for most locals, as interest on mortgages up to $750,000 (which could buy quite the house in Rochester) can still be deducted. However, at a 4 percent interest rate, you would need to borrow over $350,000 to generate enough mortgage interest for the itemized deduction to equal the standard deduction.

Various other itemized deductions are tweaked (and clipped) and miscellaneous itemized deductions are eliminated, so the impact will depend on each taxpayer's situation.

(One editorial comment: The impact of this higher standard deduction on charitable giving is regrettable. Unless a taxpayer's personal situation makes it more favorable to itemize, there will be no tax benefit from charitable gifts. One approach is to consolidate gifts every other year, in order to get over the hump. Please continue to give.)

Child Tax Credit. The child tax credit is increased from $1,000 to $2,000, and the income level at which it phases out is increased from $110,000 to $400,000 in the case of a joint return. While these are not big dollars, as we will see for our prototypical family, this change actually makes a significant difference.

AMT. In the final version of the tax bill, this dreaded beast was not repealed. However, the exemption amounts (and related phase-out thresholds) were increased, so the tax should apply to fewer people.

With that preface, we now turn to the impact of the tax on our average Rochester couple, Donald and Hillary. Brighton residents, they are parents of two (somewhat difficult) teenagers (Ted and Marco), both under age 17 and qualify for the child tax credit. Donald and Hillary have a combined income of $200,000 after 401(k) contributions. Their property taxes are $12,000 per year (a topic of much complaint) and they have a $200,000 mortgage at 3 percent interest (in its early stages of amortization). They make $2,000 of charitable contributions.

Because their income is from wage earnings, the special deduction for pass-through income does not apply. They have normal New York state tax liabilities for residents (assumed to be $14,000 in the example).

Steve Mills and Alex Siverd of Insero & Co. have computed the tax liability that this couple would have owed in 2017 under current law and 2018 under tax reform. The answer is fascinating: taxes go down from approximately $30,000 in 2017 to approximately $27,000 in 2018, primarily driven by the expanded child tax credit.

In 2017, the couple was able to itemize their deductions and claim a personal exemption resulting in taxable income of approximately $150,000. Income was taxed at the 28 percent marginal rate, and a small amount of AMT applied. However, no child tax credit was available due to the phase outs. Total tax was approximately $30,000.

In 2018, it did not make sense to itemize because the property and state income tax limitation was limited to $10,000. In addition, the personal exemption was eliminated. Accordingly, taxable income was approximately $176,000. However, using the new lower tax rates, the amount of tax generated was only about $1,000 more than 2017. Add in the previously unavailable child tax credit, and tax liability ends up $3,000 less for a total of $27,000. Thanks, Ted and Marco.

As illustrated by this example, the computations depend on many factors, and (though there are a number of online calculators that do some interesting guesstimating) it's really tough to generalize.

We recommend that individuals review how their liabilities will change in 2018 with their tax advisors and plan ahead to make sure that their withholdings and estimated tax payments are accurate. Depending on your personal situation, these may be "big, beautiful tax cuts" — or something much different.

Josh Gewolb is a tax partner at Harter, Secrest & Emery. Steve Mills and Alex Siverd of Insero & Co. CPAs, LLP collaborated with Gewolb on this article.