The Colony Group

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Tax Cuts Part II

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It seems an obvious understatement to say that tax planning during the second half of 2018 should be easier than it was during the second half of 2017. The Tax Cuts and Jobs Act of 2017 (TCJA), which was enacted in 2017 but largely became effective at the beginning of 2018, changed many of the fundamental underpinnings of tax planning, including in the areas of tax rates, estate taxes, expense deductions and choice of business entity. Making matters even more challenging, the year-end timing of the new legislation forced planners to work quickly to understand and then incorporate the new rules into their client plans for 2017 and 2018.

It is now appropriate to turn our focus to some of the tax provisions that have not yet become effective. With only a quarter to go in 2018, time is running out to consider the key provisions of the law that will become effective starting next year. We'll call these provisions "Phase II" of the law. Planning for Phase II—or not planning for it—can make a substantial difference for many people.

Phase II, Part 1: Repeal of the Deduction for Alimony Payments

What is this?

Currently, for federal income tax purposes, alimony and separate maintenance payments (which we'll call collectively "alimony payments") are deductible from the taxable income of the payer as long as they are includible in the taxable income of the payee under the applicable provisions of the Internal Revenue Code. The alimony deduction is an "above-the-line" deduction included in the calculation of adjusted gross income (AGI), often increasing the net value of the deduction.

Under the TCJA, this well-settled, long-standing tax principle is set to change—dramatically. Alimony payments made under a divorce or separation instrument executed on or after January 1, 2019, will no longer be deductible from the taxable income of the payer or includible in the taxable income of the payee.

What are the key planning implications?

Normally, the income of the payer of alimony payments is higher than the income of the payee. Therefore, under the law as in effect today, through careful use of the alimony deduction, taxable income may be shifted away from the ex-spouse subject to higher marginal tax rates to the ex-spouse subject to lower tax rates. Under the new law, however, the deduction no longer will be available, so ex-couples may owe more in aggregate taxes.

While the loss of the ability to shift income is the most obvious new dynamic, keep in mind that the TCJA also may have an impact on the divorce resolution and settlement landscape. Under the TCJA, negotiation and adjudication may become more difficult. Currently, because of the deduction, alimony is less costly after taxes for the payer and more costly for the payee. With the loss of the deduction, payers may be less likely to agree to an alimony arrangement, and, as a result, negotiation and adjudication may be more difficult.

For now, separating couples who wish to benefit from the current law will need to move quickly and finalize their divorce or separation instruments prior to 2019. Even if the divorce or separation instrument is subsequently modified, as long as it is executed before 2019, it will be grandfathered unless the modification specifically states that alimony payments will be included in the taxable income of the payer.

Phase II, Part 2: Increase in the Medical Expense Deduction Floor

What is this?

Since 2017, qualified medical expenses that have exceeded 7.5% of AGI generally have been deductible. Beginning in 2019, qualified medical expenses will have to exceed 10% of AGI to be deductible.

For example, consider Joe, who has an AGI of $200,000 and itemized deductions in excess of the standard deduction. Suppose that Joe normally spends $25,000 in annual qualified medical expenses. In 2018, $10,000 ($25,000 - $15,000 (7.5% x $200,000)) will be deductible from his taxable income; but in 2019, only $5,000 ($25,000 - $20,000 (10% x $200,000)) will be deductible.

What are the key planning implications?

Since the TCJA roughly doubled the standard deduction, many households that itemized deductions before the TCJA no longer will do so. The medical expense deduction is a “below-the-line” deduction and is therefore available only to those who itemize.

If possible, short-term “bunching” may be advisable. Again, let’s consider Joe, with his AGI of $200,000. As mentioned above, he normally pays $25,000 in annual qualified medical expenses. If he continues to do so, $10,000 will be deductible from his taxable income in 2018, and $5,000 will be deductible in

2019, for a total of $15,000 in deductions in 2018 and 2019. If, however, he were able to pay $35,000 in 2018 and only $15,000 in 2019, then a total of $20,000 ($35,000 - $15,000 (7.5% x $200,000)) would be deductible in 2018, with no deduction available in 2019 (because $15,000 is less than $20,000 (10% x $200,000)). In total, he would deduct $5,000 more over the same time period.

Even after 2018, "bunching" of expenses into a single year may be advisable in order to overcome the 10% threshold. Suppose that Joe can "bunch" his 2019-2020 medical expenses so that he pays $35,000 in 2019 and $15,000 in 2020. In this case, his total deduction will be $15,000 (($35,000 - $20,000) + (no deduction for 2020)). If he pays $25,000 in 2019 and $25,000 in 2020, his total deduction will only be $10,000 (($25,000 - $20,000) + ($25,000 - $20,000)).

Importantly, the new law should also increase the need to consider tax-savvy ways to pay for medical expenses. Health savings accounts, health reimbursement accounts, medical savings accounts, and flexible spending accounts are set to become even more important starting next year.

Phase II, Part 3: Elimination of the Penalty for Individuals Failing to Maintain Minimum Health Insurance Coverage

To understand this provision, we'll first need a little background on the Affordable Care Act of 2010 (ACA). Generally, under the ACA, it is illegal for insurance companies to increase premiums for an individual or a small group on a policy or plan and not for others on the policy or plan, except in light of family size, geography, age or tobacco use. In addition, insurance companies generally must cover all who apply, provided that they pay their premiums.

Nevertheless, if premiums for healthy people and premiums for less healthy people are the same and if less healthy people must be covered, then healthy people may have to pay more and may choose to be uninsured. In turn, premiums may increase even more, and additional healthy people may choose to be uninsured. The result could be a "death spiral," in which more and more healthy people choose to be uninsured as premiums escalate.

The solution, under the ACA, is an "individual mandate" coupled with tax subsidies. Individuals in the United States must maintain minimum coverage unless they are eligible for an exemption. The uninsured and underinsured must pay a penalty to the IRS of $695 or 2.5% of household income, whichever is greater. Meanwhile, there are tax subsidies, so that insurance is more affordable for lower- and middle-income households.

Under the TCJA, beginning in 2019, neither the uninsured nor the underinsured will be required to pay a penalty to the IRS. There still will be an individual mandate, but the mandate effectively will be toothless, at least from the perspective of federal law.

What are the key planning implications?

According to general ACA theory, in the absence of a penalty for the uninsured and the underinsured, premiums for individuals could increase substantially. Some insurers already have announced an increase in premiums for 2019 in anticipation of the repeal. Nevertheless, there is still considerable uncertainty with respect to the direction of post-TCJA premiums.

Remember that some uninsured and underinsured Americans already were eligible for exemptions before the TCJA. For example, there are "hardship exemptions," which apply to anyone who has experienced personal circumstances that create a hardship in obtaining health insurance coverage.

Additionally, even though there will be no penalty at the federal level, there still can be penalties at the state level. Massachusetts has had an individual mandate since 2006; and more recently, New Jersey, Vermont and Washington passed individual mandates of their own.

On the other hand, with the loss of the IRS penalty for the underinsured, non-ACA-compliant plans may become more attractive, which again could be disruptive, especially for the individual insurance market. Therefore, it remains unclear what precise impact the TCJA will have on future premiums. Prudence suggests the need to plan for higher premiums. Alternative coverage structures should also be considered, such as higher-deductible plans coupled with health savings accounts.

What are the key planning implications?

Much has been written about Phase I of the TCJA. Now it is time to focus on Phase II as well. With just a quarter left in the year, alimony, medical expenditures and individual health insurance must be reconsidered—quickly. Decisions made in the next few months can have a substantial impact this year and in the years to come.

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