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New Tax Reform: Answers to Common Questions

At Calamos Wealth Management we are receiving common questions in light of uncertainties around compromises that arose leading up to the final version of the new Tax Act. We have summarized those questions and related answers here for your convenience. And, we will update accordingly as additional common questions arise or changes to legislation warrant.

Capital Gains on Primary Residence Sale

Q: What are the new rules affecting deferral of capital gains on the sale of a primary residence? Can taxpayers still defer capital gains? What are the deferral thresholds? Has the taxpayers' time requirement in a primary residence changed?

A: These rules have not changed under the new Tax Act. Taxpayers still may defer capital gains on the sale of a primary residence. The deferral thresholds remain $250,000 for single taxpayers and $500,000 for married taxpayers. The taxpayers' time requirement in a primary residence remains set at two of the last five years.

HELOC Interest Deduction

Q: Can taxpayers still deduct interest paid on a Home Equity Line of Credit (HELOC)?

A: Likely, no. Under the new Tax Act, taxpayers only may deduct interest on primary mortgages, unless HELOC is used specifically for home improvements and is within deduction limits.

Q: Does this answer change if there is no primary mortgage but only a HELOC? Is the HELOC then considered a first position loan and thus tax deductible?

A: Unfortunately, no...again, unless the HELOC is used specifically for home improvements and is within deduction limits.

Primary Mortgage Interest Deduction

Q: How has the primary mortgage interest deduction changed? How does it affect a taxpayers' current loan that exceeds the new limits? Have these taxpayers now lost part of their prior mortgage interest deduction?

A: For taxpayers who had outstanding mortgages prior to December 15, 2017, primary mortgage interest remains deductible up to $1 million of principal. Certain mortgages on pending transactions also were grandfathered under the prior rules. This grandfather provision applies to those transactions under contract by December 15, 2017, purchased by January 1, 2018 and closed by April 1, 2018. New mortgages will be deductible up to principal amounts of $750,000. For all purposes, primary mortgages apply to totals on primary and secondary homes combined.

Back Door Roth IRA Conversions

Q: Can taxpayers still make IRA contributions and then simultaneous conversions to ROTH IRAs?

A: Yes. The "back door" ROTH IRA conversion remains available. However, taxpayers cannot recharacterize Roth IRA conversions afterwards any longer, so Congress has eliminated that additional planning benefit under the new Tax Act.

Each taxpayer now has a personal estate tax exemption amount of $11.2 million; married couples can now shelter up to $22.4 million from estate tax. Congress will adjust these amounts for inflation over time.

Estate Tax Exemptions

Q: I understand the estate tax exemption has now doubled under the new Tax Act?

A: You are correct; the estate tax exemption has doubled under the new Tax Act. Each taxpayer now has a personal estate tax exemption amount of $11.2 million; married couples can now shelter up to $22.4 million from estate tax. Congress will adjust these amounts for inflation over time.

Q: Do I even need an estate plan anymore now that I am not subject to the federal estate tax?

A: Yes. An estate plan provides other benefits beyond tax planning, namely:

- » Privacy – estate plans that use funded trusts still promote privacy and keep courts from becoming involved in the affairs of a disabled person.
- » Probate Avoidance – estate plans that use funded trusts still avoid probate and keep courts from becoming involved in the affairs of a family estate. They also provide you with control over who inherits your estate and how they inherit it.
- » Creditor Protection – estate plans that use funded trusts still protect beneficiaries from creditors (including most divorcing spouses). Many parents have estate plans that distribute an inheritance outright to children over time—protecting a child's inheritance in trust can leave a child in control while offering this important creditor protection.

Q: Do I need to review my old estate plan?

A: Yes. State estate taxes may now present problems that did not exist before.

Prior to June of 2001, most states collected estate taxes based on the federal state death tax credit. In other words, they would collect one dollar of estate tax for each dollar of credit allowed on a federal estate tax return.

Since June of 2001, Congress has changed the estate tax laws significantly over time. These changes ultimately phased out the federal state death tax credit. As a result, the majority of states (29) no longer collect any estate or inheritance taxes. Six different states, however, still maintain their own inheritance tax system, and two other states collect both estate and inheritance taxes. Still, other states (13 plus Washington, D.C.) have "decoupled" from the estate tax system by recognizing a lower estate tax exemption amount than the one available for federal estate tax purposes.

Even though a taxpayer may not be subject to the federal estate tax due to its higher exemption amount, that taxpayer may still be subject to a state inheritance or estate tax in light of these changes. Those taxpayers should update their estate plans to account for their particular state laws to avoid triggering the applicable state estate tax prematurely.

Estate plans that use self-adjusting formulas should be reviewed to ensure the resulting trusts and funding amounts still reflect intended results among beneficiaries. For more information on this particular situation, see our recent insight piece entitled, *Estates & The New Tax Law: Blue skies or unintended consequence?*

Tax Savings Discussion

Q: Congress stated the new Tax Act would provide tax savings for all Americans. It seems as if married couples making between $200,000 and $400,000 are actually facing higher tax bills?

A: Single taxpayers with income over $157,000 and married couples with income over $315,000 likely will pay higher taxes under the new Tax Act. This result seems likely because these taxpayers previously spent more time in the 28% bracket before progressing into the 33% bracket. These same taxpayers now will spend less time in the lower 24% bracket before progressing into the 32% bracket (while losing key itemized deductions that have been reduced or eliminated under the new Tax Act).

Pass Through Entity Income Deduction

Q: How does the new Tax Act apply to income earned by pass through entities? What is the deduction amount and applicable tax rate? Do the new rules exclude or limit this deduction among any particular industries or professions?

A: The new Tax Act provides for a 20% deduction against qualified business income. Pass through entity income will still be taxed at individual income tax rates.

Qualified business income includes (and, thus, the deduction is applicable to) only income that is effectively connected with the conduct of a trade or business within the United States.

Qualified Business Income does not include:

- IRC Section 707(c) guaranteed payments for services;
- amounts paid by S corporations that are treated as reasonable compensation of the taxpayer;
- amounts paid or incurred for services by a partnership to a partner who is not acting in the partner capacity.

Qualified Business Income also does not include income from services in the following fields:

- health or law;
- accounting or consulting;
- financial or brokerage services;
- or generally any business that relies on the reputation or skill of its owners or employees.

The deduction is limited to 100% of the taxpayer's combined qualified business income. For example, a taxpayer with several businesses may lose the deduction if combined losses from some qualified business exceed combined income from other qualified businesses.

The deduction is limited to the greater of (i) 50% of the W-2 qualified business wages or (ii) the sum of 25% of the W-2 qualified business wages paid plus 2.5% of the unadjusted basis for its depreciable property.

This last limitation does not apply to income earned through publicly-traded partnerships. It also does not apply to single taxpayers with income under $157,500 or married taxpayers with income under $315,000.

This last limitation may also affect real estate private equity funds and real estate ventures that do not have their own employees if they, instead, rely on the services of their partners, managing members or related management companies.

This 20% deduction will expire after 2025 unless otherwise extended by Congress.

About the Author

Terry LaBant, J.D. is Vice President and Sr. Wealth Strategist at Calamos Wealth Management. He has more than 25 years of experience consulting with clients in the core areas of wealth creation, preservation and protection. These include: strategic planning for tax, estate, retirement, asset protection/allocation and succession planning for business owners.

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